Fiscal Austerity and Innovation in Local Governance in Europe

CARLOS NUNES SILVA
University of Lisbon, Portugal

AND

JÁN BUČEK
Comenius University, Slovakia

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Chapter 2

Local Self-government Finance in Slovakia During the 2008–11 Crisis

Ján Buček and Andrej Sopkuliak

Introduction

The impact and success in coping with the economic and financial crisis varies across states, regions and partial markets, as well as across individual local governments. It offers an important challenge to scientists in many disciplines, including geographers. Despite increasing attention on the current economic and financial crisis, or 'the geography of crisis', there prevails a focus on the financial markets, banks, states and housing issues (for example Aalbers, 2009; Lee et al., 2009; Harvey, 2011). Attention paid to the impact of the crisis on local government financing and functioning is also growing. However, as this was not a mainstream issue, it started with a certain delay. Taking into account the important role of local governments in contemporary society is a very useful research orientation. A large number of local governments had been seriously hit by the direct impacts of the crisis through losses in own capital investments, limited access to borrowing or facing a sudden decrease in own revenue (summarised for example by CEMR, 2009). Besides such immediate impact of the crisis, wide-ranging and longer term difficulties have emerged. They are related to the financial scarcity that spread across public finance in general, and accompanied by the inevitable fiscal consolidation not only at central but also at sub-national levels of government. This development has motivated the expansion of analytical works that focus on local governments' financial situations and their responses to the pressure generated by the crisis.

We have to be aware that financial scarcity is not new to local governments. There have been numerous experiences with a lack of resources caused by various circumstances accumulated over the past decades. Besides the not-so-frequent global crises situations, there have been experiences with regional as well as national crises. Financial scarcity can also be the result of specific central-local financial relations, leaving or transferring fewer resources to local governments. It has been a familiar situation in post-socialist countries. Many local governments suffered long-term fiscal scarcity caused by general public finance shortage. We cannot overlook the troubles of individual local governments caused by collapsing local economic and social environments (for example in systems with more direct links between the local economy and local revenues). Not so rare have been the cases of local governments facing critical financial situations caused by own mismanagement (bad investments, long-term high deficits and extreme local debt). The situation related to the global financial and economic crisis that started in 2008 is both more specific and dangerous for local governments. Due to the global nature of crisis, it concerns numerous local governments in many countries. It is also longer term and multiplied in effect by the extensive shift of the crisis into the public finance of many countries, accompanied by various levels of fiscal stress and austerity. It means that under this kind of crisis, opportunities for external support and consolidation are limited. Under financial pressure are banks, the private business sphere, as well as higher levels of government, and ordinary citizens. The search for a balanced response in the sharing of related burdens while sustaining the provision and development of local public services is not an easy task.

Fiscal stress and austerity, related strategies and measures at the local level have been widely debated in literature in recent decades. Well known and extensive was publication activity in the field of fiscal austerity and urban innovation 'initiative' (for example Clarke, 1989). Local austerity policies were examined by Lobao and Adua (2011) in the USA during 2001–08. Coe (2008) focused on opportunities for the supervision and assistance of states to local governments in fiscal trouble. Besides the increasing number of academic papers focusing on the crisis at the local level, we cannot overlook the reports prepared within various institutional settings (international, non-governmental organisations). Such are for example the cases of the White Paper focusing on strategies for local leaders during the crisis prepared by Miller and Svara (2009), or the Council of European Municipalities and Regions (CEMR, 2009) report on the impact on and responses of local governments in the early stages of the crisis. It is also the case of Pailais' (2009) analysis of local governments and the crisis performed for Cities Alliance. Among the latest initiatives we have to mention the activities of the Council of Europe, expressed for example in texts and recommendations edited by Davey (2011). If we concentrate on the crisis in Central and Eastern Europe (CEE), more studies quickly emerged (for example Smith and Swain, 2010; Staehr, 2010). Among the most comprehensive attempts, we can mention the effort to monitor the crisis in CEE countries and their regions in the volumes edited by Gorzelak and Goh (2010), and Gorzelak, Goh and Fazekas (2012). To date, less attention has been paid to local government during the crisis in Central and Eastern Europe. A rare case of such research is the early assessment of crisis responses in CEE countries prepared by Sedmihradska, Bobcheva and Lados (2011). Of course, many practical reflections can also be found in printed and electronic resources of the directly involved associations of local governments, or individual global cities.

The study of crisis in the context of local government offers many important research topics. Among which the most critical are the basic dimensions of the crisis, for example the depth of consequences and duration. Sensitive issues are its impact on local service provision and administration. The crisis is also a challenge to local representatives to adopt reasonable responses. There are multiple opportunities in strategies and measures that could be used to mitigate negative effects. It also concerns intergovernmental co-ordination, which is hardly avoidable. Researchers should not shy away from the discussion about the contribution of local governments to the economic recovery. It is a question whether they can provide or contribute to economic stimulation during the crisis. Standard attention should be paid to the study of best practices, organisational adjustment, prevention and so on. Very positive outcomes can be provided by analyses of the development and efficiency of responses over a longer time. Such can offer valuable knowledge concerning the dynamics of the crisis and the evolution of the situation and responses of local governments. We can consider various general as well as individual factors that influence success in crisis mitigation.

The crisis situation in such a scale is quite unique also for local self-governments in Slovakia. It is true even despite the financial scarcity that emerged in the first half of 1993, related to the difficult public finance situation of the newly established Slovak Republic (Buček, 1993). However, at that time it had been a short-term lack of resources, and the powers of local self-governments were reduced. They were also less autonomous and more dependent and interlinked to the central state. Not surprisingly, we can also find experiences of individual self-government that faced serious problems in financing as a result of their worse financial management during the second half of the 1990s. Such local financial difficulties were also faced by large Slovak cities such as Košice and Banská Bystrica, due to too excessive borrowing (Kling and Nižňanský, 2004). This led to the introduction of stricter limits on local borrowing by central state legislation since 2005. Although the majority of local self-governments experienced financial scarcity during the transition period, they are less experienced in coping with the consequences of unexpected, deep and longer term crisis. Despite the strong impact of the crisis on local government finance in Slovakia, there has been a lack of systematic attention to the study of this issue until now. Among few cases we can mention is Buček (2011) who focused on the specific issue of municipal property during the crisis period in Bratislava. More practically oriented debates among practitioners and policymakers can also be found.

The main aim of this contribution is to analyse and evaluate the financial situation of Slovak local self-government during economic, financial and subsequently fiscal/debt crisis over 2008–11. After outlining the main features of the economic crisis in Slovakia, we focus on selected items of local budget developments with the intention of revealing the impact of crisis on budget financing. Our objective is also to identify local self-government techniques in coping with fiscal stress, as well as the related important contextual factors. We would also like to reveal the character of co-ordination and cooperation between the central state and local self-governments in resolving the public finance imbalance by tracing their relationships. Our contribution concludes with a debate concerning the sensitivity and adaptation of local self-government finance to crisis.

As main sources of information we used legislative and financial documents concerning central, as well as local government – especially the final accounts of the Slovak Republic (focusing predominantly on local finance data 2008 to 2010), macroeconomic data according to the Statistical Office of the Slovak Republic and tax data provided by the Financial Directorate of the Slovak Republic. The interplay between central state and local government had been studied by tracing and interpreting documents and the statements of the main representatives of both levels. The central state represented the central government and the Ministry of Finance. On the opposite side were associations of local self-governments. They are represented by two main associations – The Association of Towns and Communities of Slovakia (in Slovak – Združenie miest a obcí Slovenska – ZMOS) with more than 2,700 members (there are almost 2,900 local self-governments in Slovakia), and The Union of Cities of Slovakia (in Slovak – Únia miest Slovenska – UMS) with about 70 members (including the largest cities). As an important source of information, we used the main weekly newspaper that focuses on local self-government issues – *Obecné Noviny*. From the terminology point of view, we use the term 'local government' in a more general and international context. We prefer the term local self-government (in Slovak – miestna samospráva) which respects the tradition and terminological accuracy in the Slovak context.

Basic Features of Economic and Public Finance Development During the Crisis

Slovakia could not avoid the crisis that hit global finance and the economy mostly since 2008. After an era of spectacular economic growth exceeding during short periods even 10 per cent of GDP (see Figure 2.1), the first effects of the economic and financial crisis emerged in October 2008. The decline in production of many sectors culminated during the first half of 2009. At the same time, a key central government anti-crisis measures package had been formulated and went into effect. Although the macroeconomic situation has improved since 2010, some serious negative features have remained. Such was especially the case of a high unemployment rate and stagnating wages. Above all else, the negative economic development also spread into worsening the public finance situation. Due to increasing budget deficits and public debt growth, combined with troubles in the Euro zone, urgent pressure has emerged for longer term fiscal consolidation.

There were no serious internal reasons leading to the expansion of the financial and economic crisis in Slovakia. For example, there were no serious problems with the banking sector that had been transformed a few years previously, and no signs of an extremely overheated real estate and property development market. The consequences of the economic crisis also mitigated many economic reforms completed earlier as well as the joining of the Euro zone in 2009 (although certain effects have been contradictory). The economic decline had been predominantly the result of global economic interdependency. The Slovak economy is small, but extremely open, depending on external economic environment development. It lost its growth dynamics during the last quarter of 2008, when GDP growth sharply

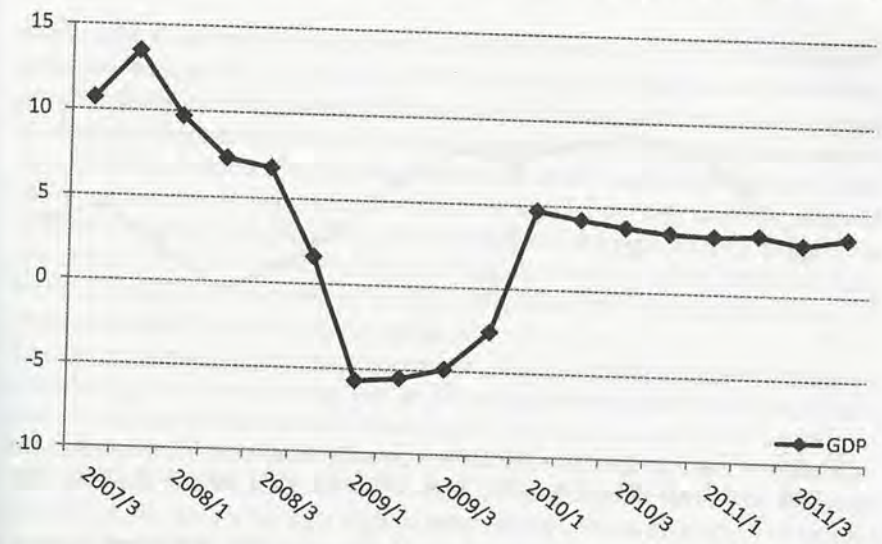

Figure 2.1 GDP development on a quarterly year-to-year basis in Slovakia
Source: Statistical Office of the Slovak Republic, 2012a.

decreased to a poor 1.6 per cent. The worst economic decline measured by annual GDP was in 2009 (-4.8 per cent). We can summarise, according to Buček (2010), that the largest decline had been the collapse in manufacturing (reflecting a large dependency on the car industry and electronics) and selected service branches. The crisis in the construction sector grew with a certain time lag. A more positive development returned in 2010 (4 per cent annual growth of GDP), but this was in comparison to the less productive 2009. The shift to more stable but still fragile economic growth was documented by a repeated GDP growth rate exceeding 3 per cent in all consecutive quarters of 2011 (3.3 per cent for 2011 annually, Statistical Office of the Slovak Republic 2012a). The positive economic development confirmed data about exports after 2009. While exports decreased 5.1 per cent in 2009 (compared to the previous year), they increased to 21.5 per cent in 2010 and 16.9 per cent in 2011 (Statistical Office of the Slovak Republic, 2012b).

Such negative economic development was naturally reflected in a worsened unemployment rate. Within a year, the registered unemployment rate increased from 7.5 per cent to 12 per cent (September 2008 to September 2009; UPSVAR, 2012). Even worse unemployment rate data was provided by a labour force survey (Figure 2.2). It culminated in a 15.1 per cent unemployment rate in 2010 (first quarter). Despite the signs of economic recovery since the beginning of 2010, this had not been converted into increased employment. The minor improvement seen in 2011 had been insufficient (unemployment rate 14 per cent in the last quarter of 2011, Statistical Office of the Slovak Republic, 2012c). The economy had focused on increasing its productivity and efficiency during the crisis (between 2006 to

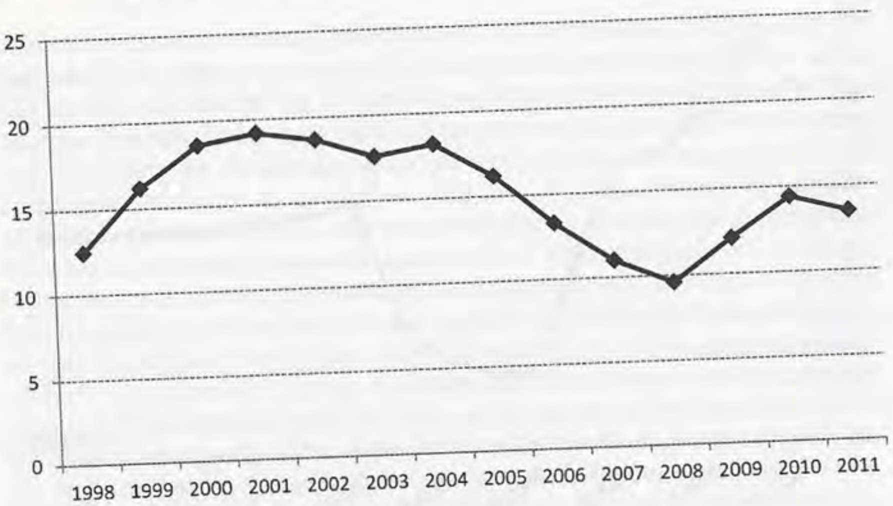

Figure 2.2 Unemployment rate development in Slovakia 1998–2011 (according to the labour force survey)

Source: Statistical Office of the Slovak Republic, 2012c.

2010 Slovakia moved became top of labour productivity per person employed in EU new member states – 81.3 per cent of the EU average according to Eurostat, 2012). It can be considered as a case of 'jobless recovery', when an economy is growing again but the unemployment rate remains high. The high unemployment rate also accompanied the loss of growth dynamics in wages. While in 2007 and 2008 nominal wages increased by more than 7 per cent, it was only 3 per cent in 2009, 3.2 per cent in 2010 and 2.2 per cent in 2011. This represented a decrease in real wages. In particular the tax base of public budgets was substantially eroded by this development.

Economic development had a deep impact on public finance. Any crisis usually means a decrease of tax incomes and the increase of public spending. The worsening of the financial situation was apparent at all levels of government. The most evident crisis indicator was the increase in the state budget deficits. While only 2.1 per cent in 2008, it increased to 8.0 per cent (2009) and 7.7 per cent (2010) of GDP. Reduction of the deficit to 4.8 per cent of GDP achieved in 2011 (Ministry of Finance, 2012) is an important improvement, but still insufficient. As a result, most public sector budget deficits during the crisis years were generated by the state budget. The share of local budgets of total public sector budget deficits was only 5.6 per cent in 2009 and 10.4 per cent in 2010, being in surplus in 2011. Another important indicator of public sector finance is the development of public debt. Total public sector debt was EUR 29.9 bln in 2011, compared to EUR 16.8 bln in 2006. While only 30.5 per cent of GDP in 2006, it jumped to 43.3 per cent in 2010. It is clear that after years of moderate growth of total

public debt, it substantially increased during 2009 and 2010. Public debt had been lower thanks to positive economic development and a careful fiscal regime during previous years, prior to joining the Euro zone. Increased debt is primarily related to decreased budgets incomes related to the financial and economic crisis, and the absence of more extensive spending cuts in the public sector. The share of local self-governments of total public debt is also minor (5.2 per cent in 2010), although growth dynamics were higher in 2009 and 2010 compared to total public debt (Figure 2.3). A further increase should be reduced thanks to the adoption of 'debt brake' legislation (Constitutional Act No. 493/2011) in Slovakia, among the first countries in the European Union to do so.

The responses of central government to the crisis were aimed more at stimulating the economy, and less at reducing public spending. Explicit anti-crisis measures adopted especially during the first half of 2009 did not require huge resources. They were estimated at EUR 350–400 mln a year (for 2009 and 2010). Buček (2012) stressed that among the problems of anti-crisis measures adopted in Slovakia were their high number (about 60) and diversity. For various reasons, part of these resources was not spent (lack of interest, administratively demanding procedures). Among the more successful were contributions for new workplace creation, contributions to cover insurance payments of workplaces threatened by layoffs, support of local public workplaces and conditions for more flexible employment, as well as tax legislation concerning depreciation, or increased non-taxable income. Also popular were programmes focused on housing – credits for insulation, or subventions for solar panels and biomass heating. The central state also attempted to mobilise its investments (for

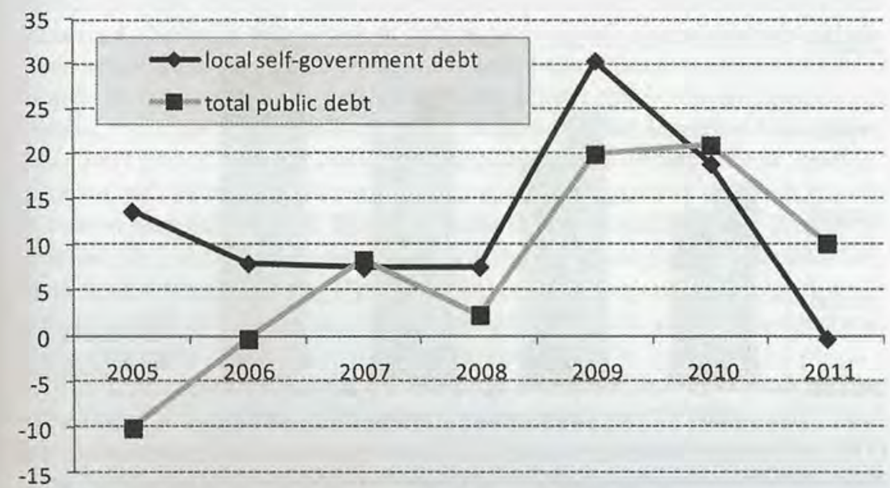

Figure 2.3 Year-to-year growth rate of public debt (in per cent)

Source: Ministry of Finance of the Slovak Republic, 2012.

example motorways) and support private sector investments (as in the energy sector). Longer term worse public finance development led to probably the most important intervention into the pre-existing public finance framework, with the increase of value added tax from 19 per cent to 20 per cent from 2011 (adopted in 2010). The decision to increase the central state share of personal income tax (PIT) from 6.2 per cent to 12.7 per cent from 2012 (adopted in 2011) had a similar background. It confirmed that central state reluctance to reduce public expenditures on the larger scale finally led to the search for additional resources on the revenue side of public budgets.

Local Self-government Finance Development

Slovak local self-governments were outside the direct influence of the financial and economic crisis. They were not involved in risky financial operations, and did not lose money in troubled banks. Due to the model of local taxation and revenue allocated to them, they were not so directly linked to the state of the local economy, but rather to the general situation in the economy and employment. Surprisingly, they did not face a reduction of revenues and expenditures in absolute terms in 2009 and 2010 (Figure 2.4). Nevertheless, they were confronted by significant changes in the composition of their revenues, and consequently were forced to react by adjusting their expenditures. The most serious have been the decrease

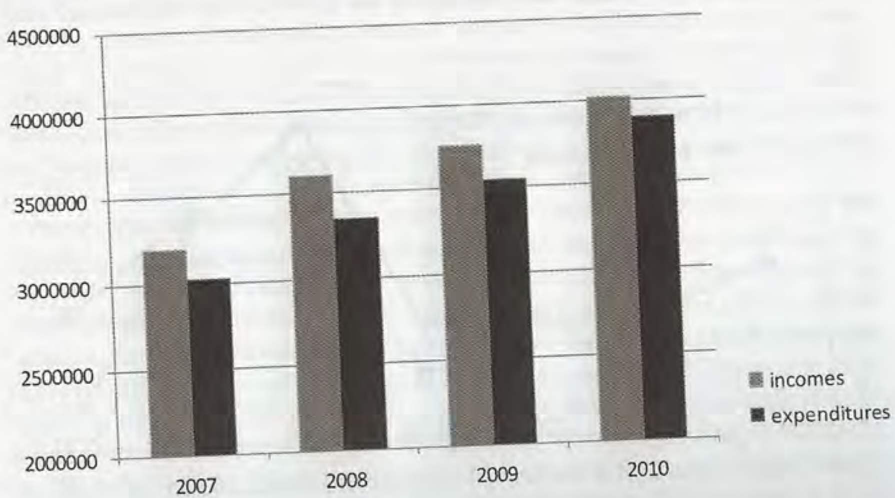

Figure 2.4 The development of local self-government incomes and expenditures (in thousand EUR)

Source: Ministry of Finance of the Slovak Republic, 2012.

in shared tax income (PIT), and increased dependency on state budget transfers and financial operations. The highest pressure on their expenditures was evident in 2010. One of the main issues that caused uncertainty in managing local finance had also been the unpredictability of future financial flows. Although the financial situation of local self-governments had not been so critical in general, they will still be under pressure in coming years.

We have to take into account the position of local self-government in Slovakia. It has developed into a well-respected level of government during the post-socialist period following 1989. The introductory phase of basic structures of local self-government building typified the first decade of post-socialist development. The next decade was accompanied by the strengthening of such structures by power decentralisation (for example in education, social services, planning, more delegated powers). The main reform period (2002–05) completed the fiscal reforms introduced from 2005. Since this year, we can observe the positive combination of more powerful and financially strengthened local self-governments and positive economic development in Slovakia. This was expressed by the expansion of local government activities, the completion of various development projects and increased financial capacity. These ‘good times’, mainly in 2007 and 2008, challenged the global economic crisis that intensively pervaded local self-government functioning from 2009.

The overall development of local finance confirms the less negative consequences of the crisis, if measured in terms of total incomes and expenditures. Even the more sluggish growth of incomes and expenditures during 2009 did not indicate substantial restrictions of their basic functioning. The first signs of the influence of the crisis could be seen in the changing basic composition of local finance structure (current, capital and financial operations). As far as incomes were concerned, the main shift occurred in the decrease of current incomes and the increase of incomes provided by financial operations. Current incomes decreased from a 76 per cent (2008) to a 66 per cent (2010) share of total incomes. In contrast, the share of financial operations of total incomes increased from 10 per cent (2008) to 18 per cent (2010). The basic structure of expenditure changed in favour of capital expenditures, accompanied by stagnation or minor growth in current expenditures and financial operation. This confirmed the priority of investments, more prudent behaviour and savings-oriented growth in the other two basic expenditure categories. The share of current expenditures decreased from 72 per cent (2008) to 66 per cent of total expenditures (2010), with a minor increase in absolute terms.

The decrease in shared tax yield can be considered as the most important influence of the crisis on local self-governments (Figure 2.5). Originally, local self-governments had been recipients of 70.3 per cent personal income tax (PIT) yield in Slovakia. It was transferred by state tax administration on a monthly basis reflecting set criteria (the main role being population number). The decrease in economic activity expressed in various forms such as reduced production, shorter working time, frozen salaries, no extra salaries and less employment meant a

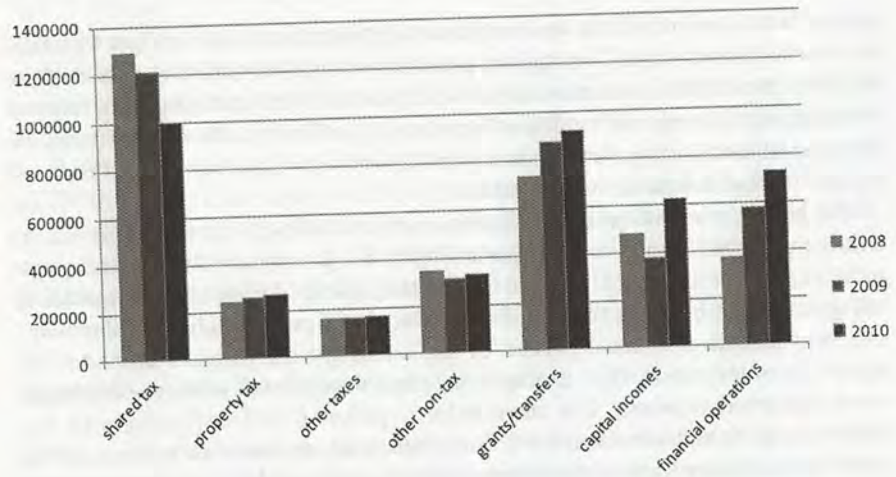

Figure 2.5 Main income items of local self-government (in thousand EUR)

Source: Ministry of Finance of the Slovak Republic, 2012.

decrease in this tax income. Increased non-deductible income introduced by the central state as an anti-crisis measure also had a negative influence. As a specific problem, the timing of the transfer of PIT yields to local self-governments emerged. Such had large disparities on a monthly basis, with the largest decline of transfers in May and June each year (see Figure 2.6). This was caused by tax legislation and related procedures such as tax declaration submission, tax payment postponement and so on. The huge decline in transfers during the mentioned months caused serious problems in the financial flow of many self-governments, peaking in 2010. Local self-governments intensively negotiated the problems with this important source of income with central government.

Local self-governments avoided any larger increase in local taxation within taxes under own administration during the first years of the crisis. Specific was the situation in real estate property tax collection, as one of the most stable and purely local taxes. Although we can observe an annually moderate increase of tax collection, a tax income increase in 2009 is clear compared to 2008 (7.3 per cent). However, this was not caused by a significant increase of taxation level (documented for example by Rohoška, 2012), but by a strong effort to collect property tax liabilities from previous years. It is important to mention that local self-governments in Slovakia directly administer this local tax, so it was quite a reasonable reaction to worsening financial flows during the first months of 2009 when the crisis peaked in the economy. It confirmed the immediate search for own ways to cope with the crisis. A minor increase of the income of local self-governments arose from other tax incomes (less important local taxes under direct administration).

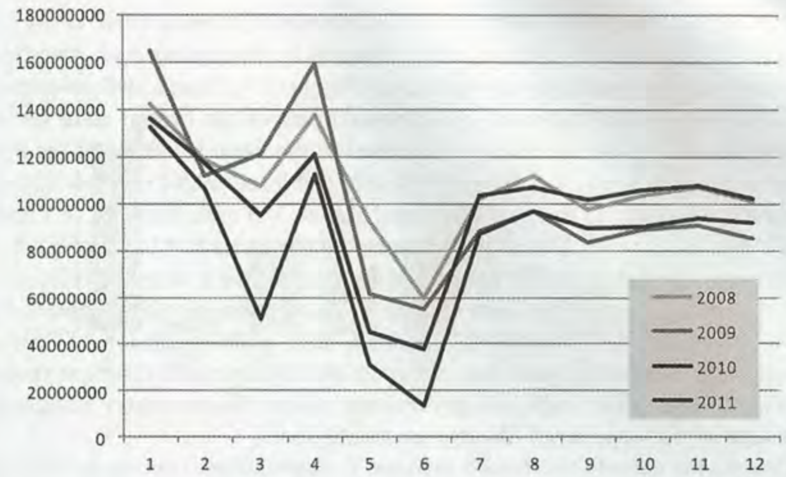

Figure 2.6 Personal income tax revenue of local self-governments according to months (in EUR)

Source: Financial Directorate of the Slovak Republic, 2012: own calculations.

The crisis influenced a decline in other non-tax incomes (for example local self-government entrepreneurial activities, yield from rented property) of about 10 per cent in 2009 compared to 2008. Even in 2010, despite a minor increase, this income was lower compared to 2008. The crisis had a similar short-term impact on capital revenues (Figure 2.5). This income had been only 79 per cent of 2008 income in 2009. It was caused primarily by the interim decline in interest in buying municipal property, caused by economic uncertainty and worse access to credit, for example for developers. However, this decline was compensated for in the next year: while this income was only EUR 376 mln in 2009, it increased to EUR 623 mln in 2010. A contrary trend concerns grants and transfers. Their increase at almost EUR 200 mln is quite significant (2008 to 2010, or 25 per cent). It confirms their stability despite the crisis, and it also already included compensation of the decline in PIT tax share decided by the central state. The largest increase within the local revenue system could be seen in financial operations. While it was only EUR 370 mln in 2008, it sharply increased to EUR 576 mln in 2009 and EUR 729 mln in 2010. This growth was based on borrowing and the use of own reserves from previous years.

Local self-government debt is a crucial indicator of the local self-government fiscal situation during the crisis. Its large growth is understandable, taking into account the abovementioned developments. It is important to know that it is a less influential section of total public debt growth. The local self-government share of total public debt was only 5.2 per cent in 2010. However, it had increased from 3.4 per cent in 2004. While the debt of local self-governments was EUR 720 mln in 2005, it was EUR 1390 mln in 2010. A major increase arose in the crisis years of 2009 and 2010. The growth dynamics in these years was even higher compared to total public sector debt (see Figure 2.3). Local self-governments in Slovakia had been criticised by representatives of the central state for such large-scale borrowing expansion, as opposed to the fiscal priorities of the public sector in general. Local self-government debt stabilised in 2011, when it slightly decreased compared to the previous year (EUR 1 386 mln, Ministry of Finance, 2012). The increase of debt in contributory organisations had been minor. Local self-government debt has in 90 per cent of cases a long-term nature (2010). Almost half of debts were resources provided by the State Housing Development Fund (Slov. Štátny Fond Rozvoja Bývania). Such large-scale expansion of debt was related to the borrowing needed to complete already started investment projects. On a significant scale, local self-government needed the necessary resources to co-finance already approved EU project completion.

Despite the already mentioned increase in expenditures, the crisis influenced the proportions of such increases across the various expenditure fields. This restructuring is more evident in 2010 and less so in 2009. It is partly the result of local budgets adopted even before the crisis, during the last months of 2008. Among expenditures that were under pressure we can mention personnel costs (salaries, insurance payments). The growth thereof decreased to 3 per cent in 2010, compared to 7 per cent in 2009. Local self-governments adjusted these costs with a certain delay in comparison to the general economic trend. Extensive cuts could be seen in the procurement of goods and services – at almost the same level as 2010 compared to 2009. Local self-governments also reduced rate payments. They used lower credit rates or renegotiated their credits. These items were behind the decrease of current expenditures share of total expenditures. The approaches in favour of greater efficiency were also documented by the data concerning capital expenditures. There was a huge shift in favour of new buildings and construction activity (almost 90 per cent of total capital expenditures). This meant a significant reduction in other investments or transactions. Construction activities in the education sector, infrastructure and housing played a substantial role in this development. This to a large extent was led by projects financed by EU funds and the State Fund for Housing Development loans. Local self-government concentrated on completing these advantageous investments for the long term, and reduced other capital expenditures. According to the COFOG structure (Figure 2.7), a stagnation or decrease of expenditures in environmental protection, transport (dominant in economic affairs) and social protection was evident.

Local Self-governments and Central State – Institutional Coordination, Cooperation and Conflict in Coping with Crisis

One of the key factors in the successful navigation of the crisis in public finance was the level of coordination and cooperation among sub-national governments

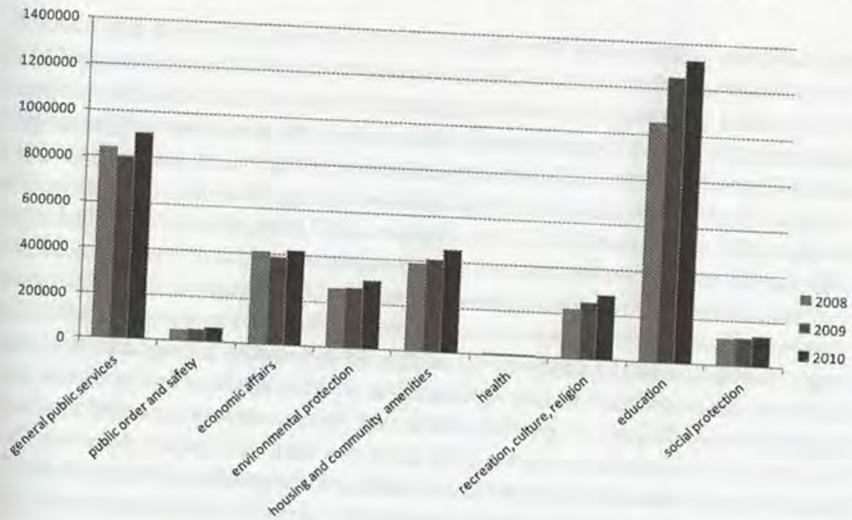

Figure 2.7 Expenditures according to selected COFOG categories in 2008–10 (in thousand EUR)

Source: Ministry of Finance of the Slovak Republic, 2012.

and central state institutions. In the case of Slovakia, the main players were central government (represented by the Prime Minister or the Ministry of Finance) and local self-governments (represented by their main associations). They negotiated various issues concerning the impact of the crisis at the local level, and the local self-government role in public finance consolidation. These relations developed across multiple phases with varying priorities and outcomes. Nevertheless, their coordinated effort guaranteed acceptable financial conditions for local self-government functioning and the delivery of services during the crisis.

It should be mentioned that at the beginning of the crisis there was a lack of significant debate focusing on the crisis' potential implications for local self-governments (latter half of 2008). It reflected the general social mood that Slovakia would not be seriously hit by the crisis. In the field of local finance, representatives of local self-governments paid greater attention to their standard agenda, even in December 2008. For example, they debated the financing of delegated powers and selected development programmes. Until the beginning of 2009, the crisis was not included in the main agenda of ZMOS's main bodies, although certain warnings had already emerged (Obecné Noviny, 2009a).

The crisis started to culminate within the Slovak economy at the end of January 2009. It stimulated the mobilisation of all institutions to search for anti-crisis measures. The central state initiated the first meeting of the national ad hoc body – the Economic Crisis Council (29th January), which included representatives of central government, employers, trade unions and banks, as well as ZMOS (this body had been active during the peak months of the crisis in the first half of 2009). Only a few days earlier, the first ZMOS working commission had been established by its Board to monitor the situation and consider necessary measures to address local finance in 2009 (Obecné Noviny, 2009b). The central government considered local self-governments as important partners – it had been aware that some measures could touch their financing and functioning. After the meeting on 6th February (Prime Minister, Minister of Finance and ZMOS Board), on 13 February 2009 the *Memorandum on cooperation in solving impacts of the financial and economic crisis on Slovak society between the Government of the Slovak Republic and the Association of towns and communities of Slovakia* was signed (in Slovak – *Memorandum o spolupráci pri riešení dopadov finančnej a hospodárskej krízy na slovenskú spoločnosť medzi Vládou SR a ZMOS; Association of Towns and Communities of Slovakia* – ZMOS, 2009). This memorandum provided the basic framework for adjustments concerning measures adopted against the crisis, and that involved local self-governments. It included the interim validity of certain measures adopted, stopped further transfers of powers to the local level and guaranteed certain compensations to local budgets related to anti-crisis measures adopted by the central level. Local self-governments promised to develop their own measures and willingness to adopt more prudent fiscal approaches. Among other initiatives, a specific declaration was prepared by the participants of the round table – *Economic crisis impact – challenges and solution for local self-government*, initiated by the mayor of Bratislava at the beginning of March 2009 (Obecné Noviny, 2009c). The real scope of crisis impact was not clear in March 2009, and representatives of local self-government were focusing on proposals to mitigate the crisis in general (for example addressing public finance and national economy). ZMOS prepared a 'package' of proposed measures to mitigate the crisis impact and sustain economic growth in April 2009 (Obecné Noviny, 2009d). It identified fields with the potential to generate employment at the local level (for example in anti-flood measures, energy savings, waste management, local roads, housing), possible sources of their financing (EU funds, special state funds) and mentioned the need to prepare new strategic development documents, as well as related legislative changes.

This framework preceded the adoption of new anti-crisis-oriented legislation – amendments concerning budgetary rules (Act No. 583/2004 as of Act No. 54/2009) and income taxes (as Act No. 60/2009). It released selected strict rules in local financing. For example, it allowed the use of capital income to cover current expenditures. Also allowed was more extensive spending without the obligation to have a budget in balance or surplus (in fact it meant more freedom in borrowing) until the end of 2010. The most damaging measure introduced by central government was increasing the tax deductible minimum for personal income tax (interim until the end of 2010). It generated a loss of available resources for local budgets, later multiplied by increased unemployment and salary freezes. During the first months of 2009, in many cases local self-government had adopted preventive measures to save some resources, but on a moderate scale (for example

3–5 per cent of current expenditures). However, as soon as May and June 2009 it was already clear that the negative effects of the crisis would be much deeper.

Despite the aforementioned central-local basic anti-crisis coordination as expressed for example in the *Memorandum on cooperatio*, local self-governments (as well as regional self-governments) were not directly involved in central state measures. Although quite a large number of central state measures were adopted, local self-governments did not participate in their direct implementation. For example, they were not involved in the extended public investments that remained under central state control. Aligned with the deepening of the crisis at the local level, the initial atmosphere of mutual understanding between central government and local self-governments was subsequently strained. As Buček (2010) pointed out, local self-governments were not satisfied with the strong restrictions they faced, while in contrast central government finances were increasing due to various measures and a lack of any notable spending cuts.

The rising tide of dissatisfaction had been expressed in various ways, especially after the sharp decrease of PIT yield transfer and adjusted forecast prepared by the Ministry of Finance concerning PIT tax income that appeared in summer 2009 (declared 17 per cent annual decrease in PIT income, or EUR 230 mln for 2009 and EUR 379 mln for 2010). Such development was considered unacceptable. Statements of disappointment were addressed to the Ministry of Finance by individual mayors, regional association of towns and communities (for example local self-governments from the Žilinský region in northern Slovakia), as well as the Union of Cities (for example Obecné Noviny, 2009e). Growing difficulties and pressure forced the Ministry of Finance to negotiate with representatives of ZMOS from July to October 2009 (including the formation of a joint working group). As compensation, ZMOS demanded EUR 130 mln for 2009 and EUR 200 mln for 2010. As a potential step in favour of such compensation, representatives of local self-governments proposed distributing 6.2 per cent state share of PIT to local and regional self-governments. This represented a change in PIT distribution formula to 75 per cent for local self-governments and 25 per cent to regional self-governments, and no share for the state budget (Obecné Noviny, 2009f). As a result, a special transfer to local budgets was negotiated in favour of local self-governments. As partial compensation for the income lost by lower PIT yield, they obtained EUR 100 mln for 2009 (in December 2009). These resources had to be obligatorily used for current expenditures, but not for salaries (Obecné Noviny, 2010a). A similar compensation package of EUR 72.5 mln was also announced for 2010, which was subsequently decreased to EUR 40 mln.

Central-local relations in the financial sphere were influenced by persisting lower yield from PIT, and calls for its compensation to local self-governments in 2010. In April local self-governments requested at least EUR 33 mln compensatory subvention, which was granted (Obecné Noviny, 2010b). Local self-governments pressed for subsequent compensation payments, especially after the repeated very low transfer of PIT yield during the spring and summer of 2010 (even compared to 2009). However, due to the parliamentary elections held in June 2010 and related changes in the government coalition, no important decisions were taken at the central level during this period. More symbolic and administrative was for example the decision to transfer the share of PIT tax yield one week earlier in July 2010 (Obecné Noviny, 2010c). The new central government considered local self-governments as a new opportunity for the negotiation of their need to mitigate the influence of the crisis. Besides financial compensation totalling EUR 141 mln, they emphasised the need to speed up the refunding of pre-financed expenditures spent on EU financed projects, as well as refunding new powers in social services. They also attempted to again open the issue of total PIT yield distribution only to self-governments (Obecné Noviny, 2010d). It should be mentioned that some interim changes ended in 2010 (such as the increased deductible tax minimum). The situation of local self-governments and their combined efforts also influenced the better economic outlook for 2011.

Local self-governments' tax revenues still suffered from the high unemployment rate and stagnating wages in 2011. A large oscillation also remained in the monthly transfers of PIT yield to local self-government (lower transfers in May and June). Nevertheless, the resources available to local self-government from PIT increased in comparison to the previous two years. Later in 2011 were the first proposals from the new central government concerning changes in the public finance system. Such also concerned local self-government. Among the most debated changes were proposals for the obligatory substantial increase of real estate property taxes (purely a local tax) at about 50 per cent, and the reduced share of local self-governments of PIT yield of a similar financial value. This was rejected by local self-governments. They also asked for a reasonable part (30–50 per cent) of the subvention provided to the Slovak Republic from the EU Solidarity Fund (Obecné Noviny, 2011a).

The central government proposal to change the main source of tax income for local self-governments initiated one of the largest mobilisations in the history of self-governments. The stable percentage share of PIT (since 2005) should have been replaced by a 'tax-mix' based on 9.72 per cent yield from the basket of main taxes (PIT, VAT, consumption taxes; National Council of the Slovak Republic 2011). This was refused by ZMOS as the main association of local self-governments, because they anticipated it would lead to lower income and financing difficulties for small self-governments (rural, small cities). The opposition was so strong that ZMOS called its first extraordinary congress in its twenty-plus-year history (Obecné Noviny, 2011b). Under such pressure, the legislative proposal that would have introduced this change was withdrawn before the second reading in the Slovak Parliament. Nevertheless, under the influence of the necessary fiscal consolidation, the share of local self-government of PIT yield decreased from 70.3 per cent to 65.4 per cent. This represented a compromise solution that guaranteed 7 per cent annual increase of total yield in financial terms for 2012. This was also balanced by the inclusion of local self-governments (as well as regional self-governments) into the constitutional act on budgetary responsibility (or colloquially 'debt brake act') and participation in public finance consolidation

(Trend, 2011). As a result, the debt of self-governments is not allowed to exceed 60 per cent of the previous year's current income (under the threat of penalty). The state does not guarantee the solvency of individual self-governments, and new powers cannot be transferred to self-governments without the related financial controls. Part of the new fiscal limits will be valid from 1 January 2015, providing time for adjustments in individual local self-governments.

From the previous paragraphs we can conclude that the debate between these two partners had more phases: initial and less intensive at the beginning of the crisis in the second half of 2008 (I); a deepening of the crisis leading to the intensification of the anti-crisis effort in spring 2009 (II) – however still with a less active role for local self-governments; facing stronger consequences of the crisis and following the publication of more realistic fiscal forecasts in the second half of 2009 (III), the pressure and activity of local self-governments to protect their financial interests increased; the next stage was negotiation within the 2010 state budget preparation in the second half of the year (IV); and the most intensive mobilisation caused the central government to plan, substantially changing the framework of local self-governmental finance during the second half of 2011 (V). While in the first phases it had been negotiation induced by the dynamics of the crisis, subsequently it followed the more general processes of public budgets preparation. The crisis became a longer term issue incorporated into standard processes of public finance management. Later developments were also influenced by longer periods of 'silence' and less activity caused by the change of central government, and a more positive macroeconomic development. In fact two points dominated these debates – taxes and central state compensations. Central-local relations in such a sensitive field and circumstances could not avoid short-term disruptions and mutual criticism. While local self-governments were criticised for increased borrowing and less cuts in spending, the central state was criticised by local self-governments for not responding sufficiently to their difficult financial situation. The delayed responses led to working less efficiently at local level. The local level also responded slowly, not calculating on such a deep escalation of the crisis into their budgets. Proposals from local self-governments were only heard in a minor scope (for example employment at the local level). Adopted measures were orchestrated predominantly by central government, as were their implementation.

Adaptation of Local Self-governments to the Crisis

Local self-governments had adapted quite successfully to the crisis in Slovakia. They were not so seriously hit, and avoided overly painful restrictions. Most could protect the standard and scope of services that they usually provided, and they prevented larger staff layoffs. Despite complications, they achieved acceptable progress in development as expressed in investments and own property value increased. In their responses, we can see measures that focused on revenues as well as expenditures. Such were reflected more in the internal restructuring of financial flows, and less in the significant decrease of financial options. While on the revenue side the search for the compensation of lost revenues dominated, on the expenditures side was the pressure for sustaining investments and cutbacks in current spending. The situation had been acceptable also thanks to the support of central state and access to EU funds. Despite focusing on own interests, local self-governments participated with understanding and solidarity in a social effort for public finance consolidation. They also avoided own measures that could have substantially increased the burden of the crisis on their citizens and local businesses.

We can highlight the most important adaptation techniques of Slovak local self-governments in the financial sphere that can be identified from aggregate data. Local self-governments avoided any radical measures that we could have expected under such conditions. Prevalent had been the search for compensation of declining revenues with other income sources. Extensive had been the use of returnable resources, mostly borrowing (as confirmed by debt growth) and the spending of own reserve funds. Local self-governments also carefully turned to the mobilisation of resources within their own local tax base (property tax and local taxes), but without any significant immediate increase of taxation (as well as no reduction of local taxation). They did not increase own local taxes, with the intention of limiting the burden of the crisis on local citizens and the business sector. Slowly evident was a progressive reduction in personnel costs, indicating the low increase of salaries and very limited increase (or even freeze) in staff numbers. Not surprisingly, we could observe standard short-term cuts in spending on goods and services, as the standard short-term method of reducing expenditures. Very reasonable can be perceived the prioritisation of investments into new buildings and public infrastructure, balanced by less investments into other assets.

The cohesive, clear and active representations of local self-governments by their associations against central state institutions was an important part of the success in preventing more devastating impacts of the crisis on their functioning. Nevertheless, local self-governments were less open, less flexible and less innovative in searching for measures to mitigate the crisis impact within central-local relations. Their approaches document the preference given to the preservation of the existing local finance framework that had been very beneficial for them already before the crisis. Such was expressed in strong efforts for the preservation or increase of PIT share, as the main source of their tax revenues. Very important is that the central state provided a stable basis with no cutbacks concerning standard transfers for local powers (for example in education). On the other hand, central government instability (parliamentary elections in 2010 and 2012) and internal diversity prevented the introduction of wider systemic changes in public finance, also in terms of local finance. It is questionable whether under a more compact central government coalition and longer term pressure for fiscal consolidation local self-governments would have been able to protect their current financial framework without making substantial changes.

The time aspects of local finance development during crisis are important issues from the perspective of institutional learning. The timing confirmed known experiences with a delay compared to the rest of the economy. Obstacles came later, thanks to procedures in tax collection and distribution. Although the first difficulties and serious financial scarcity emerged within the first 6–9 months after the crisis started, its impact and required adaptation culminated much later. If we consider October 2008 as the starting month of the crisis in Slovakia, it seems that a major impact in financial terms was observable within 18–24 months (approx. in 2010). This is confirmed especially by the decrease of PIT tax transfers to local budgets. While during the first months of the crisis local self-government functioned in accordance with planned budgets, they could use available reserves and so on, these possibilities subsequently became more limited. Mitigation of the crisis can be observed in 2011, when local finances were already closer to the standard situation. Although it seems that the situation in local finance has already improved, the crisis will continue to influence local self-government finance for years to come, especially due to the overall state of public finance in Slovakia.

The adaptation of local self-governments is also influenced by budgetary procedures and officially published public finance forecasts. Local budgets are also political documents that must be adopted by the Local (City) Council (as well as in the case of substantial changes) and its preparation requires a long period. Local budgets for 2009 were adopted before the crisis had started to strongly influence the real financial situation. Hence adaptation strategies were less deep in 2009, compared for example to 2010. Budgets for 2010 were already prepared within a different set of general expectations, and also keeping in mind the forecasts indicating the crisis' impact on the economy and public finance in Slovakia. Nevertheless, less precise public finance forecasts prepared under the supervision of the Ministry of Finance that are used in the drawing up of local budgets in coming years also contributed to insufficient responses. Such forecasts were mostly more optimistic than the actual development (for example tax revenues), and partially caused a larger gap between revenues and expenditures.

The Slovak local self-government financial system demonstrated quite a high level of robustness, as well as adaptation flexibility to mitigate the effects of the crisis. This has multiple reasons, which demonstrates that the current system has its advantages. As far as tax revenues are concerned, despite the decline in yields, the level of dependence on PIT share has been acceptable. Compared to other tax revenue options, PIT is a better choice as it is less sensitive and oscillating, for example compared to corporate taxes or VAT. As an analogy, quite suitable is the real estate property tax income framework. Due to the fact that Slovak local self-governments apply *non ad valorem* taxation (combining the size and location of real estate property), such tax generates more stable income compared to value based on real estate property taxation (with potential annual changes related to the devaluation of property), or unstable income from property transactions as applied in some countries (see for example Davey, 2011). Tradition and experience from the transition period can be considered to have played a role too. Most local self-governments used to have reserve funds available in times of (unexpected) scarcity. Due to the longer term regulation of local borrowing, they also had the capacity to borrow. Their access to required credits was not a problem thanks to the very limited effect of the crisis in the Slovak banking sector (municipal bonds are in fact not used). Current and new limits prevent too high local indebtedness in the future. Local self-governments avoided the sudden cuts and substantial financial restructuring that could be damaging. Of course, we should bear in mind the quite good situation in public finance in general. This allowed the central state to adopt a compensatory approach to local self-governments, compared to states with more urgent public finance scarcity. Besides the stable central state transfers, an important role is played by access to EU funds in protecting progress in local development (new investments). Part of the ability to adapt is related to the current division of powers, with the limited role of local self-government in crisis-sensitive fields of expenditures such as the financing of social welfare, housing and unemployment assistance.

Another issue is to which extent local self-governments contributed to the stabilisation and stimulation of the local and national economy, as well as public finance consolidation (despite their minor role from the macroeconomic perspective). Slovak local self-government did not substantially contribute to increased unemployment. According to the aggregate data, we consider that no substantial reduction in employment occurred. However, they were also unable to contribute to the creation of new workplaces. Miller and Svara (2009) see expanding or accelerating local capital projects as an option. The effort to sustain capital investments with reserves and borrowing has also had a positive and stimulating effect, also in the Slovak case. Their cutbacks in the procurement of goods and services were also mostly temporary. Local self-governments avoided any sharp increase in local taxes, user or administrative fees that could have harmed the business sector. After the criticism, local self-governments turned to more prudent financial behaviour that contributed more to the needed public finance consolidation, for example in reducing deficits and decreasing borrowing (at least in 2011).

We have to be aware that there are also large disparities in the financial situation between individual self-governments. This also means a wide range of responses compared to those outlined in local self-government adaptation to crisis. Such varied responses reflect diverse local conditions, local fiscal capacity, property situation, availability of reserve funds, access to credit links and so on. Numerous local self-governments were under fiscal pressure even before the crisis arrival. Unexpected and long term, this crisis caused difficulties especially to this group of local self-governments. There are documented cases of individual cities in Slovakia where such adopted measures were quite serious.

Conclusion

One of the key features of local self-governments functioning during the crisis was the less stable, less predictable and less autonomous financial environment. Such was not good news after the long-term effort for the stabilisation of basic frameworks and decentralisation of powers, which came into practice from the mid-2000s in Slovakia. It represents a reverse development, returning this level of government to a similarly unstable transitional period. Financial scarcity and dependency on transfers and grants provided by the central state or EU funds also reduces local fiscal autonomy. It is in fact against the longer term effort to increase the autonomy of local financing. It is against the priorities of the decentralisation process introduced one decade earlier that was considered a substantial part of the modernisation process of the post-socialist transition.

Experience has confirmed the importance of having well-functioning and responsible intergovernmental relations. Nevertheless, either central governments or local self-governments were unable to obtain support for their 'extreme' opinions in key tax issues (tax mix in the case of central state, as well as no PIT share for the state by local self-governments). This documents the moderate approaches that were possible. Finally, all government levels contributed to the fiscal consolidation processes in an acceptable manner. The situation of local self-governments positively influenced the efficient and active representation of local self-governments towards central government. But some strategic measures will be adopted during 2012 as a result of new central government activities, as well as the pressure of 'Fiscal Compact' initiated measures.

The situation of local government finance also indicated some opportunities that could be changed and which can act as 'first line' preventive measures against financial difficulties at the local level. Besides the limits already introduced within the 'fiscal brake' legislation, further options abound. If the gateway for the financial crisis to penetrate into local finance was largely dependent on PIT as shared tax and its oscillating yield, a certain emergency bottom limit of transfers can be introduced, for example on a monthly basis (to avoid sudden decreases with serious impacts). This is better and is efficiently manageable at the central level, and balanced within the framework of subsequent monthly transfers. The second option is the need to consider a shift toward more diverse and balanced local revenues. Reserve funds also appeared useful in preventing the escalation of the crisis at the local level. Rules, situations and obligatory limits for minimum reserve funds at the local level could be established. Among eventual measures could be the more efficient and preventive monitoring of the financial situation in individual self-governments (rating, automatic warning system), detecting fiscal stress (see for example Coe, 2008) with the more sophisticated use of information amassed by the Ministry of Finance. This should include regular information for their citizens regarding the financial situation by way of simple ratings. Nevertheless, financial planning and cash flow management should be improved. Local self-government can calculate for the already known annual cyclical nature of selected transfers (repeated decline in the spring). Public finance forecasting should be improved, and better fit the needs of local finance.

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Chapter 3
The Economic Adjustment Program Impact on Local Government Reform in Portugal

Carlos Nunes Silva

Introduction

The XIX Government program includes as one of its main objectives the reform of local government (Governo de Portugal, 2011). This has been in the political agenda almost since the first revision of the democratic Constitution in 1976 but this time the constraints determined by the economic adjustment program seem to have created the conditions for the implementation of some of the most controversial of these proposals.

The chapter addresses the following research question: to what extent did the economic adjustment program (2011–14) determine the content and the method adopted in the current local government reform in Portugal? For that, the chapter examines and discusses the adjustment program, in particular its proposals in the field of local government, and argues that the nature and the extent of some of the 'local state' reforms have been in part required and/or facilitated by this program. Nonetheless, the analysis also shows that part of it, as is the case of the reduction of the number of parishes, had been tried or initiated by previous governments, supported by a different political majority in Parliament. The chapter describes the main options and the rationale behind some of these political options and describes measures related to local government or with a direct impact on this sub-national tier of public administration.

In what follows, the chapter is organized into 3 main parts. In the first – Local Government Reforms in Portugal – the chapter offers an overview of local government reforms implemented in the last decades. The second part examines and discusses the structure and content of the economic adjustment program (EC/ECB/IMF, 2011) and how it impacts on local government. The third part analyses each of the four components of the local government reform proposed by the XIX Constitutional Government. The chapter ends with some concluding remarks on the implementation of the proposed reform and on the need to monitor its impacts.