Local Government Debts in the EU countries

Purpose of the paper

According to the official Eurostat figures the total debt amount of the local governments worth € 847.4 billion in 2017, which is 6.7 % of the EU28’s general government gross debt (€ 12,504 bn).\(^1\) Therefore public debt is still a quotidian topic in economics, most countries worldwide face its management challenges. For EU member states this problem has a pivotal importance both from a legislative and from an economic point of view; the Maastricht Treaty contains certain provisions on public finances, which are binding for the EU member states, and governing benchmark for other countries for sound monetary and fiscal policy. Specifically, Article 126 and 140 of the Treaty on the Functioning of the European Union prescribes that general government debt shall be not exceeding 60 % of the gross domestic product.\(^2\) Regardless of this, however, a country with a higher level of debt can still adopt the euro provided its debt level is falling steadily. This extenuates the economic importance of an effective budgetary management of local governments, since their debt also needs to be calculated into the national public debt, according to the unified methodology.\(^3\) This paper examines the magnitude and relevance of local government debt for sustainable public finances at a national level.

1. Basics – debts and local governments

The basics deal with the definition of debt, and with the typical types (loans, bonds), the coverable assets, and the parties: debtors and creditors.

a) debt and assets

The debt means usually something, especially money, that is owed to someone else, or the state of owing something,\(^4\) that can be expressed in monetary value. The meaning of money should be interpreted broadly, because local governments prefer in practice loans, bonds, notes,

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\(^1\) Eurostat (2018): Local government debt [gov_10dd_logd] and General government gross debt (tsdde410)
\(^2\) Treaty on European Union and the Treaty on the Functioning of the European Union, Protocol (No 12) on The Excessive Deficit Procedure
\(^4\) Cambridge dictionary
and mortgages, which are all typical types of debt. According to the legal relation, it is generally subject to contractual terms regarding the amount and timing of repayments of principal and interest.\textsuperscript{5} In the case of loans, the suitable coverage is important for the lender, who usually sets up strict conditions, which have a restrictive impact on the local budget, however, it is easier for the local government to borrow a higher amount in a short time. The bonds are the other typical debt obligation, for which the conditions are defined by the issuing municipality, thus the lenders have no influence on them, but it is a slower process to accumulate the necessary amount.

In the examined European countries, an overwhelming proportion of the local government debt is denominated in loans, the average is 64.8 %. Another significant rate belongs to the accounts payable: 29.5 %, and only 11.8 % in bonds. Due to this fact, it is simpler and easier for municipalities to borrow money from the financial intermediaries and are able to provide suitable coverages. While there is a lower or a lack of confidence in local bonds and securities,\textsuperscript{6} therefore collecting money directly from the market is more difficult. In some countries special funds, financial institutions, agencies were established by the state or the municipalities for local government financing.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{structure_of_local_government_debts.png}
\caption{Structure of local government debts}
\end{figure}

Source: Own compilation based on the OECD subnational government country profiles 2017.

\textsuperscript{5} cf. national civil codes or in US case law: Superior Court of Pennsylvania (1894). "Brooke et al versus the City of Philadelphia et al". Weekly Notes of Cases Argued and Determined in the Supreme Court of Pennsylvania, the County Courts of Philadelphia, and the United States District and Circuit Courts for the Eastern District of Pennsylvania. Kay and Brother. 34 (18): 348

Sometimes it can be observed, that after when the local government cannot borrow more money from the banking system, switches to bonds.\(^7\) For example, in Hungary, the municipalities started with loans (in 2006 € 1.55 billion in loans and only € 0.07 billion in bonds), and after 2007 more and more bonds were issued.\(^8\) By 2010 the debt in bonds nearly was the same amount as credits and bills of exchange (€ 2.12 vs. 1.96 billion).\(^9\) In Estonia the same situation can be found: the share of loans for municipal outstanding debt accounted for 56\%, that of bonds, 22\%, the remaining part is made up “other accounts payable.\(^{10}\)

It is a crucial point that, which **assets** can be calculated or not (as a coverage) in the debt management of local governments. According to the general principles and practice, the assets which can be calculated towards debt settlement: that portion of the assets which is over and beyond the non-marketable registered assets as defined by the law, and is over the assets necessary for the provision of basic services for the citizens. The other types are the assets which may not be calculated towards debt settlement: non or limited marketable assets defined by the law, assets related to the performance of a public tasks to which the state grants and contributes, revenues and funds of local government associations, supports and grants awarded to implementation of public tasks, or – for social considerations – flats and non-housing premises (which have been transferred from state ownership to local government ownership).

**b) subjects – parties**

By subjects, the debt is owed by one party, the borrower or debtor, to a second party, the lender or creditor. In the certain topic, the owners of the debts, the *creditors* need to be divided in two main categories upon the type of the debt. In the case of local government bonds they can be anyone: natural person (citizens), private and public, domestic or foreign, international legal persons. Credits and loans can be provided usually and only by banks, since these are considered as a business activity. In some countries, specialised financial institutions, special purpose vehicles or so called local government financing vehicles were established. These agencies and funds will be mentioned in the additional resources subchapter.

The *debtors* are local governments, local self-governments, municipalities with fiscal autonomy. In the European Union classification, it means the lower levels of Local Administrative Units (LAU level 2, formerly NUTS level 5), which consisted of municipalities or equivalent units in the 28 EU Member States.

\(^8\) Ákos Aczél, Dániel Homolya (2011): Risks of the indebtedness of the local government sector from the point of view of financial stability. in MNB Bulletin October 2011.
\(^9\) The local governments’ credit and bonds on the basis of Hungarian local government reports 2005-2013.
### Facts on LAU2 in the EU Member States 2016-2017

<table>
<thead>
<tr>
<th>Country</th>
<th># Lau</th>
<th># change</th>
<th>% change</th>
<th>Max population</th>
<th>Min population</th>
<th>Average population</th>
<th>Total population</th>
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<td>1,280,508</td>
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<td>FR</td>
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<td>*</td>
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<td>941</td>
<td>44,025</td>
<td>590,667</td>
</tr>
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<tr>
<td>LT</td>
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<td>1,455,280</td>
<td>780</td>
<td>5,625</td>
<td>590,667</td>
</tr>
<tr>
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<td>144,303</td>
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<td>590,667</td>
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<td>68</td>
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<td>229</td>
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<tr>
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<td>44,025</td>
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<tr>
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<td>47</td>
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<td>PL</td>
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<td>0.8%</td>
<td>1,753,977</td>
<td>1,323</td>
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<td>66,250</td>
<td>43</td>
<td>3,416</td>
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<td>RO</td>
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<td>0.2%</td>
<td>2,102,912</td>
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<td>22,222,894</td>
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<tr>
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<td>367</td>
<td>9,745</td>
<td>2,065,895</td>
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<td>635,181</td>
<td>96</td>
<td>17,695</td>
<td>5,503,297</td>
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<tr>
<td>SE</td>
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<td>935,619</td>
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<td>UK</td>
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<td>400</td>
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<td>1,073,045</td>
<td>2,203</td>
<td>157,759</td>
<td>61,368,314</td>
</tr>
<tr>
<td><strong>Total</strong>:</td>
<td>99,759</td>
<td>827</td>
<td>0.8%</td>
<td>3,574,830</td>
<td>0</td>
<td>5,054</td>
<td>504,194,519</td>
</tr>
</tbody>
</table>

Source: Eurostat (2018): Correspondence table LAU – NUTS 2016, EU-28 and EFTA / available Candidate Countries

### 2. Statistics

In a macroeconomic context the general government debt consists of the central and the local government debt, therefore EU member states raise attention to the financial obligations of the municipalities, which need to be calculated into the public debt. According to the official Eurostat figures the total debt amount of the local governments worth € 847.4 billion in 2017, which is 6.7 % of the EU28’s general government gross debt (€ 12,504 bn). A significant reduction can be identified, because in 2011 it was 13 % of the public debt. In some European countries, unsustainable local government debt has emerged as a problem during and after the financial crises, as a consequence of the central transfer reductions (Greece, Ireland, Italy, Portugal, Spain, Romania, United Kingdom). In these instances, actions must be taken to

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11 Eurostat (2018): Local government debt [gov_10dd_logd] and General government gross debt (tsdde410)
12 Kenneth Davey ed. (2011): Local Government in Critical Times: Policies for Crisis, Recovery and a Sustainable Future. Council of Europe. p. 43. For non-EU members see Network of Associations of Local Authorities of South-
correct any fundamental imbalance between responsibilities and resources. This also applies to the often murky financial relationships between municipal budgets and those of their utility companies,\textsuperscript{13} public service provider institution (e.g. local public education, healthcare).

**The amount of local government debts (million €)**

This treemap demonstrates that four European countries bear the largest local government debt. More than two-thirds of this belongs to four countries: France (€ 201.8 bn, 23 %), Germany (€ 147.2 bn; 17 %), Italy (€ 128.2 bn; 15 %) and the United Kingdom (€ 107.3 bn, 12 %). These are the largest countries in the European Union, with the highest population. Furthermore, with the Netherlands (€ 56.1 bn; 7 %) and Sweden (€ 50.4 bn; 6 %), it rises more than four-fifths (81.5 %).

In itself, the size of the debt is not enough information, because not the indebtedness is the real problem but the financing of it. Under the most favourable circumstances, the debt is proportional in size and rate of growth in its tax base; does not extend past the useful life of the facilities that it finances; is not used to balance the operating budget; does not require repayment schedules that put excessive burdens on operating expenditures; and is not so high as to jeopardize the credit rating.\textsuperscript{14} If the local government faces with the higher debt, but it has a balanced budget and enough revenues, resources to pay off the loans and bonds, then the debt behaves just as a temporary burden. Hence it is more interesting to take into consideration its burden for a single municipality or for a citizen (per capita).

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\textsuperscript{13} Eurostat (2018): Local government debt [gov\_10dd\_logd] and General government gross debt (tsdde410)


According to the statistics the ratio to the GDP or to the public debt of the local government debts show great variation, therefore there is no determining correlation ($R^2 = 0.32$ only) between them. The average rate in the European countries is approximately 3.8 % of the GDP and 7.7 % of the public debt. In small and central, southern European countries, both of them below the average, in which over 90 % of their debts belong to the central government. But it is worth to be mentioned that Eastern European local governments are financially strongly dependent on central state transfers, therefore the deterioration of local government finances can be partially attributed to EU funds: the co-financing requirements place a huge financial burden on local governments which are already striving to find sufficient resources for the provision of local services. In two cases the debt ratio is close to zero (Greece, Hungary). There is an exception of them: Estonia, where the local government debt is 36.7 % of the public debt, but according to the GDP is still low, 3.3 %. In the case of some leading European country (United Kingdom, France, Italy) the municipality debts are over 10 %, but according to the high public debt, it does not mean a great burden in the indebtedness. The French and Italian local government systems are similar, both of them centralised countries, with the small fragmented system. The third group contains the Scandinavian countries, in Finland, Sweden, Denmark the local government debt proportion is higher, especially in Sweden, where it is 10.6 % of the GDP and 26.6 % of the public debt. In these countries, the municipalities have a strong fiscal autonomy.

Local government debts as percentage of GDP and of Public Debt

Source: Own compilation based on Eurostat Government finance statistics [gov_10dd_logd], [gov_10dd_cgd] and OECD National Accounts Statistics http://dx.doi.org/10.1787/888933531611 and http://dx.doi.org/10.1787/888933531630

The total local debt and divided by the number of LAU level easily represents the different structures of the local government system of the EU member states. According to the number of LAU 2 level in the member states, the debt burden draws attention to another kind of problem. Due to the large differences, there is only a loose correlation ($R^2 = 0.52$ only) between the sum of the local government debts and per LAUs. Even country groups can be identified, by the structure of the local government system.

Local government debts in million € and per LAUs

![Graph showing local government debts in million € and per LAUs](image)

Source: Own compilation based on Eurostat (2018): Correspondence table LAU – NUTS 2016, EU-28 and EFTA / available Candidate Countries and Local government debt [gov_10dd_logd]

Especially in Denmark can be observed that the sum of local government debt is not so high (only € 19.7 bill.) but for a single municipality is significant: € 199.2 million. This can be noticed in the case of the Netherlands or in Sweden. The highest debt burden can be found in the United Kingdom, where the total amount and the debt per local government is the greatest: € 268.5 billion. It is a consequence of the fact, that in these countries, there are only few local governments: Denmark (99), the Netherlands (388) or in Sweden (290) or in the United Kingdom (400). But it is even interesting, that the debt burden per a municipality is low in French, German and Italian local governments, because of the small, fragmented, rather decentralized local government system: France (35,462), Germany (11,135) and Italy (7,983). In the southern and CEE countries the total amount and the debt per local government is not significant, as a result of the low level of the local debt, and the small fragmented settlement network (number of LAU 2 level): Greece (6,134), Czech Republic (6,258), Hungary (3,155),
Slovakia (2,926), Austria (2100). The position above the dotted line means, that in a local government system with strong autonomy the lower total amount of local debt, for the single municipalities the local debt burden is still significant; while the countries which are small fragmented, bear a larger sum, but this is dispersed among the numerous cities and villages.

On the other hand, it is worth to compare that how great is this burden for a single local citizen (per capita).

Local government debts in million € per LAU, and € per citizen

The southern and CEE countries are located in the same place; therefore, the small amount of local government debt is not significant for the local residents. Except in Lithuania (€ 1,618) and Austria (€ 1,710), which can be explained by the lower population. But in this context, some countries have rearranged. The highest debt burden per a citizen can be identified in Sweden: € 5,052 per capita. The same shift can be recognized in the case of Finland (€ 3,606), Denmark (€ 3,403) or in the Netherlands (€ 3,288). Even Belgium moved in the same direction, according to a higher debt per a citizen: € 2100. In France (€ 3,047), Italy (€ 2,116) and Germany (€ 1,784) or the United Kingdom (€ 1,749) the opposite can be observed, with the highest total amount of local government debt, the burden is lower, thanks to the larger population. At the beginning, Estonia was highlighted, but it is worth to be mentioned, that for a municipality (€ 758.1 million) and per a citizen (€ 576) the local government debt is low. According to similar differences, there is no interpretable (R² = 0.42 only) between the local government debts per LAUs and per local capita.
3. Possible solutions

The purpose of the debt management is the redemption: the way how the local government can escape from the debt burden.\(^{16}\) This typically means the repayment of a loan and/or bonds. Another major dimension is the confidence, even a temporary inability to repay debt can damage the credit rating of the municipality, which may increase the cost of future borrowing.\(^{17}\) In the case of the debt management strategy, several methods and processes can be distinguished, which can be applied parallel, depends on the amount and the structure of the debt and the decision of the local government. But it is difficult to generate a satisfactory general theory.\(^{18}\) Four categories can be classified for the redemption: changing the conditions (lower interest cost – debt conversion, advance refunding debt consolidation, compromise) repayment strategies (terminal annuity, snowball or stacking method, debt management agency) additional resources (surplus, sinking fund, specialised financial institutions), and finally state intervention (bailout – consolidation, limitations, financial guardian - insolvency administrator).

a) changes in the debt conditions

First of all, it is important to emphasize, that any changes in the debt conditions does not mean repayment or redemption. In the case of debts, the interest rate is a crucial point. At the beginning lowering the \textit{interest cost} even on loans and bonds, therefore the cost of the debt service will be lower for the local government, and ultimately for taxpayers, particularly for local citizens. This method bears public benefit, because it reduces the burden of the debt service and the taxpayers, but the reduction in interest rate even reduces the ability of bondholders to pay taxes.\(^{19}\) The \textit{advance refunding} means, that the local government exchange the loans or securities for a new loan or secured with a longer maturity, usually for raising new funds in order to payoff the matured loans. There is a strong correlation between maturity and the debt burden, because for long-term the local government should impose a higher tax burden on the taxpayers, or rearrange the expenditures in the local budget. The \textit{debt consolidation} method means that the local government takes out a new loan to pay off your other debts. Consequently, this allows grouping all or the relevant part of the debt under one plan that has a single interest rate. At last, if bankruptcy has occurred the negotiating a \textit{compromise} can be a solution, where the conditions, the maturity can be redefined.

b) repayment strategies

A temporal, maturity strategy, that – in accordance with the fiscal year – the local government follows the practice of paying off the debt on the basis of a *terminal annuity* by equal annual instalments. This method facilitates the debt service for the planners and policymakers, and even favourable for the lenders. There are some general *repayment methods*, how can the redemption formulate during the debt management by different ranking based upon the amount or the rates. In the case of *snowball method*, the focus takes place on the loan with the lowest balance (amount), regardless of the interest rate; then use the monthly payment for that debt to add to the payment being made on the next debt. The second one is the *stacking method*, which lists the debts in order of highest to the lowest interest rate. Once it is paid off, the municipality then shifts the focus to the next highest rate loan. If the local government cannot handle its indebtedness, a *debt management agency* can provide such services, and financial, legal, and administrative experts establish the strategy.

c) additional resources

The most evident and simplest method of debt redemption for the local government is to impose *additional taxes* on local citizens and firms, to pay off the old loan’s principal and interests, or the bonds’ yield. Anyway, this is a burden for the current local community and in long-term for the future generation. In exceptional situations, local governments are able to generate a *surplus* in the local budget, when this higher amount can be utilised as a prepayment in the case of loans, paying back another old debt, or buying back from the market (the creditors) their own bonds and securities. By establishing a separate *sinking fund*, the municipality deposits a certain (fixed) percentage of its annual income into this for usually 10 – 15 years, therefore it works like a depreciation fund, which is a systematic method of debt redemption. In some countries, for additional resources, state or local government-owned *specialised financial institutions* were established: France (Agence France Locale), Portugal (Fundo de Apoio Municipal), Spain (Fondo de Liquidez Autonómica), Sweden (Kommuninvest i Sverige AB), Italy (Cassa Depositi e Prestiti) or Denmark (Kommunekredit with a market share about 95% for 110 years), UK (Public Works Loans Board).

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d) state intervention

Despite of the theory, that the central government / budget is not responsible for the local government debts, in some cases, the central government bailout is the easiest way, which sometimes covered by the expression consolidation, as a euphemism. In Hungary the central government implemented a comprehensive consolidation between 2011 and 2014 in four phases, meanwhile a task-based financing system was introduced and many public tasks were transformed to the state administration The Italian government set up a funding plan in 2013 to repay the subnational governments’ accumulated liabilities (debt buyback), the municipalities are financed through the Cassa Depositi e Prestiti.

Another method of state intervention, when the legislator – upon the initiative of the central government – defines limitations for the indebtedness of the local governments. These mean restrictions of the fiscal autonomy of local governments, but as an ultima ratio, they can prove to be useful to gain the sustainability of the general government debt, and meet with the financial requirements of the Maastricht criteria. The limitations focus on a balanced local budget and as well-defined reduction goals, or prescribe authorisation of the borrowing from the central government, or both of them are applied simultaneously.

Types of limitations on local government debt

<table>
<thead>
<tr>
<th>Balanced local budget and/or a defined reduction goal</th>
<th>Authorisation of the borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria, Estonia, Finland, Greece, Italy, Netherlands, Poland, Portugal, Slovakia, Spain, Sweden, UK – England, Scotland and Wales</td>
<td>Czech Republic, Denmark, Germany, Hungary, Ireland, Latvia, Belgium, Croatia, France, Luxembourg, Slovenia, Romania, UK – Northern Ireland,</td>
</tr>
</tbody>
</table>


All the three solutions are followed by numerous countries, most of them apply the rules on balanced local budget and/or a defined reduction goals, while the authorisation of borrowing is also popular. Unfortunately, there is no correlation between the regulation method and the results in local government debts, because in each group some outstanding value can be found.

Another exceptional resolution, when ultimately for debt management a financial guardian or an insolvency administrator is seconded to the local government by the central government to conduct the debt settlement procedure. This process may be initiated by either the local government or its creditor(s). The financial guardian monitors the management of the

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local government, reveals the reasons for the indebtedness, accesses to all documents relating to the assets of the local government, prepares a referral on debt settlement, initiates the recovery of the overdue receivables, contacts with the creditors, carries out the duties and powers mandated by the law.

4. Main findings and implications

The amount of local government debts is not a major problem, the average ratio in the European countries is approximately 3.8% of the GDP and 7.7% of the public debt. It is not a significant macroeconomic obstacle for most of the EU member states to meet the Maastricht criteria. Only a few countries are faced with difficulties, the local government debt in Estonia 36%, in Sweden 26% or in Denmark 18.8% of the public debt, while in Finland and in France it is close to 9% of the GDP. The total local debt worth €847.4 billion, which four-fifth belongs to six countries (France, Germany, Italy, the United Kingdom, the Netherlands and Sweden). An overwhelming proportion (64.8%) of it is denominated in loans, since it is simpler and easier for municipalities to borrow money from the financial intermediaries, and they are able to provide suitable coverages. It can be observed, that according to the structure of the LAU 2 level, in countries with larger and more populous local governments (the United Kingdom, Denmark, the Netherlands or Sweden) the sum of the local government debt is not so high, but for a single municipality or for a local citizen, it still means a higher burden.

The purpose of the debt management is the redemption, which has many different ways, and for it is difficult to generate a satisfactory general theory. Four debt management categories can be classified: changing the conditions; repayment strategies; additional resources and finally state intervention. Unfortunately, there are no good/best practices for the first two methods. For additional resources, in some Mediterranean (France, Portugal, Spain) and Scandinavian (Sweden, Denmark) countries, state or local government-owned specialised financial institutions were established. The limitations focus on two main areas: a balanced local budget and as a well-defined reduction goal, or prescribe authorisation of the borrowing from the central government. In five countries, both of them are applied simultaneously. Finally, in most cases, only the direct and/or indirect state intervention methods were proven to be successful solutions.
References

- OECD (2017): Subnational government country profile. OECD.