

## **Economic Development Policies of Local Government in Slovakia**

Soňa Čapková Associate Professor  
Matej Bel University, Slovakia

### **Abstract**

Economic reform and restructuring in Slovakia has resulted in significant quantitative and qualitative changes in local economies, which have pressed local government to develop new policies and measures addressing these changes. Economic development has emerged as a policy priority for many local authorities.

The paper looks at some aspects of the actual local government economic development policies in Slovakia. It presents some of the results and findings from the survey exploring the role of local government in creating local entrepreneurial environment. Attention has been also given to the legal and economic context of these policies, defining the current roles and responsibilities of local governments in supporting the economic growth in their areas, the limitations and constrains for local government initiatives in economic development.

### **1. Slovakia - basic statistical data**

Area: 49 035 km<sup>2</sup>

Population: 5 379 455 (2001 census)

Population density: 109/km<sup>2</sup>

GDP per capita 15 983.3726 US dollars, in current prices and PPPs (2005)

Inflation rate: 4, 5% ( 2006)

Unemployment rate: 12% (2006)

Since the establishment of the Slovak Republic in January 1993 (due to dissolution of Czechoslovakia, which split into the Czech Republic and Slovakia) Slovakia has mastered much of the difficult transition from a centrally planned economy to a modern market economy. The main progress in macroeconomic stabilization and main structural reforms was made in 1998-2006. Major privatizations are nearly complete; the banking sector is almost completely in private sector hands, the government has helped facilitate a foreign investment boom with business friendly policies. Slovakia's economic growth exceeded expectations in 2001-06 despite the general European slowdown. Headline consumer price inflation dropped from 26% in 1993 to an average rate of 2, 7% in 2005. In 2006, Slovakia reached the highest economic growth among the members of OECD and the third highest behind Estonia and Latvia). The Slovak economy has grown strongly in recent years, driven by rapid

productivity growth, but still has far to go to catch up to the per capita income levels in the advanced European countries.

FDI in Slovakia has increased dramatically. Cheap and skilled labour force, low taxes, a 19% flat tax for corporations and individuals, no dividend taxes, liberal labour code and a favourable geographical location are Slovakia's main advantages for foreign investors. FDI has grown by 600% since 2000. Foreign investment in the automotive sector has been strong.

Despite the high rates of economic growth, the country has failed to address regional imbalances in wealth and employment. The unemployment jumped to very high levels immediately after the reforms began in 1998, it peaked at 19.2% in 2001. Employment growth accelerated in following years and, with many Slovaks working abroad, the unemployment rate down sharply, to 12% in late 2006. However, it still remains among the highest rates in the EU and long-term unemployment remains stuck at around 10% of the labour force. GDP per capita ranges from 129% of EU average in Bratislava to only 42% in Eastern Slovakia.

## **2. Legal and fiscal framework of local government**

In terms of territorial administration, the Slovak Republic is divided into 8 regions and 2,891 municipalities (as at Dec. 31, 2002). The public administration is organised on three levels: state – region – municipality. The regional local government was established as at January 1, 2002. Every level has its own elected officials, distributed responsibilities and liabilities. Slovak public administration is of dual nature, with relative separate lines of local government (local and regional) and state administration (regional general state administration, specialised state administration). Recent development has been characterised by strengthening of local government and reducing the role of state administration. Within the processes of public administration reform, more powers are transferring to local and regional government (higher territorial units) since 2002.

Basic task of municipalities is taking care on the development of its territory and needs of its citizens. Main responsibilities and functions of local government -

administration of communal property; preparation and adoption of local budget and final account; local taxes administration; supervising of economic activities (including adoption of binding decisions on investment activities and starting of entrepreneurial activities); construction and maintenance of local roads, public spaces, cemetery, and other municipal facilities; organisation of public services provision (waste disposal, public lighting, water distribution, sewage, public transport etc.) housing, pre-school and school facilities, social facilities, health-care facilities, some hospitals, culture, attestation of deeds, some offences, local police,; own investment and entrepreneurial activities; adoption of territorial planning documents, as well as development documents concerning particular spheres of local life; establishment and control of own budgetary and contributory organisation and other legal entities.

Basic responsibilities of regional government include: regional roads, territorial planning, regional development, secondary schools, hospitals, some social service facilities (retirements homes, social services for children, crises centre, orphanages, etc.), cultural facilities (galleries, museums, theatres, some libraries, etc.), participation at civil defence, licences for pharmacies and private physicians, hospitals.

The degree of responsibility in carrying out responsibilities and functions by a local government assumed are closely related to its financial room for manoeuvre: a local authority can only undertake administrative and political responsibility for carrying out public functions if it has the necessary financial resources. An access to resources and sufficient fiscal autonomy determines how far local authority can play its part in economic development activities. Financing of local government is a crucial factor in its economic development policies.

New system of financing of the municipalities and higher territorial units (local governments), was prepared taking effect in 2005, the substance of which was to strengthen revenue collections of the municipalities and to determine revenue collections of the higher territorial units. Fiscal decentralization links to the transfer of executed competences from the public administration bodies to the municipalities

and higher territorial units that gradually passed to the regional self-government from 1st January 2002 to 1st January 2004.

The new system of financing was to strengthen the independence and responsibility of local governments in deciding on the use of public funds for provision of services. At the same time, it should contribute to the self-government's revenue stabilization for a longer period.

Decentralisation has provided local government with more flexible forms of public governance that can be used in undertaking economic development activities using their own resources. To implement them local authorities need their own independent sources of revenue and adequate expenditure competences. The number of local government expenditure competences has substantially increased since the beginning of the 1990s. Subnational expenditure levels account for 19% of general government expenditure in 2005 compared with 11, 5% in 2002 and 8, 1% in 1995.

### **3. Local government and economic development**

Economic reform and restructuring in the national and international context has resulted in significant quantitative and qualitative changes in local economies, which have influenced the need for active economic development measures in many municipalities and regions of Slovakia. Local authorities faced with having to cope with high unemployment and economic distress as a consequence of comprehensive structural adjustment. At the same time, regions and municipalities face difficulties which have arisen from rapid restructuring local industries and the increased international competition in an open economy.

In the past decade the decentralization process has grown substantially. The return of competences to local and regional governments has given local officials much more authority to deal with local problems. Greater responsibility has been placed on local government in promoting economic development and activities. Gradually it has been accepted that economic development initiatives are an important component of local public policy. Local authorities have had to learn to provide more than the traditional local public services. To be successful local authorities need to understand the

demands and needs of the private sector and then intervene to create a better local environment to support the growth of the private sector. Local governments needed to develop tailored activities and programmes designed to stimulate local economic development addressing their circumstances. Emerging awareness of the positive impact of managing economic development among local government representatives could be also seen as a result of support to municipalities, through economic and regional development projects funded by EU structural funds.

There is not a consistent definition of what is meant by the term local economic development. In his book on economic development planning, Edward J. Blakely (1994) defines local economic development as „a process by which local government and / or community-based groups manage their existing resources and enter into new partnership arrangements with the private sector, or with each other, to create new jobs and stimulate economic activity in a well-defined economic zone.“ Generally, local economic development represents a broad strategy in which local actors and institutions try to make the best use of local resources to conserve and create jobs and strengthen and promote business activity.

Within this context local authorities in Slovakia could have become involved in promoting economic development of their areas because:

- In the course of transition, central governments have transferred significant properties and other assets to local government. As a result of property restitution, many local authorities are substantial property owners
- Local authorities have discretion over a number of fiscal instruments and capital assets, which can be used to provide direct assistance to new and existing enterprises.
- Local authorities also frequently have access to information and extended networks of agencies, which can be used to assist new and existing enterprises, and to help attract inward investment.

- Local authorities as local service and infrastructure providers can frequently support new and existing enterprises through the organisation and provision of a range of local services to ensure that special needs are met

This paper draws on a recently completed research project analyzing entrepreneurial climate in Slovakia. Within the research structured interviews were conducted on a face-to-face basis with mayors or city managers of all municipalities with more than 10 thousands citizens and 56 mayors representing small municipalities. Interviews were completed in 2004-2005. The interviews were designed to explore a range of issues relating to policies used by local government to promote local economic development. The survey helped us to discern general trends across municipalities but also differences within different size categories.

#### **4. Policies and Instruments**

Local government activities designed to stimulate local economic development are numerous and various. They were predominantly focused to

- Save the threatened jobs and help generate new ones
- Increase the productivity of enterprises through enhanced management and workforce skills and access to new technologies
- Enhance the image and attractiveness of the area to firms seeking to relocate or invest

Local economic development encompasses many local government functions, including planning, infrastructure provision, real estate development and finance. Subsequently, local governments use a variety of tools in their local economic development policies. Given the current situation the principal appear to be:

1. strategic planning
2. financial tools,
3. property-related tools,

4. place marketing,
5. infrastructure development.

### ***Strategic planning***

Local governments tend to adopt strategic planning as an alternative to manage the devolved policy areas including economic development policies. The linkage of economic development policy implementation and strategic planning appears to be significant. Strategic planning helps municipalities adjust to a major economic and social transformation.

The emphasis on regional planning generated a wave of strategic development plans both at municipal and regional level. The survey has indicated that most local governments (60%) prepared a development strategy, which is a critical component of municipality planning process. In general, the historical practice when planning was conducted by central level and planning directives were transferred to lower administration levels for execution has been considerably changed. The focus of planning has altered from top-down, central government-driven and strongly planning oriented to more local-based and participatory approaches. As smaller local government do not have personal that is adequately skilled, the strategy documents are often prepared by contracted consultancy or academic expert groups with different level of citizen (and local authority) participation. The results of surveys show that there is a correlation between the size of municipality and local businesses participation in strategy preparation process. The time horizon for local development strategy is typically four to ten years, frequently the planning period has been adjusted to EU programming period.

Just a quarter of municipalities prepares a formal economic development plans (SME promotion strategy, business support strategy, etc). Activities focused on strengthening the local economy form a component of a broader strategic plan for development in most local government.

Local development plans are based on a territorial approach to development. The method of developing SWOT analysis to outline vision, goals and objectives, identify strategies and actions for socio-economic development programs has been used by

most local government. Effective strategic planning requires a sound analysis of an area's strengths, weaknesses, opportunities, and threats based on the careful interpretation of relevant data, both quantitative and qualitative. Unfortunately, one of the most important obstacles constitutes general lack of reliable planning information at local level. Especially socio-economic profile data, dynamics and trends are either unavailable or invalid or outdated. As a result many local governments have a tendency to focus on the collection of data and spend less effort than is needed in analyzing and applying the data to form strategies, priorities, and actions.

Preparing development strategy document is frequently raised by expectation to acquire financial support from European Union or other external source, which strongly emphasise programming principle. These strategies give usually also direction and focus for local economic development activities. Anyway, the main role of such strategies is often to produce a document to be able to bid for funds. Thus having strategy may be more important than its content.

The planning of local development leads to closer involvement of all local actors in decisions. Strategic development plans have provided space for co-ordinating local policies with economic and social development measures as well as adapting EU, national and regional policies to local conditions.

With respect to planning framework it should be pointed out, that on one hand some local government try to approach economic development in a strategic manner, on the other hand local economic development activities are often limited to particular project that should contribute to development of local economy, but it is not a part of any overall strategy or plan. Many local authority initiatives aimed to economic development are inadequately co-ordinated. Adequate co-ordination does not occur with other local authorities or/and with the initiatives of other agencies.

#### ***Utilizing fiscal and financial tools to incite economic development***

Local authorities may take actions to enhance the attractiveness of their area to new eligible firms and to protect existing enterprises by using *fiscal initiatives*, principally through *the use of discretionary local taxes*, especially property tax.

Taxing powers (the discretion in deciding local tax rates) are inevitable to use tax incentives in order to promote local economy. There are quite a variety of local taxes imposed to local businesses. The current legislation provides Slovak local governments with eight separate local taxes which are employed to generate local revenue. Municipalities administer seven local taxes (property tax and six specific local taxes), rates of which and whether they are imposed, are discretionary.

Local authorities have the power to offer concessions or waivers on rates of local taxes, which they consider using as a way of supporting new and existing enterprises, and the attraction of new investment projects<sup>1</sup>. By reducing the tax bill to local businesses, local authorities may try to protect existing jobs, fund new recruitment or free up cash reserves, enabling enterprises to fund expansion or invest in new equipment.

The possibilities of stimulating economic development via tax incentives were relatively limited until 2004. The new situation has appeared in 2005 when further steps of fiscal decentralization provided local governments with enhanced taxing powers.

Besides fiscal initiatives there are other mechanisms that have been used such as *grants, loans, loan guarantees*, but the scope of using them is usually constrained by tight local budgets. *Loan guarantees* are according to legislation used in favour of own companies, or companies with local self-government capital participation. Local government can provide subsidies and soft loans from local budget to local businesses to support entrepreneurship and employment. These financial tools must follow rules defined by local by-law and cannot lead to increase local government debt.

The research indicates that almost half of Slovak municipalities enforce their taxing powers to promote local economies (Figure 1). They consider deferment of local taxes and tax concessions for proper way of business support. Those, who have not used these instruments, highlighted no request for such form of support from local businesses and the need to fill local budget. As seen in figure 1 grants and loans to local businesses are provided considerably less. The interview evidence suggests limited local budget funds as a main reasoning.

***Property-related policies***

Positive influence has also a possibility for local governments to manage own property towards economic development and availability of public money especially from the structural funds. As mentioned above, many local governments are significant property owners. Besides new property, they were involved in transfer of property of communal enterprises located on their territory at the beginning of transformation period, restitution of historical communal property, participated in privatisation processes during transition processes. The legislation provides local governments with autonomy in utilising their property for local economic development activities<sup>ii</sup>. .

In cases where an enterprise has a particular property need which a local authority is able to satisfy from its own portfolio of property, local government may agree to *sell the property* to the enterprise below market prices. A further option is to rent the property. In order to support enterprises, local authorities may set rents at lower than market rates, or devise payments packages, which results in cost savings for enterprises. Another alternative is to provide rent holidays or "staggered" rental agreements to enterprises. Such agreements usually consist of an initial period of months or years in which rent is charged at lower than market rates, but the rent is increased in a series of timed stages to reach parity. These agreements are in effect a form of rent-subsidy and are most commonly undertaken as a means for supporting new enterprises.

The evidence from research shows that property related tools are used to promote local business most frequently (Figure 2). Local government indicated property-related tools as proved way in SMEs support. However, the extent to which property can be used to promote local businesses clearly depends on the amount of property owned. Several municipalities complained of the lack of land and suitable premises for the purpose.

Distinct subcategories of incentives are activities centred specifically on the development of land and /or property. These include mainly

- land development such as land acquisition and lot consolidation to create large sites

- land support activities such as infrastructure development.
- industrial parks

Despite often highlighted financial insufficiency as many as 38% of municipalities invest in acquisition and infrastructure development of land with intention to sell it to businesses/investors. (67% municipalities intend to use this form of business promotion in the near future.)

Many municipalities invest in industrial parks and other infrastructure in the hope of luring firms to their community. If large companies are to be attracted to come and set up factories and offices, then they need attractive sites with good communication links. This is closely connected with the consideration of 70% of interviewed local government to build an industrial park.

Small business incubators both high-tech and low-tech have become a popular way for local authorities in large municipalities to foster business development through the provision of facilities, technology transfer assistance, and management training and marketing assistance. The critical issue for industrial parks and business incubators are high capital costs.

### ***Infrastructure development***

Economic development also includes support for, or provision of, economic infrastructure. Infrastructure investments are often considered to be a stimulant for promoting local economic growth. Improvement of the infrastructure is critical to economic development in Slovak municipalities and regions. The lack of basic facilities is an obstacle to increasing productivity of local businesses and attracting inward investment.

Many local governments are making great efforts to carry out capital improvements in their regions. With the help of national and international funds they concentrate on improving the functioning and capacity of infrastructure controlled by municipalities (water, sewage, heat supply, garbage collection, public transportation, etc) and on extending infrastructure services to new areas for development.

There is a significant weight of local capital expenditure in total expenditure in local budgets. The infrastructure needs in municipalities are high and their financing in part falls to local governments. Local capital expenditure in Slovak municipalities represented 28-32 % of total local expenditure in 1994-2002, and 20% 18-21% in 2003 -2006, compared with 9, 7 % of capital expenditure in total general government expenditure in 2005. Weight of local public capital expenditure in general government capital expenditure has been 34, 9% (municipalities 29, 1%, regional government 4, 8%) in 2005. Results of surveys indicate, that prevailing ratio of local government expenditure is related to local economic development activities (Pisár, 2006).

##### **5. Some emerging issues**

The study findings point to significant differences between the large and small municipalities. Large municipalities are obviously much more engaged in economic development as they have greater professional capability as well as greater capacity for financial and non-financial interventions. In contrast the hundreds of small municipalities lack not just the financial but also the technical and professional resources to undertake any discretionary activity. The other fundamental fiscal problem of small municipalities is finding the means to invest in basic infrastructure at an acceptable level.

In large number of areas local government financial resources for economic development are scarce and do not extend to expensive interventions such as provision of soft loans, grants, major infrastructure development. The small size of many local governments precludes the possibility of implementing meaningful economic development initiatives. In many cases activities will not be feasible either because of resource constrains, or because activity can be only effectively implemented over a larger geographic area. Many difficulties associated with small size and limited resources can be overcome if local governments join forces and undertake collaborative initiatives. With the European Union accession local

government have become increasingly adept at identifying sources of European funding.

The common approach adopted by local authorities to local economic development has been primarily concerned with promotion of inward investment. Rather than providing a favourable entrepreneurial environment and good locations for businesses already established in the region, local authorities consider questions of regional competitiveness in the context of inward investment. Strategies are based on creating better conditions to attract private sector resources in new productive investments. The purpose is to attract private, predominantly foreign, investment to the community/region on the assumption that such investment has a salutary effect on the community with the result that all residents will benefit. The arguments in favour of foreign investment attraction are based on advantages of foreign investments - access to capital not otherwise available, access to modern technologies and know-how, much greater access to export market and existing distribution and sales channels provided by foreign partners. Frequently used incentives (e.g. tax abatements, grants, infrastructure improvements and industrial parks) are key development tools to spark new investment in the municipality or region.

The potential for job creation from existing firms and from new businesses that may be started within the local area has not been sufficiently recognised until recently. But the rise of new entrepreneurial activities can be more important than attracting large investors. In addition to the recognition that SMEs can play in the local economy and job creation, some local authorities have begun to adopt strategies to foster local enterprise development. With the help of national and international funds, local government have gradually started to provide technical assistance, loans, interest rate subsidies, low-cost premises, tax concessions focused on small and medium-sized businesses.

The benefits of many activities (such as tax incentives, subsidies) are uncertain. There is a possibility that many local authorities' grants or provision of sites and premises are leading to subsidies to firms which do not need them or which replace in the market firms serving the same demand but without subsidies. Firms end up with more

benefit than necessary to locate, to expand or to survive. This is just one of general emerging issues local government need to tackle as an early priority. Further, there is the issue of equity or fairness. There is a question if granting tax concessions, loans, loan guarantees, etc. to local firms are done on a consistent and open basis. Frequently written policies, outlining principles, which will be invoked as a basis for decision making, are missing. Seldom are local economic activities evaluated. Most municipalities have not developed any systematic measures to evaluate the results and impact of undertaken policies. Evaluation has been confined to local economic development agencies, which have to justify the use of EU or other international assistance funds.

### **Conclusion**

Local economic development policies in Slovakia are both a reaction to economic transformation and response to decentralization process providing more discretion and option in addressing local problems. The local governments have started to undertake new activities, some of which are clearly designed to stimulate economic activity in their areas. There is no doubt, that the scope for bringing about economic development through local policy is limited by forces operating in the national and international economies over which local government has little or no control. However, there is increasing recognition that local communities must use their current human, social, institutional and physical resources to build self-sustaining local economies. There is no illusion that economic development can arise only from local actions. But there is general agreement that local governments have incentives to pursue economic development policies and economic development initiatives are an important component of local public policy.

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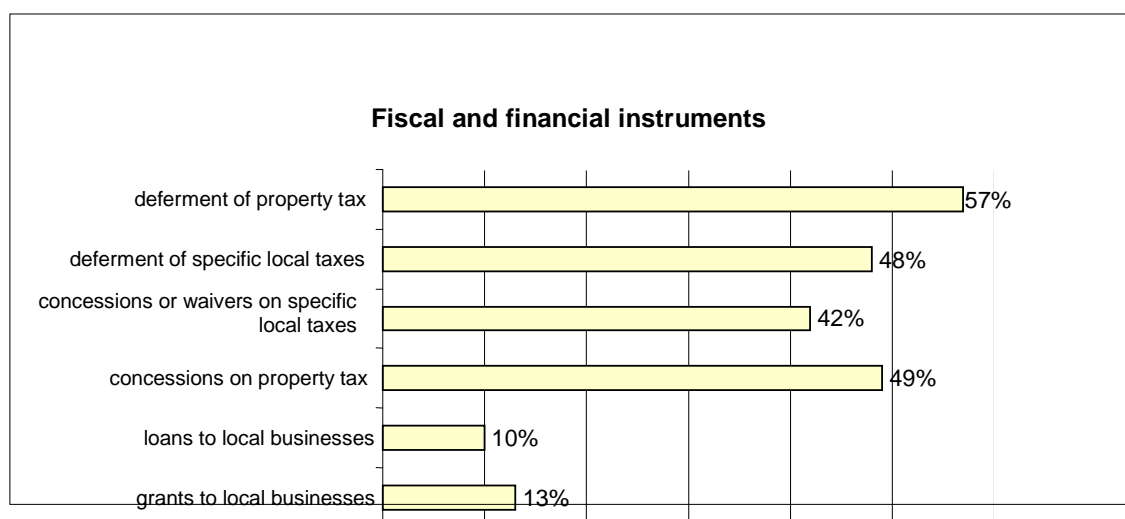
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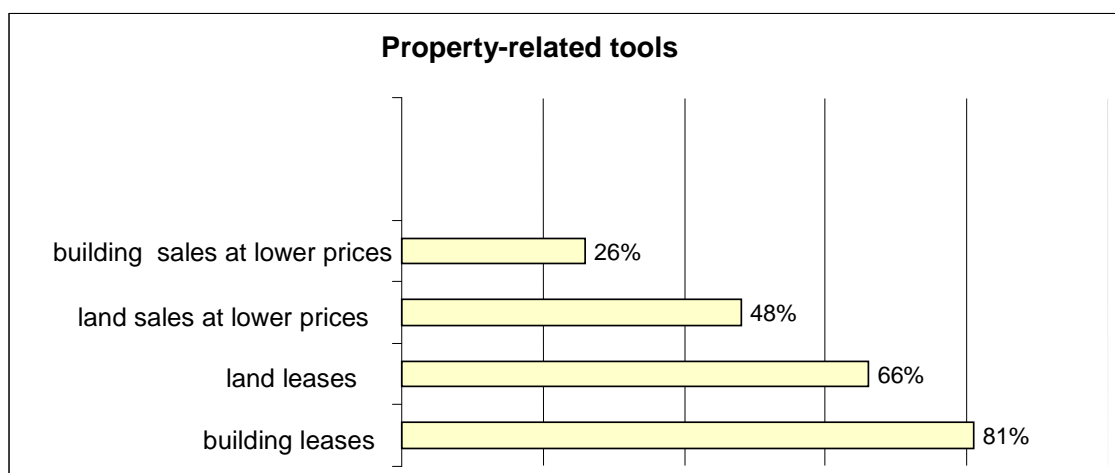
Fig. 1 Fiscal and financial tools



Note: Local governments utilising specific financial tool in percentage of total local governments interviewed

Fig. 2 Property-related tools

## Economic Development Policies of Local Government in Slovakia



Note: Local governments utilising specific property-related tool in percentage of total local governments interviewed

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<sup>i</sup> It should be mentioned that some studies concluded that state and local tax differentials seemed to have little effect on business location. This was because businesses are influenced by more important factors than differences in taxes.

<sup>ii</sup> Certain limits in exploiting property are related especially to property transferred to local self-governments within processes of decentralisation. Facilities such as schools, hospitals must remain to serve original purpose, or change of their function must be negotiated with relevant central state institution