

# Local Government Budgeting: Estonia

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## Table of Contents

1.	Local Government System .....	277
1.1	Legal Framework .....	277
1.2	The Local Government System .....	280
1.3	Functions and Competencies of Local Governments .....	282
1.4	Cooperation between Local Governments. Local Government Associations .....	284
1.5	Structure of Local Government Revenues .....	285
1.5.1	Own Revenues .....	286
1.5.2	Shared Taxes .....	290
1.5.3	Central Transfers .....	290
1.6	Borrowing and Macro-Economic Control.....	295
2.	Local Government Budgeting .....	297
2.1	Budgeting at the National Level.....	297
2.2	Strategic Planning at the Local Level.....	300
2.3	Structure of the Local Budget.....	301
2.4	Budgeting Process .....	304
2.4.1	Participants in the Budgeting Process .....	304
2.4.2	Budget Cycle.....	305
2.4.3	Changes in the Budget .....	308
2.5	Capital Budgeting .....	308
2.6	Budgeting Techniques .....	310
2.7	Information and Accountability .....	311
2.8	Budget Implementation .....	313
2.8.1	Accounting Dimensions of Budgeting .....	313
2.8.2	Cash Management .....	314
2.9	Audit System .....	315
3.	Issues and Recommendations .....	318
3.1	Local Government Organization and Budgeting.....	318
3.2	Local Revenues .....	320
3.3	Improving the Rules Governing the Assumption of Financial Obligations .....	321
3.4	Government Grants.....	323

3.5 Investments.....	324
3.6 Strategy Development and Budgeting.....	324
3.7 Reporting and Controlling.....	325
Notes .....	330

## List of Tables and Figures

Table 4.1: Municipalities by Size in 2000 .....	279
Table 4.2: Current Expenditures by Function and Level of Government, 1997–1999 .....	282
Table 4.3: Total Expenditures by Functions in 1999 .....	283
Table 4.4: The Structure of Current Revenues of Municipalities in 2000 ....	285
Table 4.5: Number of Municipalities Where Local Taxes Have Been Imposed, 1996–1999 .....	287
Table 4.6: Sources of Investment Funds According to Local Community Size (2000) (in %).....	295
Figure 4.1: Institutional Structure of Local Government in Estonia .....	280

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## 1. LOCAL GOVERNMENT SYSTEM

### 1.1 Legal Framework

Estonia has developed a rather autonomous model of one-tier local government with 247 local governments—42 urban and 205 rural municipalities. The main pillars of local government autonomy were introduced by the Constitution:<sup>1</sup> an independent representative council (ch. 156); independent budget and the right to levy and collect taxes (ch. 157); the guarantee that the state cannot impose supplementary functions without funding from the state budget (ch. 154); the right to form unions and joint agencies with other municipalities (ch. 159) and the right of municipalities to give an opinion that must be taken into consideration before the boundaries of municipal units are altered.

The following acts also play a significant role in the legal framework for local governments:

*The Local Government Organization Act* (adopted on June 2, 1993). From 1994 until 1999, 26 amendments were made to this Act.

*The Rural Municipality and City Budgets Act* (adopted on June 16, 1993). Provisions concerning borrowings by a municipality are considered to be the most important amendments to this Act.

*The Rural Municipality and City Budgets and the State Budget Correlation Act* (adopted on December 13, 1995).

*The Local Taxes Act* (adopted on September 21, 1994). The Act followed largely the text of a similar act adopted in 1938 and did not take into account the substantial changes that have occurred since then.

*Territory of Estonia Administrative Division Act* (adopted on February 22, 1995).

*The Municipal Council Election Act* (adopted on May 29, 1996).

In addition to the basic principles and regulations set out in these Acts, the local governments are regulated by general acts:

*The Principles of Property Reform Act* introduced the institution of municipal property.

*The Rules Concerning the Municipalization of the State Property* were adopted in 1992 (and last amended in 1999).

*The Government of the Republic Act* (adopted in December, 1995) regulates the activities of government agencies, including the function of the county government in relation to the local government as well as the right of local government unions to influence the nomination of the county governor.

*The Public Service Act* was adopted on February 15, 1995.

Parliament (*Riigikogu*) ratified the *European Local Government Charter* on September 28, 1994.

All municipalities are governed by universal regulations, although their size and capacity are rather different.<sup>2</sup> In case they are unable to perform their responsibilities, the local government cannot delegate its functions to the upper-tier (county) of government. The central government can and has intensively delegated supplementary functions, including its own functions, to the local government. The Constitution states that the government must cover the costs of implementing any function delegated by the law. However, the issue of whether the legislator and the government have actually followed this requirement is one of the most debated issues in the negotiations between the local government and the central government.

Municipalities can establish *municipal districts* and delegate its functions to this sub-level. Sub-governments are established in larger cities (Tallinn). In some geographically large municipalities with several “centers of gravity,” sub-units were developed to better represent the interests of the remote areas.

Municipalities may establish *voluntary associations* with the aim of mutual cooperation in the delivery of services and in the representation of the interests of local government at the county and state level. These cooperative associations have not developed however, because municipalities have taken very selfish positions. In addition, they have rather different priorities and bottlenecks in the management of their own areas. Government still has not identified a better tool than compulsion: ranging from the idea to obligate local governments to join unions on up to the consolidation of units. Associations of the second type were established in all Estonian regions with the aim of mediating intergovernmental relations.

Hence, along side the idea of consolidating the local government units, the centralization of government services is in progress. This is testimony to the fact that the

government is changing the overall paradigm of the autonomous model that initially relied on the priority of democratic values.<sup>3</sup>

*County government* is the general administrative agency, which represents state interests at the regional level and which supervises the activities of the local government units. There are fifteen county governments. Central government field offices are located in counties (25–40 in each county) and the county governor is supposed to coordinate their activities to ensure balanced development within the region. The government appoints a county governor for a fixed five-year term after the approval of the local government union. Only after this body has rejected the second candidate nominated by the government can the latter appoint the governor without approval of the local government union. Although the county governor is responsible for the supervision of the work of government field offices, he/she has no formal devices for the steering of those offices except through informal contacts. The creation or abolition of field offices is completely at the discretion of the ministries. As a result, these offices are mushrooming at the regional level. Field offices frequently employ from three to five civil servants. The Department of Local Government and Regional Development is located within the Ministry of Interior.

In addition to these formal and informal coordination mechanisms, the Ministry of Finance plays an important role in steering local government activities. Finance departments at the county government level are responsible for the supervision of government finances at the regional level. The recently established state treasury has substantially reduced the importance of these departments.

Local governments in Estonia have a high average population size per unit (see Table 4.1). Half of the local governments have less than 2,000 inhabitants. The majority of the population lives in the largest municipalities. The biggest towns in Estonia, by population, are Tallinn (411,594) and Tartu (100,577). The smallest municipality is Ruhnu, a rural municipality on the island of Ruhnu, with 72 inhabitants (as of January 1, 1999).

*Table 4.1*  
Municipalities by Size in 2000

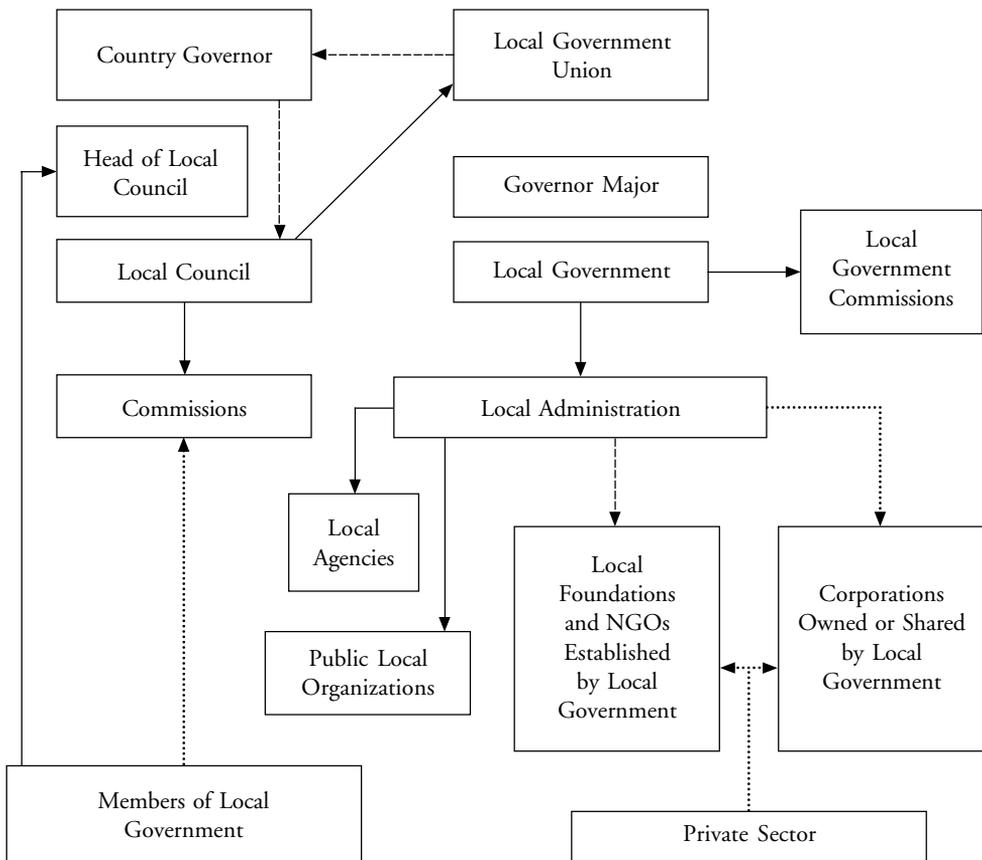
Number of Inhabitants	Number of Municipalities
Less than 999	25
1,000–1,999	96
2,000–4,999	88
5,000–9,999	22
10,000–49,999	11
50,000–99,999	3
Greater than 100,000	2

## 1.2 The Local Government System

The institutional structure of Estonian local government is presented in Figure 4.1. It is the typical structure for the local self-government with an elected council that appoints the local government.<sup>4</sup>

The *municipality council* is elected every three years. It has the sovereign authority to adopt the municipality statute, to make the development plan and budget, to establish local taxes and tax exemptions, to fix the rules for managing municipality property and to appoint the members of government and define their salaries. In short, the council has full control over the final decisions concerning local finances.

Figure 4.1  
Institutional Structure of Local Government in Estonia



The local council is much more regulated by the legislation than other institutions of local government. The number of local councilors is regulated as is the inclusive list of its sovereign competence. The law does not prescribe the creation of committees, except the audit committee. The statutes of the municipality establish other committees. A great variety and combination of committees can be observed.

There are standing and *ad hoc* committees. The head of committee must be a member of the council. Other members of council can be representatives of the community. This is not the case for the audit committee, in which all of the members must also be members of the council. The audit committee has no authority to audit all the activities of government. So external experts are also involved in the audit committee.

The formation of a party faction is not prescribed by the law, but can be prescribed by the statutes of the local government unit.

*The local executive committee.* The head of the local executive committee is appointed by the local council and can be dismissed following a vote of no-confidence. The rules for electing the head of government as well as those for forming the government are regulated by the statutes of the local government. Members of the government (four to six persons on average) are appointed by the head of the government following the approval of the council.

Actually, members of the government are politically senior to the head of a department or—where (as in small governments) the departments do not actually exist—the latter are assistants to them. Members of the government can be part-time and have their full-time occupations in business or in the public sector. The vice-governor is usually responsible for budget and financial issues of the government. Municipal government may establish committees and working groups in order to work out proposals with the participation of external experts.

The local government may found *independent agencies and organizations*. Agencies have been created in the largest cities for the implementation of government functions that in small municipalities are managed by the unified administration. Public *organizations managed by local government* do not carry out direct government functions, but have managerial autonomy in the delivery of services. Although they are usually completely financed from the local budget, some of them can receive supplementary financing (user fees, individual contributions and donations, external aid, etc.).

With some caveats, the creation of organizations regulated by private law, but affiliated in different ways to the local government, is very reasonable. *In this way, principles and values of classical public administration and budgeting could be well combined with modern practices of public management, above all with market-type mechanisms.*

*Foundations and non-governmental organizations (NGOs)* are established in cases where the public law restrains effective management or service delivery. Most frequently these are organizations managing culture and heritage, specific real estate, tourism and housing.

*Commercial enterprises* are different from foundations and non-profit organizations because they have their own basic source of revenues arising from service delivery or the production of goods. Local government can be the owner, a shareholder and/or one of the contractors of these companies. Their budgets are completely independent and the local government does not have any financial or other responsibilities for their economic performance. The local government directs these enterprises through the supervisory boards and attempts to control the prices of natural monopolies.

Smaller local governments often cannot sell their assets and therefore are forced to deliver services alone. However, the local government can decide to limit the commercial risks involved in providing these services. In order to do this, the following specific forms of organization are used.

- a) *Cooperative society of apartments.* The status of a cooperative is similar to that of a NGO, but with some specific differences. The foundation of a cooperative is decided on by a general meeting of the council. Following that, all apartment owners automatically become members of the cooperative. Thereafter, the local government also cannot determine this part of budget expenditures, because these are then obligatory for the local government after a decision by the general meeting has been taken.
- b) *Property rental company.* For instance, in the city of Türi, the local government rents heating equipment to the heating company.

### 1.3 Functions and Competencies of Local Government

The reliance on the general laws usually improves the accountability for the implementation of its functions by the local government. Areas that are exclusively the responsibility of the local government are prescribed by the Local Government Organization Act and cannot be negotiated.

Table 4.2 below shows some macro-economic figures concerning expenditures at both governmental levels.

*Table 4.2*

Current Expenditures by Function and Level of Government, 1997–1999

	Central Government and Social Security			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
As a % of GDP	29.07	30.03	31.65	6.82	6.80	7.12	33.28	34.25	36.20

Expenditures by functions are shown in Table 4.3.

*Table 4.3*  
Total Expenditures by Functions in 1999

Functions	As a % of the Local Government Budget
1. General public services	10.8
2. Defense and public order	1.3
3. Education	35.1
4. Health	2.3
5. Social security and welfare	10.4
6. Housing and community amenities	2.9
7. Recreation and sport	4.1
8. Culture and art	7.9
9. Economic services	13.1
10. Fuel and energy	1.5
11. Agriculture, forestry, fishing and hunting	1.6
12. Transportation and telecommunications	6.9
13. Other economic affairs	1.1
14. Other functions	1.0
15. Total	100.0

The accountability for the implementation of functions by the local government depends largely on how the functions of local government units are assigned. The plan to establish a clear mechanism for the assignment of functions could not be realized. Instead, the following very complicated and confused system of assignments and tasks emerged.

- 1) The definition of the primary competencies of the local government is contained in *the general laws* on local government.
- 2) There is an assignment of concrete *local tasks* to the local government *by specific legislation* within the framework of general functions.
- 3) An assignment of *state functions* to the local government is made *by special laws*.
- 4) Any function that the local government is responsible for, but that it currently cannot implement due to insufficient capacity, is still managed by state organizations. These include, above all, organizations involving social care (for the elderly, for the disabled, etc.).
- 5) There are functions that the local government could and did take over because of local customs and needs (e.g., the development of heritage).

- 6) Finally, there are state functions that are financed from the local government budgets because of the low capacity of the field services (e.g., police services).

Art. 154 of the Constitution declares that “all local issues shall be resolved and regulated by local governments, which shall operate independently in accordance with the law.” There has not been, however, a general definition of *what the local issues are*. The list of functions should be supplemented by the criteria for differentiating tasks *between the local, regional and central levels*. This absence of clear criteria has made it possible to assign numerous supplementary functions to the local governments by special laws and especially by governmental decrees.

According to the constitution, expenditures related to the implementation of central government functions should be covered from the state budget. The normative redistribution of government support funds and the use of general grants are given as reasons for the refusal of the central government to transfer additional funds. Besides, the financial calculation of the costs of implementing legislation in Estonia is inadequate.<sup>5</sup> Therefore, the simultaneous assignment of functions by laws together with the definition of appropriate rates of compensation cannot be carried out even in cases where the central government would like to do this.

Even in cases where it is obvious that the local government is not able to fulfill its functions, they have no right to delegate them to the upper-tier; nor does the central government have any responsibility to ensure a minimum level of services to citizens in that local government unit. The only way to increase the capacity up to a certain minimum level is through the consolidation of local government units. Hence, this structure of local government units prevents the building of capacity through further decentralization.

On the other hand, the central government has no tool to compel the local government to implement its functions. The central government is aware that the assignment of functions to the local authorities does not take into account their real capacities. Thereby, it overlooks the failure of some local government units to implement their functions appropriately. The gap in accountability is more than obvious. Since governmental grants are calculated on the basis of revenues, *implementation standards* are not used in the evaluation of the financial needs of the local government.

## 1.4 Cooperation between Local Governments. Local Government Associations

According to Ch. 12 of the Local Government Organization Act, a local government unit can establish local government associations. Currently, there are three of these:

the Estonian Association of Towns, the Association of Rural Local Municipalities and the Association of Estonian Local Authorities (founded in 1993).

These associations were formed for the purpose of representing the joint interests of local governments to central powers. As quasi-representative bodies, they are also the forum for the settlement of controversies that emerge between local governments. The obvious rivalries existing between these associations led to the formation of the fourth body: the Cooperation Assembly of the Local Government Unions. This was established in February 1994 as the standing representative body of the three local government national associations for the purpose of coordinating negotiations with the central government. The primary functions of this council are:

- the development of contacts with parliament and government;
- the definition of basic principles and tools for local government associations to cooperate;
- the participation in the elaboration and harmonization of acts related to local government activities and interests;
- the formation of joint expert committees for the elaboration of joint positions.

Not all local government units are members of these unions. The larger local government units are usually members and have to contribute the major share of funds to the unions budgets. At the end of the 1990s the central government attempted to make membership of these unions compulsory. This was viewed as a crude violation of the concept of local autonomy. The role of local government regional associations is currently one of the most controversial issues being discussed as part of the development of a revised conception of local government.

## 1.5 Structure of Local Government Revenues

The following table shows the structure of current revenues of Estonian municipalities in 2000.

*Table 4.4*

The Structure of Current Revenues of Municipalities in 2000

	% In Total Budget
1. Own revenues 68.1	
Of which: local taxes	0.9
2. Current transfers from the central government and tax sharing on non-derivative basis	20.0

*Table 4.4 (Continued)*  
The Structure of Current Revenues of Municipalities in 2000

	% In Total Budget
Of which: unconditional transfers	11.0
conditional transfers	8.0
matching transfers	0.9
<i>ad hoc</i> transfers	0.1
3. Other revenues	10.4
Total	100.0

### 1.5.1 Own Revenues

#### *Local Taxes*

According to the law concerning local-taxes, the local government may impose in its territory the following taxes:

- Poll tax;
- Local income tax (from the year 2000 a separate law);
- Sales tax;
- Boat tax;
- Advertisement tax;
- Road and street maintenance tax;
- Motor vehicle tax;
- Animal tax;
- Entertainment tax.

According to the Local Government Organization Act, the municipal council may establish taxes and amend tax rates before the adoption or amendment of the local budget. Local taxes are levied from the beginning of the budget year or from the date of a budget amendment.

The central government sets maximum rates for some local taxes such as sales tax in order to avoid detrimental tax competition among local governments. However, the possibilities for tax competition are rather limited in Estonia owing to the low level of local incomes.

Some taxes (poll tax, local income tax and entertainment tax) have not been imposed by any of the local authorities during the last few years and thus remain only theoretical possibilities (see Table 4.5).

Some of the reasons for this are detailed below:

- the financing system does not favor local taxes;
- local taxes are difficult to administer;
- it is hard to organize the collection of local taxes because local authorities do not have their own tax authorities;
- the revenue from local taxes is hard to forecast;
- imposing local taxes is locally unpopular;
- municipalities prefer fees.

*Table 4.5*

Number of Municipalities Where Local Taxes Have Been Imposed, 1996–1999

	1996	1997	1998	1999
Sales tax	24	23	21	15
Boat tax	3	3	3	2
Advertisement tax	47	49	52	50
Road and street maintenance tax	15	14	22	14
Motor vehicle tax	2	1	2	2
Animal tax	9	10	6	5

Despite the low effectiveness of local taxes, the Ministry of Finance is pushing for their use to be increased. During the negotiations on the support fund and on investments from the central government, the lack of sufficient local tax revenues is sometimes used as a justification for the refusal. However, this appears to be more of a bureaucratic device used in situations where there are no substantial counter-arguments in the negotiations.

The main sources for funding local government expenditures are taxes. The first controversy of local budgeting arises because the central tax board manages the collection of all government taxes. The actual flow of funds from taxes to the accounts of local government is contingent both on the ability of the tax board to organize the timely transfer of funds and on the smooth inflow of cash to the state treasury. Although the Estonian local authorities have not faced substantial breakdowns in the receipt of their budget funds, there are substantial monthly fluctuations. Hence, the local government cannot rely on a planned schedule of tax revenues for financing current expenditures.

#### *Non-Tax Revenues*

There is no separate regulation concerning local government non-tax revenues. There is a regulation concerning income from property (such as revenues from natural resources), fees and fines, but it is the same as for the central government.

The primary non-tax revenues are:

- revenues from water usage;
- revenues from mining;
- rents from land;
- dividends;
- interest;
- fees;
- fines;
- sales of goods and services.

A significant item of non-tax revenues comes from the *special use of water and other natural resources*. These revenues—primarily fees—are meant to compensate for the damage caused by different activities to underground water networks or to the use of these resources for business activities. Of the fees collected from special usage of water, 50% are returned to the Environmental Protection Fund and 50% go to the local government's budget. An exception exists in cases where the soil or water is polluted. In these cases, the fees to be paid are calculated according to the Law on Pollution Fees. The municipal council may decide to reduce the rate or even to not collect the part of the fee that is returned to local government's budget.

*According to a series of laws concerning the environment and its protection, 30% of the fees collected from licenses granted to large mines is returned to the state budget and 70% goes to the budget of the local government in whose territory the mining takes place. These two revenue sources make up 60–70% of the local government's budget in some municipalities in Ida-Virumaa county, where the largest mines and power stations are located.*

Other *fees* form a very small part of non-tax revenues. The State Fees Act states that fees are generally revenues of the central government. Only fees on a few services defined by law count as revenues for local governments (e.g., for some legal services provided by the *local administration* such as business licenses, notarization of documents and the issuance of sales, hunting and fishing licenses).

The fee rates are prescribed by law and their collection is controlled by:

- a central government agency, if the institution funded by it is the collector;
- the tax office, if another institution (either central or local) is the fee collector;
- a local government agency, if the institution funded by it is the collector.

*Fines* are an important source of revenues for local governments. Only fines based on administrative law (as opposed to criminal law) can be a source of revenue for local governments. The regulation of these kinds of fines is recorded in the Code of

Administrative Offences. These fines can be revenue sources for both central and local governments. A local government is the collector in the following cases:

- a person is in violation of a law made by a local government;
- a person breaks car parking regulations or uses public transportation without buying a ticket;
- in other cases defined by law.

The most significant part of non-tax revenues is derived from the *sale of goods and services* (user charges). Usually, services that are provided by *organizations subordinated* to the local governments are quite autonomous in establishing user charges for services. These charges apply to the following main fields and institutions:

- educational and scientific institutions (mainly charges to cover the cost of meals in pre-school, primary and secondary schools);
- cultural and art institutions;
- sports and recreational institutions;
- healthcare institutions;
- social care institutions;
- other sales of goods and services.

On a parliamentary or central governmental level, there is almost no regulation concerning the sale of goods and services. The establishment of the exact rules is, of course, to be defined by local government acts. (An exception exists for the cost of meals in pre-schools, as these have to be totally covered by parents, as stated in the Pre-School Institutions Act.)

Many other services at the local level—above all, infrastructure and public utility services—are provided by the *private sector*, either by *companies owned by local governments*, by *foundations*, by *NGOs* or by *private companies*.

One of the largest sources of revenue in Estonia is derived from the *sale of assets*. Together with revenues earned from rent, these revenues make up almost 15% of all revenues.<sup>6</sup>

Companies that were not sold completely were reorganized as limited liability companies owned in part by the local governments. The local governments are shareholders primarily in water and heating companies as well as housing maintenance companies. Rarely are local governments shareholders of companies involved in road maintenance, sports, health or sewage disposal.<sup>7</sup> Some revenues could theoretically come from *dividends* paid by these companies. However, since these companies are newly established and have made substantial investments, this has not yet actually been realized.

Local government revenues from assets are derived primarily from the *rents of rooms and buildings* and from payments for building sites. Some municipalities have

government-owned apartments to provide housing for low-income persons or for those who cannot purchase apartments. The rent paid by the tenants is used for the maintenance of the apartments.

### 1.5.2 Shared Taxes

*The share of the personal income tax* forms the largest proportion of local governments' revenue. Of the total tax collected, 44% goes to the state budget and 56% goes to the budget of the local government in which the taxpayer is registered. (In Estonia, the income tax rate is 26%.)

The *land tax* is the second most important tax in the local government revenue structure. The local government council may set the tax rates within the limits set centrally (from 0.5 to 2.0% of the assessed value of land per year). It is a very unique shared-tax since 100% of the land tax is returned to the local government budget. The absence of tax collecting capacity as well as the large possibilities for tax evasion could be the reasons why this is still a central tax.

Of the *gambling tax*, 5% is transferred to the budget of the local government in which the gambling site is registered and operates. Revenues from this tax are very small. Mainly large towns, e.g., the city of Tallinn, receive revenue from this tax.

### 1.5.3 Central Transfers

The Rural Municipality and City Budgets as well as the State Budget Correlation Act established general principles for the central appropriation of transfers to local budgets.<sup>8</sup> According to the State Budget Law, allocations to the municipalities can be either for allocations from the support fund (unconditional grants) or for conditional grants. In addition to central transfers, local governments can also get resources from other programs.

In 2001, the budget for central transfers was divided into the following groups:

- 1) transfers from the support fund of the state budget;
- 2) conditional transfers from the state;
- 3) investments from local governments in the Public Investment Program;
- 4) other various transfers.

In 1999, transfers from the support fund in the state budget (52.3%) formed the largest item in the budget of the municipalities. The second largest was the transfers for investments (29%). The remainder of the grants formed a relatively small part (from 0 to 3.7%).

### *Unconditional Transfers*

*Transfers from the support fund in the state budget* are unconditional, i.e., the local governments may use the amounts received from the support fund at their own discretion. The central government does not impose any restrictions on the purpose of usage. The operating expenses for tasks prescribed by law and the capital expenditures necessary development are financed from this fund.

The purpose of unconditional transfers is to supplement and equalize the revenues of local governments which have vastly different revenue bases. Special unconditional transfers are also made to areas located in specific geographical areas (remote areas, islands, etc.).

The share of unconditional transfers in the local revenues has decreased over recent years while the share of conditional transfers allocated through ministries has grown. The overall amount of support funds and other intergovernmental transfers to local government budgets have been decided by negotiations since 1994. Hence, the negotiations have mainly revolved around the issue of how much the central government can transfer to local governments while at the same time maintaining a balance at the macro-economic level, avoiding a budget deficit and minimizing the tax burden.

The transfers from the support fund to local governments' budgets are calculated according to the following formula:  $T_n = (m \cdot a_k - a_n) \cdot 0.9 \cdot c_n$  where:

$T_n$  is the amount transferred to the local government budget from the support fund at time  $n$ ;

$m$  is the coefficient of support level (the standardization coefficient);

$a_k$  is a country-wide average over the last two years for the actual income from the personal income tax and the planned average level of income paid to local governments' budgets from the land tax and fees charged for using mineral deposits per capita in Estonian kroons;

$a_n$  is the local governments' specific average over the last two years for the actual income from the personal income tax and the planned level of income paid to local governments' budgets from the land tax and fees charged for using mineral deposits per capita in Estonian kroons;

$c_n$  is the number of inhabitants in the local government unit at time  $n$ .

The formula and the basic principles of the formula are negotiated. This formula, with slight changes, has been valid since 1995. From the start, the biggest problem has been the value of the *standardization coefficient*. It depends on the total amount of the support fund. Every year this coefficient is different. For example, in 2001 it was 1.16. The Cooperation Assembly of Local Governments Associations has tried to tie

this coefficient to a specific index (e.g., the size of the state budget, the value-added tax, the income tax, etc.), but so far the attempts have not been successful.

The existing formula does not take into account the expenses and specific functions of the local governments. It equalizes only the differences in revenues compared to the country averages. Currently, the Ministry of Finance is working on a new formula for local government transfers. This formula should also take into account the level of expenditures for specific local governments.

Every year there are around seventeen local governments which do not receive support. In these municipalities, the personal income tax per capita is over 110–112% of the Estonian average. The revenue equalization system in Estonia is not completely self-financing. This means that no revenue is redistributed from one local government to another. But those local governments which have own revenues lower than the Estonian average do receive support from the state budget.

### *Conditional Transfers*

The amount and disposition of conditional grants is prescribed in that section of the state budget that treats the additional conditional transfers from the Government Reserve Fund during the budget year.

The local government can receive conditional grants directly from the *state budget* (matching transfers) or from the *budget of the appropriate ministry*. A part of conditional grants can be given for investments related to the Public Investments Program. The other part is usually given to finance current expenditures for costs related to implementing state functions or policies in the local government units. In this case, the transfers are made from the budget of the appropriate ministry.

Up to 2001, the biggest part (in 1999, almost 80%) of grants was transferred by the Ministry of Social Affairs. These represent the resources needed for subsistence support to low-income persons and for supplementary social allowances. The remainder of the transfers is for other social welfare needs: social care programs, compensation to the handicapped for public transport, compensation for electricity charges to the risk groups, governmental relief and other compensation (e.g., support in case of funerals), labor market services, etc.

The Ministry of Environment transfers resources primarily for capital expenditures (for which the local government has applied), nationwide planning and pilot projects, forest security expenses and for the maintenance of institutions related to environmental protection.

The role of the Ministry of Education was significant up to 2001. The funds were targeted to the support of youth projects, to the organization of general events at the local level and also to support the learning of the Estonian language. From 2001, the responsibility for the salaries and social security payments of teachers was transferred

from the central government budget to the budgets of the local government units. The amount of the related grant was 1.2 billion EEK, which amounts to about 10% of the typical local government budget, i.e., it is as large as the sum of all other conditional transfers.

The Ministry of Defense provides the funds to the local governments for maintaining the register of persons eligible for and obligated to serve in the armed forces. The Ministry of Culture provides funds for the maintenance of district libraries (salaries, social security payments and administrative costs), for the support of various district cultural activities, for youth sport schools, for mass sporting events, for the restoration of memorials and other expenses. The Ministry of Economic Affairs provides funds for energy saving programs and for other investments that are connected with the Ministry. The Ministry of Finance finances statistical work and the Ministry of Internal Affairs pays for the development of county government and the municipal rescue service.

The Ministry of Transportation and Communications gives: (a) resources for maintaining the ferry service to small islands (the islands that are a part of the municipality); (b) subsidies to the local and regional bus services for municipalities that contract these services out to entrepreneurs and (c) subsidies for buying buses and maintaining the harbors for ferries.

From the beginning, the strategic aim of the government has been to promote local efforts in the subsidized fields, although the actual development has been the opposite. The formula for the distribution of unconditional transfers departs from the revenue basis and is aimed at reducing differences in the revenue basis in a way that will not discourage the most successful local government units. This should be the device to motivate local governments to spend less and to increase the revenue base. The majority of local governments, however, cannot widen their revenue base because of the decline in both the labor market and the economy. Therefore, this mechanism of equalization was not conducive for lessening the dependence of local government on various government transfers to finance investments and developments.

Launched in 1995, the *Public Investment Program* (PIP) provides investment support to local governments from central government grants. Resources are allocated to investments that exceed 0.1 million EEK (or 8,000 EUR), with the stipulation that the local government's share of the financing be not less than 10% (although this requirement is often ignored). The counties have established their own rules in accordance with government regulations.

In 1995, the role of regional allocations was almost 100%, but this was steadily reduced so that in 1999 it amounted to only 28%. This system was applied until 1999. After taking office, the new government decided that the investment supports to local governments should be allocated through the ministerial budgets and this has been the case since 2000.

In the new system, the local government is required to submit its application for investment support to the county governor, who then compiles the list of investment needs and ranks them according to their priorities. The county government must submit the list of investments to the relevant ministry, where the decision is made concerning the inclusion of the projects in the Public Investment Program (PIP). A ministry must submit its application to the Ministry of Finance for the same purpose. Members of Parliament retain the possibility to include new investments through political lobbying, thereby increasing the total amount of the program through the addition of extra projects. Often the ministries change the list of priorities without the approval of or consultations with the county government or local government regional unions. This is the negative side effect of the centralization of financing within the framework of the program.

Besides the PIP, investment supports are granted to local governments from the budget of the *Heritage Conservation Inspection* for the purpose of heritage restoration. The Ministry of Culture launched "The Manorial Schools Program" effective July 1, 2001.

Local governments can have a substantial local revenue base for large investments within its own territory. An inadequate revenue base can be compensated for with other sources of investment funds. Ministerial investments are obviously targeted to partially compensate for the revenue base of the smallest local communities. (It must be remembered that more than half of the population lives in communities with less than 2,000 inhabitants.) At the same time, the larger communities depend on loans and foundations for funding.

#### *Other Various Transfers*

All local governments have the possibility to apply directly for aid from various local and foreign funds and programs. Of the local funds, the most important are the Center of Environmental Investments and the Agency of Estonian Regional Development. The problem with applying for the foreign aid is the application capacity of local governments. All foreign aid programs have very strict requirements and local governments do not have the knowledge and skills needed for the application process. The Co-operation Assembly of Local Governments Associations and the Association of Local Governments have not applied for aid at all; some bigger towns and municipalities have applied directly. There has been some cooperation with the Danish, Finnish, Swedish and Dutch Associations of Local Governments, but in these cases the foreign partners have been the applicants.

The current municipal investment support system is obviously very scattered, which sometimes results in bad coordination and duplication (see Table 4.6). In practice the appropriation of investment support is decided separately each year and for a particular

year only, which makes it impossible to plan capital expenditure in the local government with a long-term perspective.

*Table 4.6*  
Sources of Investment Funds According to  
Local Community Size (2000) [%]

Local Government Unit (Number of Inhabitants)	Own Income	Loans	Government of the Republic Reserve	Transfers in 1999	Investments through Ministries	Funds, Foundations, etc.	Other	Total
Rural municipality < 1,500	27.4	9.9	0.5	0.4	49.4	11.6	0.6	100
Rural municipality 1,500–3,000	50.9	7.4	0.5	0.0	30.7	9.9	0.6	100
Rural municipality > 3,000	56.7	6.1	0.0	3.9	30.4	2.8	0.1	100
City < 10,000	26.8	15.0	0.5	0.5	36.7	20.4	0.0	100
City > 10,000	52.9	6.6	0.1	1.3	24.7	3.9	10.4	100
Tallinn	99.7	0	0	0	0.3	0	0	100

The share of self-financing capacity is the first indicator that credit institutions consider in the assessment of loan applications. The income base also determines the possible loan burden that a local government is permitted to assume according to law. Finally, the income base determines the amount of financial obligations that municipality is capable of assuming without exceeding its debt servicing capacity.

## 1.6 Borrowing and Macro-Economic Control

Borrowing by Estonian local governments is regulated by the Local Government Organization Act, the Law on the Budget of Municipalities, the State Budget Law and the Law on Taking Foreign Loans for the Republic of Estonia and Issuing State Guarantees for Foreign Contracts.

Municipalities can take loans or issue obligations under the following conditions:

- 1) The total of all unpaid loans, issued obligations and other liabilities arising from these plus the new loans and obligations may not exceed 75% of planned budgetary revenues in the current year (excluding conditional grants from the central government).

- 2) The total debt servicing payments for both the existing and the new loans together cannot exceed during any budget year 20% of the planned budget.
- 3) The municipality can also take short-term loans to cover current costs. These loans are not classified as loans described in sections 1 and 2, i.e., those restrictions do not apply to short-term loans. Many municipalities take this kind of loan in May or June when employees are paid their vacation bonuses even though the related revenues have not yet been received in the budget. This kind of loan must be repaid by the end of the budget year.
- 4) These restrictions (section 1 and 2) are not relevant for loans that have state guarantees. The state guarantee is given for foreign loans when a creditor demands a state guarantee or when the requirement for a state guarantee is based on law. The state may give guarantees totaling up to 15% of the budget income of the current year.
- 5) Loans to be taken or obligations assumed for investments must be part of a municipal development plan.
- 6) The municipality is not permitted to give loans or guarantees for loans. Study loans are the exception.
- 7) Borrowing and assuming other financial obligations is the sole right of the municipal council.
- 8) The government of a municipality or town must present a copy of the loan contract or obligation to the Ministry of Finance within 30 days after concluding the contract. The Ministry of Finance then reviews the compliance of the new loan with the legal framework defining the loan limitations.

Regulating the borrowing activities of local governments is connected with the regulation of the financial distress situations or the so called “bankruptcy” of local governments. The law does not regulate what can be done with municipalities having payment difficulties. The local government is not allowed to declare bankruptcy according to the Bankruptcy Law of the Estonian Republic. But at the same time, there have been several situations where local governments have been in a position of financial distress. In these cases, since there did not exist a mechanism for regulating the whole situation, the government had to deal with each of these cases separately. This government intervention has only provided one-time solutions, but no general framework.

From the standpoint of the central government, Estonia’s fiscal policy is characterized by a stable tax system, an adequate control of expenditures and a conservative approach to borrowing. As a result, the general government deficit and the official debt burden have been relatively small.

## 2. LOCAL GOVERNMENT BUDGETING

### 2.1 Budgeting at the National Level

The State Budget Law and the decrees of the Ministry of Finance define the rules for budget preparation. The fiscal year of the state and the local governments is a calendar year. The budgetary process in the central government lasts 28 months, of which the preparation lasts for the first eight months, the fiscal year for the following twelve months and the auditing and reporting for the final eight months.

For local budgeting there are two interfaces. The Ministry of Finance sets the budget rules and economic forecasts that determine the general environment for local budgeting. Government support grants are decided after completion of the intensive discussions that run parallel to but separate from the state budgeting process.

A budget *strategy* was prepared for the first time in the history of Estonia in 2000. But in the State Budget Law (Adopted June 9, 1999), it was not enacted. In the draft of the new law (that should come into effect during the preparation of the state budget for the year 2003), §26 states that the budget strategy will be a legal act enforced by the government. It must be the basis for the preparation of the state budget and of the draft of the local government budgets. The strategy will also be binding for the local governments.

The central government budget *preparation process* includes the following steps:

- *Government's budget strategy:*  
In April the government announces its policy aims, economic forecasts, priorities, etc.
- *Directives for preparing the draft budget:*  
In May the Ministry of Finance prepares the decree that gives the directives and deadlines for preparing the draft budgets to ministries. In this decree the entire process of budget preparation is regulated, up to the presentation of the draft budget to the parliament. This decree is not a binding document for the local governments, but the information in it (economic forecasts, decrees and laws that will be adopted, PIP, etc) is essential to them.
- *Preparing drafts at the ministries:*  
During May and June independent of the budget strategy and of the decree of the Minister of Finance, the ministries should prepare the draft budget, plans, applications and explanatory letters. These documents will be presented to the Ministry of Finance. The draft budget of ministries should contain also the grants to municipality budgets as part of the investment plans of the ministry; at this stage, the representatives of the local government unions are involved at the ministry level in the elaboration process.

- *Analysis and negotiations of draft budgets in the Ministry of Finance:*  
In June and July the applications of the ministries are analyzed by the Ministry of Finance. After that, the negotiations are conducted at three levels during July and August. At the first level, the head of the budget department of the Ministry of Finance and the corresponding ministry will meet and discuss the application. At the second level, the chancellors will meet and following that meeting the Ministry of Finance will form its viewpoint. At the third level, the minister and the representatives of constitutional institutions will conclude the negotiations with the Minister of Finance. All dissenting opinions will be included in the minutes. After the last meetings, the Ministry of Finance prepares the final table containing the applications from the ministries as well as the proposal from the Ministry of Finance. This is then presented to the cabinet.
- *Discussions and approval of expenditure ceilings by the government:*  
At the end of August the preliminary discussion of the draft budget, of the expenditure ceilings of the PIP and of the expenditure ceilings for the following years' state budget, including the amount of investments and the PIP, takes place during two government sessions.
- *The modification of the draft budget according to the approved expenditure ceilings:*  
In September on the basis of the approved expenditure ceilings and other decisions of the government, each ministry prepares a final draft budget and investment plan for the next year. These budgets are presented to the Minister of Finance who approves it and then presents a consolidated draft to the government.
- *Revision of the draft budget and presentation to parliament:*  
At the end of September two governmental sessions are held for the presentation of the budget to parliament.
- *Budget presentation and approval by parliament:*  
From September until December the draft state budget is discussed and modified during three sessions. The first session dealing with the draft budget is a formal introduction. After that, parliament and the economic committee present proposals for amendments to the draft budget. In the second session, the author of the draft budget presents the amendments made to the draft according to the proposals. Open discussions of the proposed amendments are held, with each change being voted on. In the third session, the amended draft is presented. The proposals that were made during second session are voted on and the law concerning the state budget of 2001 will be approved. The law comes into force from the beginning of the budget year.
- *Budget year:*  
The budget year lasts from January 1 to December 31. Two weeks after the State Budget Act is adopted, it is published in the State Gazette. In January (of the

following year) the ministries plan the distribution of expenditures of their administration and present them to the Ministry of Finance.

- *Reporting:*

In January (of the following year), the ministries, organizations and agencies that are financed from the state budget start to compose the reports concerning the implementation of their budgets for presentation to the Ministry of Finance. On June 1, the central government presents the report concerning the implementation of the state budget to parliament and the State Audit Office. By September 1, the State Audit Office presents its assessment of the implementation of the state budget.

The *implementation of the state budget* is managed by the Ministry of Finance. The banks in which state money is held are chosen through an open tender process. The budget expenditures are made as soon as actual revenues are received and allocations planned.

Accounts are centralized and managed by the state treasury. An exceptions exists for transfers of tax revenues to the local governments which are made directly by the tax board following receipt of the actual tax revenues. Most central funds are transferred from the state budget to the local government budgets quarterly.

The transfer of funds from the state budget (from the budget of the appropriate ministry) for local government investments is made through the district treasury office. Money is transferred directly to the contractor based on invoices that the local government presents to the treasury for payment.

*Negotiations between the central and local authorities* are held by a government delegation and a delegation of the Cooperation Assembly of the Local Government Unions. The former is composed of the Minister of Regional Affairs and the Secretary Generals (Chancellors) of each Ministry. Several working committees—financial and budget, education and cultural, social, transportation and communications committees—were formed. The committees are lead by the chancellors of the corresponding ministries.

Central issues subject to annual negotiations also demonstrate the main dimensions of central–local relations in Estonia concerning the budget.

*For example, the agenda of negotiations in February 1997 was as follows:*

1. *Changes in taxation laws and regulations.*
2. *The scope of expenditures for the implementation of central government functions by local authorities.*
3. *Amount and principles of delivery of government investments grants.*
4. *Revenue bases of the local government units and proportions of revenues and expenditures for budgetary units.*
5. *The amount of government support grants.*

6. *Reform of social care.*
7. *Relations with the state treasury.*
8. *Government plans for local government reform.*
9. *The application of salary grade scales in specific cases at the local level.*

In 2001 the agenda of negotiations was more or less the same. This indicates the permanent nature of these problems.

The negotiation process is long and complicated. It starts in February-March within the framework for preparing the budgets for the following years. These meetings are irregular, but the next meetings are agreed upon before the end of a session. The process is the responsibility of the Minister of Regional Affairs. Following the meeting, a detailed protocol is distributed to all participants. The differing opinions as well as agreements achieved between the partners are included in the protocol.

Until recently, none of the protocols, including the final protocol, were signed as official documents. This substantially decreased the normative force of these documents.

## 2.2 Strategic Planning at the Local Level

According to the Local Government Organization Act, the local government development plan is the document that analyzes the economic and social processes as well as the current economic environment. It contains a long-term plan of action and a list of priorities for future development. The development plan must be prepared with a time horizon of at least three years. In case the local government unit has financial or other obligations covering a longer period, then the plan must be extended to cover the whole period.

According to law, the development plan must be the basis for the composition of the local government budget; for applications; for investments, including those funded from external sources; and for taking loans and assuming obligations. In practice, the role of the plan as a management tool is far from effective for several reasons.

First, the general format and techniques for the development plan have not been approved and the subsequent training of local government officials has not yet been conducted. The plan is very often a “letter of intentions” from separate sectors that are merged together as separate chapters into the whole document. Therefore, the plan is often not internally consistent and cannot serve as a basis for budgeting.

Second, development plans are subject to frequent changes, especially after elections. The development plan is usually prepared by experts in cooperation with the local government professionals, but changes are often introduced by councilors afterwards for political reasons.

The development plan as management tool is much better used in larger cities. The development plan relies on a ten-year strategic program and every large investment in the development plan is based on a specific chapter of the strategic program. These programs contain an estimate of the amount of investment, the purpose of the investment and the source of investment funds. Some local government officials make reference to the frequent oscillations in the economy. Instead of an exact timetable, they prefer to give a ranking of investment priorities along with an estimate of the budgetary consequences in each concrete case.

The development plan still includes multiple purposes and goals that can never be attained in a single budget. The applications for investments exceed the budget capacity by four to five times. Hence, some local governments have established a rule that the applicant must demonstrate the negative consequences of not making the investment.

## 2.3 Structure of the Local Budget

### *Units of Fiscal Planning*

Local budget expenditures are structured according to the following:

- The area of government, such as administration, education, culture [Parts].
- The recipient or organization responsible for that area of government; each separate activity and project has a separate budget. Actually different units of budgeting are described in chapters. In case of budget organizations, the chapter describes the general amount, with sub-budgets of an organization being presented in sub-chapters [Chapters].
- Type of expenditure. Expenditures are classified with double digits (for general types, such as administration expenses, office expenses, wages) and triple digits (for specific types, such as office expenditures, heating, electricity) [Expenditure items].

All classifications are developed by the Ministry of Finance and enforced by decree. The main local government budget units are as follows:

- a) The local government, council, government agencies and organizations. These units can also have their own income from miscellaneous services.
- b) Organizations and enterprises regulated by private law, but owned completely or partially by the local government. Appropriations to foundations and NGOs (often in kind) are expenditure line-items. Dividends or shares sold can be units on the revenue side.<sup>9</sup>
- c) Participation in various associations and joint enterprises with other local governments or public organizations.

- d) Direct support to private or non-profit organizations that deliver services with a public dimension.
- e) Purchase of services from external organizations via contracts.
- f) Program and planning activities.

Although the budget classification system implies that each activity will have a separate line for its financing, these organizations are actually financed from several different lines in the budget. In other cases, transfers (actual investments) are shown under the item "other costs." As a result of this, control over these activities is less transparent to the public.

The extra-budgetary units also have their own sources of financing and assets. Budgeting in the extra-budget units must be organized according to the classification schedule. The budgeting in the extra-budget units may be done in two ways:

- They make their own budget after the budget of the local government is accepted;
- They make their own budget for the beginning of the calendar year.

The second method is used where the local government has agreed to transfer a certain amount of money every year to the extra-budget unit.

One *extra-budget fund* was established by the central government. The Property Reform Foundation is a non-budgetary fund established by the Law on Property Reform. The local government is required to transfer into that fund 25% of all income received from the sale of assets (land, buildings, apartments) that were transferred by the state to the local government. This fund will be abolished soon.

### *The Relations of Limited and Joint-Stock Companies with the Local Budget*

During the initial period after state-owned companies were transferred to local governments, they continued to work as municipal enterprises. In 1995, the New Business Law was adopted and most state and municipal enterprises had to be reorganized into independent business companies or redesigned as budget organizations. It is common for larger municipalities to establish limited liability companies and for smaller ones to set up joint-stock companies. Usually the local governments do not make transfers from their budgets to these firms, even where they own 100% of the shares or joint stock. But there are exceptions.

The revenues from enterprises (dividends) may be included in the budget under the items "revenues from economic activities" or "dividends" or "other revenues." Many local governments do not have such items in their budgets because the companies do not operate at a profit.

The budgeting philosophy and legislation in Estonia depart from the presumption that all revenues as well as expenditures of local governments must be a part of the budget. Actually, several revenues and expenditures that are actually received and spent for the local needs and services delivered by local organizations do not appear in the budget. In addition to those related to companies, foundations and NGOs, there are several other expenditures and revenues that are spent for the financing activities and investments of the local government.

- Not all donations and own revenues, including foreign aid, are included in the budget or are included retroactively. Often, donations and projects financed from external sources are managed separately, with only the final outputs in kind being included in the balance sheet.
- Also, some investments are delivered in kind and not included in the budget.
- Earmarked funds coming from the budgets of the ministries in order to cover the costs of implementing the local and regional functions are also paid directly and do not appear in the budget.
- Teachers' salaries (as an example of the previous expenditure) account for almost one-sixth of all expenditures made by local governments, but up to 2001 were not part of local governments budgets, whereas salaries of technical personnel were. In a similar way, the payments and benefits from the state (for instance, for various social aid) are managed and paid by the local authorities, but these funds also do not appear in the budget.
- The transformation of state property into municipal property also cannot be mirrored in the budget, but is shown in the balance sheet. Only after the assets are sold is the value reflected in the local budgets.

These budget units can be evaluated from various perspectives. Foundations as well as central budget funds could represent sources of unappropriated public money for use in covering other needs. These organizations could also introduce more flexible methods for the financing of local service delivery.

The local governments are, however, punished for these expenditures by the central authorities. If these expenditures were shown in the budget, the central government could refuse to give an appropriate level of support.

*The specific budget units are state functions that local governments for several reasons have decided to finance. One example of this type of expense is for supplements to teachers' salaries that the local government must pay in order to retain good teachers. Another is for rescue services. For example, in the Koeru rural area and in the town of Narva-Jõesuu, the local government supplies lifeguards to summer swimming areas. Police and security services are also frequently financed in this way. For example, in Türi, the local government is paying for*

*the establishment and operation of a security camera. The town of Türi also finances the university college and museums that are formally functions of the central government. The local government is also supporting national heritage preservation (churches, manors) and local newspapers. Most of these are obviously regional functions that usually should be managed by the second tier of local government.*

## 2.4 Budgeting Process

### 2.4.1 Participants in the Budgeting Process

The main participants in the local government budgeting process are described as follows:

- *The budget and/or financial department* prepares all the analysis preceding the budget preparation, produces all the intermediate accounts and documents and is involved in direct negotiations with all budgeting units. Usually the committees of the council, especially the budget committee, are involved with these negotiations from the very beginning.
- *The budget committee* of the local council, that in smaller local government units has members from outside the council, is actually the main participant in the budget formation process. The role of the council committee is to discuss and harmonize the points of view expressed in numerous preparatory papers to the budget.
- *The head of local government* is responsible for the preparation of the budget and ensures that all agencies follow the budget after its approval. Actually, the head of government delegates this responsibility either to the vice-head of government, who in many local governments is responsible for local finances, or directly to the head of the budget department.
- *Municipal council committees*, such as the social, audit, budgeting, financial and economics committee, all participate to some extent in the budgeting process. The budgets of local government units and agencies are discussed in these committees.
- *The municipal council* has the right to adopt or to deny the draft budget. Also, the municipal council has the duty to supervise and assess the results of activities of executive bodies.

Other participants in the local government budgeting process include the following:

- *Temporary committees* are formed in some local governments to fulfill specific tasks, such as the preparation of a zero-based budget.

- *Local government agencies and units* should prepare their own budgets, but from the beginning they are confronted with expenditure ceilings that are established at an early stage of the budgeting process. The room for maneuvering is small.
- *Other organizations as well as individuals* that intend to get financial assistance from the local government, must submit appropriate applications within a certain time period.
- *The public* can participate in the budget process at the council because, as a rule, council meetings are open to the public. Usually, the public is not interested in participating in the budget process.
- Some local governments have used the help of *private sector enterprises* to prepare the municipal development plan and economic forecasts. But there does not exist any legally defined roles for service organizations.
- *The general public and civil organizations* can make suggestions to the municipal council concerning changes in the budget and municipal development plan. Thereafter, the municipal council will discuss these proposals in different committees and then present results to the government or council for the preparation of the budget or municipal development plan.

Local government budgeting in Estonia is a quite complicated and controversial process owing to the diversity of budgetary units and also the complex institutional structure of the local government unit. The formal roles of the participants in this process are weakly defined. The only formal regulation is that the municipal council has the exclusive competence to adopt and change the budget, to approve the report concerning the budget implementation and to appoint the auditor.

#### 2.4.2 Budget Cycle

The following rules by the central legislation exist for local budgeting procedures:

- a) The budget must be approved by the local government council no later than April 1 or three months after the state budget is approved, whichever is later.
- b) The draft budget, the approved budget, the budget amendments, as well as the report concerning the previous year's budget must be published.
- c) The previous year's budget report that is sent to the council for approval must be supplemented by the report of the auditor who was appointed by the council.

Furthermore, local governments have to adopt the “order of budgeting” that regulates budgeting and financial actions within the local government. That decree may be

presented as a separate decree or as part of the local government statutes. The other legal documents that define the content of budget are the development plan and the investment plan.

In practice, the budgeting process varies widely in different local governments and these variations are the result of real experiences. The general stages of budget preparation are described below. Let us assume that the budget year is the year 2000.

### *Budget Cycle at the Local Level*

- *March 1999*—The local government prepares the schedule for the preparation of the municipal budget for a session of the municipal council.
- *March to April 1999*—The economic department of the municipality prepares materials for the municipal council committees. The materials are: (1) The size of expenditures during the previous three budgeting years; (2) The report concerning the implementation of the previous budgeting year as well as that concerning the previous year's investments.
- *March to April 1999*—The municipal government together with the budget and economic committees of the municipal council prepares the plan of own income and presents it for discussion to the board of the municipal council (which includes the leadership of the local council and the heads of the council committees).
- *March to April 1999*—The permanent council committees discuss the amount of the expenditures and submit their applications to the budget and economic committee (BEC) of the municipal council.
- *March to April 1999*—The BEC prepares a report based on these applications with its own comments and proposals for submission to the council board.
- *March to April 1999*—The board presents the draft decree concerning the expenditure ceilings to the council.
- *May 1, 1999*—The economic department of the local government presents an analysis of revenue base and basic expenditures to the town council and prepares the draft decree concerning the expenditure ceilings.
- *May 15, 1999*—After approval of the decree, the BEC promulgates the basic data for use in the preparation of draft sub-budgets and distributes the budget preparation materials to the local government budget units.
- *June 1, 1999*—Draft sub-budgets must be presented to the municipal government.
- *June 1999*—An analysis of the sub-budgets of the budget units is conducted at the budget and economic department (BED). Within three weeks, the sub-budgets are revised for the organizations and the final version is presented to

the department. The municipal council approves the plans for the own income of the local government agencies and organizations.

- *June 15, 1999*—Relying on the approved sub-budgets, the BED prepares the draft budget of the local government and presents this to the municipal government for deliberation. With the draft budget are enclosed: (1) an explanatory letter containing data about the actual implementation of the budget during the previous year; (2) a budget containing total expenditures and revenues with sub-totals according to the classification system previously agreed upon.
- *June to August 1999*—The draft budget, the enclosed explanatory letter and the other supplementary statistical data are presented to the BEC. The BEC analyses the proposal and presents it together with its own comments to the council board. The latter presents the draft budget to the council. The first reading at the municipal council takes place.
- *August 10, 1999*—Council committees deliberate on the draft budget and formulate their proposals to the council. The committees discuss new proposals for amendments and make their own judgments. Proposals involving an increase of expenditures or a decrease of revenues must be supplemented with proposals for sources of supplementary financing to the BEC. Amendments should be presented by the second reading at latest. Amendments that were rejected by the committee must be voted on during the second reading, if the authors of amendments insist on it. Amendments approved by the council are introduced into the text of law.
- *December 1999*—The local government, in cooperation with the BEC, prepares the final version of the draft budget, relying on amendments and comments made during the second reading. The budget is usually accepted in December. If the budget has not been approved, the municipality's government is authorized to make expenditures of no more than one-twelfth of the previous year's budget expenditures.
- *Budget year 2000*—The budget may be amended during the budget year or an additional budget may also be approved. Usually the amended budget will be made when local governments receive information about the amount of central government grants.
- *March 1, 2001 (at the latest)*—The government presents the prepared report concerning the previous year's budget to the municipal council. For the budget year 2000, the external auditors' statement must be enclosed.
- *July 1, 2001 (at the latest)*—The report is considered and should be officially approved by the municipal council. The report must contain: (1) a balance sheet as of January 1, 2001; (2) a report on expenditures and revenues; (3) a report on the use of the emergency fund; (4) other data required by the municipal council.

The approved report is presented to the Ministry of Finance. These stages of the budgeting cycle described above are characteristic for most local governments. There are, however, local governments where the budget contains a large proportion (more than 40%) of support fund transfers from the state budget.

According to Estonian legislation, the state budget has the status of law. In the case of an local government, it has the status of a decree. Any deviation from the budget is considered to be a violation of the law or decree.

### 2.4.3 Changes in the Budget

There is no regulation that determines the level of detail in a local budget. In some local governments, there are multiple line-items for all levels up to the level of council. In other local governments, the council can approve the budget at the level of sub-chapters, with no details of expenditure items within these units. In the first case, changes to the budget is very time consuming because only the local council has the right to change budget figures. In the second case, the local government without the intervention of the local council can make all changes to the budget.

In case changes between the various expenditure items are made, the government can decide on changes in correlation with the items in the sub-budgets of the local government organizations. The council must decide to what extent (in %) the changes between sub-budget items will be permitted. Changes in the budget that are the result of changes in conditional grants or reserve funds of the local government can be initiated by the council committee and authorized by the council only. All applications for changes have to be justified by a detailed analysis of their necessity and sources of financing.

The local government can work out and adopt also the supplementary budget if the income to the budget is actually higher than revenues planned in the adopted budget. In this case, the adoption procedures are the same as for the adoption of the annual budget.

## 2.5 Capital Budgeting

The municipal budget is not formally required to have separate budgets for operating expenses and for capital budgeting, because the Rural Municipality and City Budgets Act does not prescribe it.<sup>10</sup> However, there are more and more examples, mainly in big cities, where the capital budget is separated. The separation is basically due to the existence of big investment programs when the creditors demand that the use of borrowed money be transparent.

Although a capital budgeting system is used, the separation of operating and capital budgets is not so strict. Real amortization rates for assets should be introduced and used in budgeting. Hence, the annual amortization would be shown as an expense in the operating budget and revenue in the capital budget. Currently, the local governments operate with the strict concept of the depreciation of assets.<sup>11</sup> The main problem is that there are no established common depreciation rates, with every local government unit deciding on the appropriate rates independently. This leads to the situation where different depreciation rates are established for similar assets (e.g., for the depreciation of buildings, the culture department uses a rate of 1.5–2.0%, while the local government office uses 8%).

*Assets valuation* is regulated by the Ministry of Finance decree of No. 44 (May 18, 2000). All assets are valued on the basis of the cost of acquisition, which includes the cost of purchasing, the non-returnable taxes and other expenditures necessary for the initial utilization of the assets. In cases where land and buildings are purchased together and the price is expressed as a lump sum, the accounting documents must clearly separate the total cost of acquisition to land and to buildings.

If they are received for free as a donation or as state or other property transferred to municipal property for which there are no purchasing documents, the assets are appraised by a committee or by experts. In these cases, asset appraisal is usually contracted from real-estate companies, where licensed experts are employed.

The cost of assets transferred to a municipal property from the state were usually accounted for on the basis of their book value. Other assets acquired by other than a market exchange are also included in the balance sheet using the same principle. Therefore, the value of assets in the balance sheet could be significantly below their market value. Rules governing the further disposition of the assets were not so clear in order to avoid corruption in the course of the selling of these assets. (There was a large backlash related to the sale of municipal apartments in Tallinn.) Currently, most of the valuable assets have either been sold or otherwise disposed of. But the real problem of the difference between book and market values remains.

The previous practice of selling assets using a procedure of semi-closed exploratory negotiations was replaced by open competition because the former device contained large possibilities for corruption. This was most acute in towns. The disposal via competition of more or less fully amortized assets in small rural areas is a rather fruitless enterprise. This has caused supplementary difficulties in investment planning. The real costs of the investments could be lower than the market prices of asset by around ten times.

There are two main reasons why the capital budget has not been applied in many local governments:

- Investments are not a meaningful part of many local budgets.
- The lack of know-how to manage capital budgets.

## 2.6 Budgeting Techniques

### *Reasons for Applying Traditional Budgeting*

In Estonia, line-item budgeting at the local level is still the dominant budgeting technique. The notion of performance and program budgeting is unknown to most professionals, let alone the politicians. The dominance of line-item budgeting can be explained by two main arguments.

First, the budget is still inevitably an instrument of *control over expenditures*. The budget classification system is established by the central government. This also makes the control and audit from the central level much easier. The reporting system and statistical data that must be reported to the government relies completely on this system. Hence, the existing system of reporting and accountability makes inevitable the application of the line-item budget.

The second reason is much simpler: line-item budgeting does not demand as much professional knowledge as other budgeting techniques. The professional capacity in the areas of financial management and accounting in the local governments is not yet developed enough for the introduction of more advanced and complicated budgeting techniques.

Most local government units have a budget that is composed almost completely of current expenditures. Larger local governments manage policy programs through the use of off-budget units or contracting. So, up to the present, the line-item budget seems most appropriate also because of the structure of the budget.

### *Application of Modern Budgeting Techniques*

*Zero-based budgeting* is used by some local governments to revise and analyze the established proportions of expenditures every four to five years. As a rule, the control function is the top priority. The real possibilities to revise substantially the budget proportions are rather limited above all for political reasons.

Recently there have been attempts to introduce elements of *performance budgeting*. In 1999 the Ministry of Finance tried to introduce cost-based budgeting with respect to current expenditures for the staff and the overhead costs of civil servants. As a result, a normative overhead cost per official in the ministries, in the agency or inspection offices and in the counties was imposed. The attempt failed owing to the significant variance from actual expenditures.

In 1999 the Ministry of Finance established the goal of introducing *program budgeting*. At the beginning, the ministry worked out guidelines for the composition of development plans and economic plans. The aim was to tie targets of the state budget with those stated in the development plans. (Central agencies—differently from local

governments—do not have development plans.) The development plan should include the following elements needed to define all services delivered by the organizations:

- Aim of service delivery—why this service is needed and should be provided by this organization; what is the benefit of the service for society as a whole and what would the consequences be if the service would not be offered by this organization.
- The description of the services or goods.
- Definition of benefit expected.
- The performance measures for the benefit and the goal attainment.
- Analysis of actions needed in order to achieve the results or benefits.

Beginning in 2002, all ministries and agencies must present their budget proposal together with a development strategy.

Unfortunately, the skills needed for properly drafting the development plans according to these guidelines were not adequate to carry out this job. Officials and experts were often not able to differentiate between current functions (activities) and aims (purposes, targets, etc.). Larger local governments have started to apply this methodology in the local government organizations, including the off-budget organizations partially financed from the local budget.

The new focus of the local government financial management on results and benefits has been achieved to a large extent via outsourcing (contract management, purchasing services from the private sector, etc.) or via the creation of off-budget units with clearly set activities. The strategic aim still does not include the development of performance budgeting *inside* the government, but instead is limited to the *delegation* of activities to organizations that can be managed through programs, price regulations, competition, etc.

## 2.7 Information and Accountability

The amount and variety of *information* reported by the local government to various institutions is very big. There are many shortcomings in the preparation and delivery of information. A large proportion of information is reported doubly and this takes a lot of the local government's time. Different departments (financial and budgetary department) of the Ministry of Finance and other central organizations do not cooperate in the exchange of information, so if they need certain information they merely request it from the local government. Because of the frequent changes in the information format, the reports from different years are not comparable and cannot be used to carry out detailed analysis. The Ministry of Finance requires the presentation of the annual reports in both electronic and paper versions. (The written report is more than 300 pages.)

There is no feedback from the Ministry of Finance. This can give the impression that the Ministry is not able to analyze this information appropriately. The local governments would like to have some comparable tables for use in the exchange of the information that they are presenting. If the Ministry has insufficient capacity and/or is overloaded with work, it could contract out this analysis to, e.g., the local government unions.

*Transparency and publicity* of the budget simultaneously provide both a form of control and a type of feedback for the purpose of increasing the quality and effectiveness of local finances. Some channels of publicity are prescribed by law. However, most channels are developed by the local authorities on their own initiative. Effective March 1, 2002, all the information must be presented on a website.

The draft budget and other draft documents are published along with the time and place of *its public discussion*. This channel is usually used for the development plan and the physical planning projects. As a rule, all council sessions are open to the public and often every session is announced in the local newspaper. The most important acts are published in newspapers as well as in official press releases. *Local government information centers* are established in the largest local government units. In others, there is an information desk or board in the local government building, in local libraries or in other public places. The new act concerning public information obliges all local governments to have websites. The larger local governments generally have all the adopted acts, protocols of sessions, etc., on the website. Some local governments publish all materials affiliated to the budget. This is quite expensive, but in some form this collection can be found in most local government libraries. Effective this year, the Law on Public Information prescribes the opportunity to get all the official non-classified information from the local government. The information must be provided within five working days. Information affiliated to the budget cannot be classified as confidential.

In all local government units, persons who are not members of the local council or of the government are *involved in committees, working groups and seminars*. Especially broad is the participation in the course of the elaboration of the development plan.

Most small- and medium-sized local governments would have difficulties in presenting all the required information to the public. Also, the quality and format of information differ enormously. Since the Law on Public Information has only recently become effective, there is as yet no information about whether the local government units have the capacity to meet the requirements of the law, especially the quite strict time limits. Obviously, the implementation of this law involves supplementary expenditures and professional preparation that smaller units cannot meet or afford. This is a good example of the imposition of supplementary responsibilities that increase the expenditures of the local government without a corresponding direct compensation from the state budget.

## 2.8 Budget Implementation

### 2.8.1 Accounting Dimensions of Budgeting

Estonian public sector accounting is based on the Accounting Law. Paragraphs 1 to 16 in the Accounting Law concern the public sector. Other elements of the public sector accounting are based on decrees of the Minister of Finance. Public sector accounting is done according to the double-entry system and is accrual based. Cash-based accounting is used only in accounting for the social tax (based on the Law on the Social Tax).

At the beginning of 1990 all public sector accounting was cash based. During the mid 1990s the change to accrual accounting was started. And from 1998, with the reorganization of accounting (by decree of the Minister of Finance), the local governments started to recognize the amortization of fixed assets using the depreciation account.

The problem is that the Minister of Finance changes accounting rules in every accounting year. Dealing with these changes overloads accountants with supplementary duties. In spite of the numerous changes, public sector accounting is still incomplete and not fully implemented. There is still uncertainty and a lack of understanding in some essential sections (e.g., accounting for assets—recording, amortization procedures, privatization, capitalization and disposition).

The differences between public and private sector accounting, first of all, concern transparency. Public sector accounting must rely on the classification schedule that is already prescribed by the central authority.

As far as computer databases are concerned, some software has been developed specifically for public sector accounting.

*From 1997 to 1999 the Ministry of Finance tried to implement a Norwegian-Swedish software (named Agresso). However, serious difficulties were encountered in adapting the software to the Estonian accounting system. As a result, a corruption scandal exploded. Even after these events, the software is in use in some local governments and several state organizations and agencies. Sometimes illegal, not-licensed or individually made software is also used (e.g., in the towns of Narva and Narva-Jõesuu).*

In the management of the accounting software, many problems have emerged, among the most serious being the accountants' lack of knowledge concerning both computer hardware and the capabilities of the accounting software in use. In addition, there is a scarcity of competent system administrators and technicians (especially for network systems). Possible solutions could include training and the implementation of centrally established requirements to apply certain software as a requirement for

participation in the Public Investment Program. The centralization of maintenance functions via the requirement to use licensed computer companies and professionals could also be helpful.

### 2.8.2 Cash Management

Many local governments keep the budgeted funds on different accounts, because there does not exist a single account system at the local level. Some local governments prefer, however, the single account system owing to the irregularities of cash flows in different periods.

Other local governments, on the other hand, maintain different accounts for different organizations and for different financial operations. Many separate standing accounts are used (in smaller local governments) to get a better overview and control over the funds. In larger municipalities, a smaller number of accounts are used and the accounts are grouped in so-called entity accounts, which provide an overview of the funds available in all accounts at any point in time.

A central government decree (effective until 2002) requires local governments to create separate off-budget accounts for revenues resulting from property reform. Similarly, separate accounts exist for the housing reserve fund and VAT reimbursements to the local government.

Transfers from the treasury also constituted one reason for different accounts. In Estonia, the state budget accounts are settled exclusively through the treasury, except for tax revenues which are transferred directly to the local governments by the tax board as soon as they have been collected. Another complication arises when a creditor bank of the local government requires that any loan be kept on its accounts and that all transfers be made solely through its systems. One bank has developed a comprehensive clearing system and a large number of local governments use the services of that bank.

The grant funds are transferred from the state budget to the local budgets quarterly. Transfers from the state for investments planned in the municipalities' budgets are made directly through the treasury. Upon receipt of a payment order from the local government, the district treasury office makes the transfers directly to the contractor and records the amount in the corresponding item of the ministerial budget. Thus, these funds do not flow through the local government account.

Banks that keep state budget accounts are selected through public tenders. Budgetary costs are financed based on actual receipts and transfers or on payments that were planned.

According to the Municipality Budget Act, the available cash of a local government comes from the surplus in the budget at the beginning of the fiscal year. The

municipal council establishes the cash balance when the budget is passed. The government uses the surplus to cover expenses when actual incomes are delayed. The surplus should be restored (up to the amount established by the municipal council) during the same fiscal year. The municipal council can reduce the cash balance in order to compensate for any shortfall in planned receipts.

Some local governments have developed cash disbursement schedules for the local government organizations and agencies. These schedules have a quarterly or even monthly basis even though the revenues of the local governments very much depend on the tax administration, which has no similar schedule of transfers. Thus, depending on the receipts from the tax administration, the transfers to the local government organizations and agencies are proportionately increased or decreased.

*In Tartu, by the twentieth day of each month, the local government organizations must give a forecast of the coming month's revenues and expenses to the financial department for consolidation and presentation in graphical format. On this basis, the cash disbursement schedule is prepared.*

## 2.9 Audit System

The supervision and control over economic and financial activities of local governments is regulated by several acts. The supervision and control over the local government economic activities is performed by:

- The governor (for the utilization of funds and investments provided by the central government, the European Union, grants and foreign aid);
- The legal chancellor (responsible for the local implementation of laws);
- The State Audit Office (responsible for funds and investments from the central government, as well as loans guaranteed by the central government);
- The Audit Committee appointed by the local government council (responsible for the utilization of funds and investments received from the central government and the European Union, from grants, from other foreign aid; as well as for the usage of municipal funds, for the implementation in the local government activities of the local government decisions and regulations, and for the implementation of financial and accounting principles in the local government institutions);
- The internal audit, which only exists in some local governments (responsible for the same areas as the audit committee).

The local council is responsible for the control and evaluation of the work of the local government organizations. The council establishes an *audit committee* to control the local government actions until the next elections. The committee must contain at least three members. Only members of the local government council can be members of the audit committee.

The composition of the committee is political. The coalition as well as opposition parties must be represented in the committee. Some local governments have the tradition of electing the head of the audit committee from the opposition.

According to law the functions of the audit committee are to control:

- the compliance of local government actions with legislation and decrees;
- the collection and recording of revenues at a fixed date;
- the proper booking of costs to the appropriate local government budget;
- the correctness of accounting in the local government's organizations, agencies and enterprises;
- the proper utilization of local government assets by local government organizations;
- the implementation of contracts that are made by the local governments.

The biggest problem facing the audit committees is the lack of competence of its members. In many local governments, the audit committee does not function properly. Usually there is no systematic and regular control over local government organizations, agencies and enterprises. A solution for all the issues raised in this section could be the introduction of a certified training program for officials appointed to or employed in positions that are directly related to budgeting and financial management: this would include members of the audit committee, the heads of departments and organizations and the financial specialists.

The audit committee must report about its actions to the municipal council at least once a year. Usually, this only consists of a list of issues discussed at committee meetings. The committee report is presented before the local government report.

The requirement for an *a priori* audit is not prescribed by Estonian legislation. At the same time, the possibility is not excluded. The audit committee reports to the municipal government in written form concerning any discovered shortcomings and proposals for the elimination of these shortcomings. The municipal government will respond within ten days following the receipt of the audit report and will present its decision together with the entire file to the municipal council. Thus, the audit committee could audit an activity before it is started and both the municipal government and the council could have the opportunity to take the shortcomings identified into consideration.

The law does not impose any additional obligations *for internal control* at local government. An internal control unit or staff position exists only in some larger local

governments. In most local governments, internal control is carried out by an audit committee of the council.

The responsibilities for internal control coincide with those of the audit committee. Internal control in local government institutions and organizations is *ad hoc*. Almost half of the internal control cases are carried out as the result of an *ad hoc* order. The effectiveness of internal control in various local governments varies enormously and depends primarily on the staff of the unit.

*The city of Tartu, for instance, has a four-year control strategy that is divided into quarterly control plans. The current control requirements not foreseen in long-term plans is taken into account when the quarterly plan is developed.*

Effective in 2001, the requirement for an *external financial audit* was established in the Local Government Organization Act. (Prior to this the audit concerning the budget implementation was not reliable, partly because it was made by persons with insufficient competence, and partly because the audit was done by the same body that approved the budget.)

The *auditor* is selected at an open competition. The auditor must have sufficient knowledge about local conditions. There are no formal requirements for choosing an auditor. The local government is also subject to control by:

- The county governor (according to the law);
- The State Audit Office (according to its competence);
- The legal chancellor.

The *governor* is the representative of the central government at the municipal level. He (or she) has both the duty and the right to exercise a supervisory function with regard to whether the local government is in compliance with legal norms regarding the implementation of the budget.

If the county governor finds that any legal act adopted by a local government does not comply with some higher legislation, he or she must make a proposal to abolish the act within fifteen days. If the local government has not complied with the proposal, the county governor must appeal to the administrative court.

Usually the request of the county governor has a strong enough force to bring about a change in the decision even in cases where the law is not formally violated. If the existence of illegal or inappropriate management of state assets is established, the county governor should apply to the State Audit Office and present it with all documents related to this case.

The *State Audit Office* is an independent budget organization set up to ensure the appropriate utilization and management of state assets. In addition to state assets, it

provides a control function in enterprises in which the state has a majority share. The State Audit must also control the appropriate utilization of government grants and subsidies.

### 3. ISSUES AND RECOMMENDATIONS

#### 3.1 Local Government Organization and Budgeting

In 1993 the Local Government Organization Act abolished—to a large extent for political reasons—the second tier of local government in Estonia. Since then, two substantially different sets of functions of governance—community and regional functions—have not been clearly defined or assigned to local and/or state regional institutions. The regional functions of government—except the abstract task of balancing—were not assigned to the county government. The regional functions cannot be carried out by the municipalities either. This paradox was solved theoretically with the idea of developing inter-municipality cooperation. This cooperation has not yet started, however.

As solutions, we recommend the following:

- a) Community service functions and regional functions must be separated and assigned to different tiers of local government. County government should treat regional functions as the province of local government (regional roads, professional training, secondary medical aid, environmental protection, etc.). Simultaneously, the county government should retain the oversight function concerning the legality of municipal actions.
- b) The implementation of functions by the local governments should be done via agreements with each individual local government. These agreements should define exactly the functions assigned to each territory and delegated by the state. The assignment of supplementary functions to the local government should be done before the budgets of the local governments are adopted and supplementary financial resources should be calculated for its implementation. The agreement could initially have the format of a development plan. Thereafter, the local government is completely responsible for the implementation of these functions within its territory.
- c) For this to be successful, the government must develop clear service and implementation standards or minimum levels of service for the basic functions of local government. These standards would also include the calculated minimum cost of implementation as well as the estimated necessary qualifications for the staff. This would make it possible to adequately assess the capacity of individual local governments to implement functions.

- d) Furthermore, in cases where the local government is not consistently able to meet these standards, the implementation of these functions should be contracted out to a neighboring municipality, to the county level of administration or to the non-governmental sector. This would, of course, lead to a change in the distribution of support funds. Following this, the real (not formal) consolidation would start, whereby the weaker local governments would acquire the status of a local government sub-unit and thereby receive formal confirmation of its actual role in the management of local issues. On the other hand, the state could start to contract the implementation of some functions selectively to the larger local governments. In this way, equalization and differentiation trends can be combined in a balanced way.
- e) A less radical version could focus on an improvement in the redistribution mechanisms. There could be imposed a sort of negative support, i.e., a redistribution of excess revenues to the local government units with fewer resources. This kind of support could be provided to local governments that do not receive transfers from the general support fund. Negative supports would be transferred from the state budget's support fund.
- f) Local executives should be able to rely on a more stable administration. This is true especially in smaller communities, where the politically appointed officials form a substantial part of the administration. Professionalism in the administration must substantially increase in order to counterbalance the tendency to politicize the budgetary process in small communities.
- g) The elaboration of the legal mechanisms necessary for out-sourcing the service provision functions between local governments that is currently made with a "settlement of accounts." These contracts should be much more consistently applied between organizations of local governments. In addition, the mechanisms of arbitration should be elaborated in order to avoid court cases between local governments.
- h) The delegation of functions to private enterprises should be more consistently carried out in smaller communities. The possibility of mandatory sub-contracting for local governments with low capacity could promote efforts to push joint contracting with enterprises. This would lead to an increase in economies of scale and the spreading of commercial risks.
- i) According to the formulas used in the tier system, a local government union could be transformed from a civic organization to a government institution responsible for the functions of the second tier council or regional assembly. The work of the assembly (union) could be financed from the state budget based on a formula that guarantees comparable financial resources to all of these assemblies, thus enabling them to substantially increase their steering and decision-making capacity. Self-financing has caused serious conflicts

within the local government unions because the varying contribution levels are linked to the population size of the local government. The capacity of the central union should be financially improved as well in order for it to be able to participate efficiently in the harmonization of laws and in negotiations with central government. Government acts and ministerial decrees should be harmonized. The final protocol of the annual negotiations must obtain the status of a legally binding document. In cases where no agreement is achieved, the mediator (probably the legislature) should draft the agreement. There does not yet exist any special scenario outlining how to achieve an assembly of unions (which is a prerequisite for their decision-making capacity) without, at the same time, restraining their independence.

- j) Local governments in Estonia should develop further the *elements* of performance and program budgeting as well as other innovations where these are justified. The application of modern budgeting techniques (e.g., capital budgeting, performance measures, etc.) in Estonia is restrained by the insufficient capacity available in the majority of local governments. This causes supplementary difficulties for local governments that can and do apply these methods. This means that the government should establish exceptions (e.g., training requirements) with the goal of avoiding supplementary expenditures for these local governments.
- k) Since local government reform is politically very controversial, the government should more consistently use pilot projects. For this purpose (and also for the development of other innovations), the legal conditions governing pilot projects should be established. These norms should be designed to prevent the enforcement of direct or indirect negative sanctions in case the project is a failure.

## 3.2 Local Revenues

Changes in the taxation system should be made only in order to reduce differences in the local government revenue base and capacity. An increase in the shared-tax rates (when these are followed by supplementary assignments) will increase the differences between local governments and make the redistribution even more intensive. The flexible redistribution of functions depends on the real capacity of the local governments and could provide an initial remedy to the problem of fitting the revenue base to the functions for which the local government is responsible.

### 3.3 Improving the Rules Governing the Assumption of Financial Obligations

*The proposal* is to define exactly the kind of data needed as the basis for calculating loan limits. The following terms should be defined very clearly:

- financial obligations—loans, obligations, leasing, principal and interest payments, etc;
- revenues—are there any articles that should be excluded.

There are different alternatives for what exactly can be done.

#### *Alternative I*

Local governments take loans primarily from commercial banks. In this case:

- We have to reduce the existing formal limits. When calculating the suitable limits, we definitely have to take into account the fact that the responsibility for teachers' salaries that was given to the local government budgets effective in 2001 will considerably increase receipts (from central transfers).
- We have to establish an *ex ante* control mechanism, i.e., that local governments must present their loan applications to the Ministry of Finance for approval before the contracts are concluded. On the one hand, this will assure that the Ministry of Finance will be informed about all financial obligations. In this way, it can discover at a very early phase if a local government has broken rules and can take suitable measures to prevent the local government from concluding the contract. On the other hand, this restriction contradicts the policy of giving local governments as much freedom as possible, i.e., a decentralized system. The Constitution states that local governments are independent units that have their own budgets.

#### *Alternative II*

If we do not apply *ex ante* control mechanisms, we should clearly establish responsibility for intentionally exceeding the limits or for submitting false data.

- As a result of this administrative reform, only general principles governing borrowing will be prescribed by law, and the government will be given the right to establish limits, to review loan applications in advance and to set registration rules for bond issues.
- To improve the follow-up control, a database of all local government loans from commercial banks integrated with the databases of the Ministry of Finance should be considered.
- It must be clearly stated in the Rural Municipality and City Budgets Act that the state does not guarantee local government loans. Following that, financial

institutions will surely assess more carefully the ability of an local government to repay the existing and new loans and the related interest.

### *Alternative III*

Local governments have little or no access to commercial banks and all borrowing must take place through the treasury. In this case, it is necessary:

- to establish the total sum of loans to the public sector every year in the state budget;
- to compose a loan committee in the Ministry of Finance to evaluate the local government loan applications;
- to establish in a law or in other legislation the criteria for assessing loan applications as well as the rules for submitting these applications.

Following is a short overview of proposals that have already been presented to the cabinet and should be effective from 2002:

- In the new State Budget Act, there is a paragraph giving the government the right to reduce allocations to any local government that has exceeded the borrowing limits set according to the rules. The allocations can be reduced by a sum equivalent to the amount that the borrowing limits were exceeded.
- Beginning with the new State Budget Law (effective from January 1, 2002), a new classification of revenues and expenditures is enforced. This classification is mandatory for all local governments. According to this classification, there is an explicit presentation in the budget of all loans, foreign grants, national aid and investments. There will no longer exist any extra-budgetary funds. All financial transactions (lending and borrowing, interest payments, buying and selling shares, etc.) will be reflected in the budget. This new classification should provide a complete overview of the finance situation.
- An amendment has been proposed to section 8 in The Rural Municipality and City Budgets Act in the following way: "The total of all unpaid loans, issued obligations, and other liabilities arising from these, together with loans to be taken and obligations to be issued may not exceed 55% of planned budgetary revenues in the current year (excluding conditional grants from the central government)."
- It has been proposed to supplement section 8 with sub-section 9 in The Rural Municipality and City Budgets Act as follows: "The government has the right, following a proposal by the Minister of Finance, to stop payments from the support fund to a local government, if the Ministry of Finance declares that the local government has not presented a copy of the loan contract or the registration of obligations to the Securities Inspection Authority of Estonia and to the Ministry of Finance."

- It has been proposed to amend section 375 in the Code of Administrative Infraction as follows: “There will be designated a monetary penalty in an amount of from 50 to 200 daily salaries for infractions of the requirements of the State Budget Act or the Rural Municipality and City Budgets Act.”

Publicly issued bonds are effective instruments only for very few Estonian municipalities. The growth of the local capital market may open up opportunities for the development of a municipal bond market.

### 3.4 Government Grants

- The equalization fund at the county level should be developed and the role of the general support fund should be proportionately reduced. From these funds, services will be financed that are contracted out to neighboring municipalities or to other organizations owing to undercapacity of the local government. Government support will be thus better targeted and justified via applications from the local government. (This is similar to the former practice of PIP.) The dominant view in Estonia has been against equalization because it could result in an unjust redistribution of gains from more successful to less successful local governments. If the legally binding system of payments for mutual service delivery between the local governments is introduced and mandatory minimum standards of service delivery applied, the distribution of support funds will direct money to the service providers that manage the most efficiently. The more efficient local governments will then start to enhance their service delivery functions. The primary beneficiary will be the local population. Actually, the poorer local governments cannot currently compensate their neighbors, e.g., for education expenses, and therefore are subsidized already.
- At the same time, the ministerial financing of the functions that are actually regional or even community functions should be reduced. The delegation of the payment for teachers’ salaries to the local government in 2001 revealed that the administration of salaries has become much more flexible and simple. This earmarked money has increased the role of the branches (of ministries) at the expense of the regional principle of administration. This branch principle of fund distribution is also obviously more bureaucratic and less targeted. The result, in our opinion, is to increase the role of regional institutions in the system for financing the local and regional development. This development is obviously inevitable in case of applications for EU funds.

- Recent changes in the system for distributing grants have reduced substantially the link between investments and the priorities established by the local government. In addition, the principle of self-financing by the local government has not been followed in the actual investment process. The proposal has been made to separate investments according to size, with only large grants of PIP being funded through the ministerial budget. The role of regional authorities in grant applications and in the supervision of the project management could be increased. This makes the utilization of grants more transparent and helps to avoid political “logrolling.”
- The general amount of government grants must become much stable and should be determined for several years in advance. The government must take more risks to ensure the level of financing based on its forecasts. Simultaneously, intensive training in forecasting methods should be organized in the municipalities.

### 3.5 Investments

The system of municipal investments should be adjusted to meet the requirements necessary to enable local governments to receive funds from the programs of the European Union. Various public channels, through which external investment funds could be obtained, should be integrated. It should be possible to consider the resources of local governments as well as the support grants from the state as joint financing sources with respect to applications for structural funds from the European Union. The Ministry of Internal Affairs has also suggested that resources should be allocated from the state budget in accordance with the project-principle for the entire period of an investment project.

### 3.6 Strategy Development and Budgeting

- The process of adoption and especially of amendment of the development plan should be more conservative. A simple majority should be sufficient for adopting and amending the development plan. Also, amendments to the development plan should be made public with the participation of experts. The plan should extend beyond the period between elections (five years), thus making local policy-making more consistent. The government should produce a detailed manual describing the contents and quality standards for the plan and

also conduct training for persons responsible for the contents of the plan. In the future, the certification of these persons could be introduced.

- Multi-year budgeting could be tested and applied. This would not only reduce the amount of administrative work, but would also establish a better link between budget strategies. It will help local governments to plan their revenues and expenditures better and to promote more targeted investment plans. It will also provide a guarantee to the local governments that the amount of grants from the central government will be available during the three-year planning period.

### 3.7 Reporting and Controlling

- In most local governments, the audit committee of the council is the only unit that carries out the internal control function. The work of the audit committee should become more regular and clearly scheduled. This would enable it to control all budget units within a predetermined time period. In smaller communities, the internal control could be jointly contracted out to regional development centers.
- The legally mandated information should be separated from the information that is essential for analysis. For the development of analytical capacity in the Ministry of Finance, it is not essential to increase the amount of personnel. The analysis could be contracted out. Local government unions could be the contractor in cases where their capacity is increased as a result of the change in their status and roles. It is important to discuss the results of the analysis with local government financial managers for the purpose of unifying the financial management practices in local governments.
- The Minister of Finance makes changes in public sector accounting frequently during the accounting year. These changes overload accountants with supplementary duties. The solution could be to work out the accounting requirements by the beginning of the budget year. If something must be changed, then it should only become effective from the beginning of the following budget year.
- Centrally established requirements to apply certain software could be implemented through the Public Investment Program.
- The centralization of information technology maintenance functions could be carried out with the requirement to contract only with certified computer service companies and professionals.
- Experts should be hired for complicated areas of control to support the audit committee.

- For accounting reports, a universal web-based software could be developed, with the paper version being abolished. The web version is also important because all local government can then have access to compare their budgets with the budgeting practices in other local governments.
- The classification schedule is too detailed in some parts (up to four levels of detail), whereas many other large expenditure items are not included in the classification schedule and are merged into a single item “other costs.” Quite a lot of expenditure items in the report are seldom used and therefore should be abolished. New expenditure items should be added to the classification more often. The revision of the classification schedule should be done annually.

## NOTES

- <sup>1</sup> Põhiseadus ja Põhiseaduse Assamblee. Tallinn. 1997.
- <sup>2</sup> Our fieldwork includes five case studies, carried out according to the research protocol in the Koeru rural municipality, in three Estonian towns with rather different budget practices (Narva Jõesuu, Türi and Keila), and in the second largest Estonian city—Tartu.
- <sup>3</sup> The initiative to consolidate the local authorities might stem from the intention to avoid coalition trends and instead develop party balances in local politics. This aim may shift politics at the local level to the right.
- <sup>4</sup> For a more detailed description of local government structures in Estonia see S. Mäeltsees, “Local Government in Estonia”, in: T. Horváth (Ed.)—*Decentralization: Experiments and Reforms*, (LGI Books, 2000).
- <sup>5</sup> G. Sootla, H. Kadakmaa in *Estonian Human Development Report 2000*. (Tallinn, 2000).
- <sup>6</sup> The majority of assets that were transferred to municipal property were sold several years ago. Local governments own primarily trade and individual service enterprises that were privatized very quickly. Also, a substantial part of infrastructure and community services have been privatized.
- <sup>7</sup> However, these enterprises usually do not have profits because the local government is the shareholder and is interested in keeping prices of these services as low as possible. In some smaller towns, these enterprises have still not been privatized.
- <sup>8</sup> Effective 2002, amendments are expected to the State Budget Law.
- <sup>9</sup> These organizations are used by local governments to finance activities that are committed to the delivery of public goods. The largest foundation with the

participation of the local government is the Clinic of the University of Tartu, the large center of hospitals and research institutes. Also, in other regions, hospitals were transformed into foundations regulated by private law. Specific development and training centers were also transformed into foundations. Local newspapers in small towns that cannot be profitable are usually managed as foundations.

NGO is used with the aim to develop new services at the local level or to create a parallel (competitive) service delivery organization to the public one. In the latter case, the local governments prefer to finance the NGO directly without local government membership.

- <sup>10</sup> The World Bank recommends the separation of capital and operating budgets. But the Ministry of Finance has decided to employ the international standards (Government Finance Statistics) established by the IMF—which does not imply the use of a separate capital budget. Therefore, the Ministry of Finance has not established any requirements and methods to separate these two types of budgets. Presumably, in developed countries, this separation of budgets is a reasonable strategy. But in transition countries, the unification of the operating and capital budgets can have some advantages.
- <sup>11</sup> Municipal assets emerged as the result of the transformation of former state-owned property into municipal property. At this time, all municipalities tried to acquire as many tangible assets as possible without having a clear vision of their functions and expenses related to their maintenance. A part of their assets was completely amortized without any purposeful use. During the first part of the 1990s the local governments became aware of the complicated nature of the efficient management of assets. Therefore, during the second part of the 1990s all local governments tried to dispose of all unnecessary or unmanageable assets.