Local Government Functions and Their Financing and Local Government Borrowing in Estonia

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INTRODUCTION

The aim of my presentation is to give an overview of present situation of local government (later on LG) budgets and of problems connected with budget. Mainly I will concentrate on two themes: borrowing of local governments and financing of local government functions. The preparation of my presentation was especially difficult for two reasons:

(a) Estonia has adopted from the very beginning a very autonomous model of local government. So, the central legislation may prescribe various functions to the local government but there are very few standards, structures and procedures obligatory to follow. The central legislation is as a rule the framework of statements that every LG should adapt to its own needs and capacity. For instance, central legislation prescribes only two structural units of local executive: the head of government, secretary to the LG (chancellery). Hence every local unit may develop the structure of local government at their own discretion.

(b) The size and capacity of Estonian LG units is so different that to spoke about the universal practices are almost impossible. There are also rather different practices concerning budget structures, using capital budgets, performance indicators etc.

In spite of that I will try to give an overview of main common problems and I will also try to offer some solutions.

Like its citizens, local governments in Central and Eastern Europe are struggling through a painful economic and political transition. In order to become effective and better contribute to their fledging democracies, local governments need financial autonomy, adequate organisational structures and improved managerial practices.

In decentralisation process that characterises the transition, local governments are given new responsibilities. This critical change is hampered by little or not clearly defined authority granted to local authorities, the inadequate structures and processes, the lack of resources and their poor mobilisation, and, not least, by adequate skills and competence of the professional staff handling the matters under new conditions. Resources, above all are adversely conditioned by the revenues systems – characterised by limited fiscal discretion, a falling tax base and in many cases uncontrolled inflation, irregular central government transfers and limited ability to borrow.
1. BASIC DATA AND DESCRIPTION OF LOCAL GOVERNMENT IN ESTONIA

Estonia has today one tier local government with 247 LG units – 42 towns and 205 rural municipalities. All municipalities are governed by the same regulations in spite of the fact that their size and real capacity are rather different.

According to the law local government can not delegate its functions prescribed by the law to the upper tier (county) of government. But municipalities may delegate its functions to the sub-level and found municipal districts. Usually these sub-governments are founded in larger cities (Tallinn) but also spatially larger municipalities with several centres have sub-units to represent better interests of the remote areas.

Municipalities may found voluntary association with the aim of mutual co-operation in the service delivery and in representing interests of local government at county and state level.

The emergence of the first type of association was one of the main arguments against the necessity of the second tier of LG at the beginning of 1990-s. These co-operative association have not developed however because municipalities took a very selfish positions. Besides they have rather different priorities and bottlenecks in managing own areas.

The second type associations were established in all Estonian regions and they play important role in mediating intergovernmental relations incl. during the negotiations over the state grants to municipalities from government budgets. But not all LG units (frequently the larger ones who must pay majority of fees to the unions budget’s) are members of these unions. At the end of 1990-s Government attempted to make the membership in these unions compulsory. But then this was considered as the crude violation of conception of local autonomy by the representatives of local governments. The role of LG regional associations is up to now the most controversial issue in the course of development of new conception of local government.

**County government** is the general administrative agency representing the state interests on regional level and supervising the actions of LG units. There are 15 county governments. The size of counties does not differ so much in comparison with LG units. County governor ought to co-ordinate their activities to ensure the balanced development in the region. Although county governor is responsible for the supervision of the work of government field offices he/she has no formal devices to influence activities of those offices except via informal contacts.
Alongside with formal and informal co-ordination mechanisms, the Ministry of Finances plays an important role in steering local government activities. Department of finances at the county government is responsible for the supervision of government finances at the regional level. Recently established State Treasury has substantially reduced the importance of this department.

Estonia has quite well institutionalised mechanism of negotiations over the delivery of state grants to local government. The normative basis of equalisation grants has diminished the possibilities of arbitrary or biased distribution as well as logrolling in the distribution of these grants. Practices of borrowing and low budgetary discipline (in investments) have forced the central government to work out more efficient accountability and control mechanisms over the budgeting and financial management.

Estonia has an autonomous (vs. integrative) system of local government. State authority could have only the right of supervision of the legality of local government actions. County governor could apply to the municipal council to revise its decision that in his/her opinion is not compatible with the law. After the refusal by LG council to do this, county governor could apply to the state chancellor for the further application to state court.

2. LOCAL GOVERNMENT FUNCTIONS AND THEIR FINANCING

2.1. Local government functions

There are six general laws regulating LG, among them two laws regulating local government finances. The reliance on the general laws makes usually the accountability more transparent and the system less controversial. As stated the functions of LG are prescribed unambiguously by the Local Government Organisation Act (later on LGOA) and could not be negotiated with state authorities. The Act determines the functions, responsibilities and organisation of municipalities, and the relations between municipalities and with state agencies. The Act provides the basis for participation in economic activities, procedures for the formation of municipal districts, general structure of the council, principles for the formation of the government, competence of municipal agencies and other issues. This did not make, however, the definition of LG functions and accountability for their implementation transparent.

Also the other issue was discussed whether the LG could delegate its functions to the county government in case of failure to fulfil them. This right of LG was denied however. The only way to increase the capacity up to the minimal level becomes the amalgamation. Currently the Government prepares the amalgamation of LG units. Around 100 units are planned to remain after the amalgamation. (I.e. reduction is 2.5 times). The average of LG unit will be more than 500 km2. Such an amalgamation could increase the economy and efficiency but this will substantially reduce the access to the elementary services and democratic devices of LG. In Estonia the amalgamation of LG units will enhance the territory up to the point when the transportation and communication costs may exceed savings from the economy of
scale of scope. Besides, LG would be distanced from the members of local government that might diminish the public scrutiny up to the critical point to erode gains from the economy of scope and scale.

At the moment there exists a very complicated and confused system of assignment and tasks emerged.

Firstly, the art. 154 of Constitution declares that “all local issues will be resolved and regulated by local governments that operate independently in accordance with laws”. There has not been, however the general definition what are local issues. They could be issues that are not regulated and implemented by the state. The list of functions should be supplemented by the criteria of differentiation of tasks between local, regional and central levels that one could not still find in Estonian legislation.

Secondly, in spite of the general competence of LG is defined by the LGOA, specific functions that could be observed and judged at the level of implementation, are prescribed by numerous special laws.

The third, the same is true concerning assignments of state functions to LG. According to constitution expenditures committed to the implementation of these functions should be funded from the state budget. The normative redistribution of government support and the use of general grants might make the devices of compensation of expenditures by the government rather vague. As financial calculation of costs of legislation in Estonia is insufficient, the spontaneous assignment of functions by laws was not accompanied with the definition of rates of compensation.

The other side of coin is that the government has no device to compel the LG to implement its functions. This has become a silent agreement between LG and the state. The government does not control the ways the money from government budget is used and does not notice the failure of the part of LG units to implement its functions appropriately. Because the government knew well that this is because the executive has not been able to work out formula of distribution of functions that could take into account insufficient capacity of the part of local government units. As government grants are calculated on the basis of revenues, implementation standards are not used in evaluation of financial needs of the local government.

In 2000 the Ministry of Finance made a proposal to give some functions that were so far performed by the state over to local governments. It would be practical to give these additional functions over in several stages. Taking into account the opinions of other ministries it was technically possible to hand over the teachers’ salaries and management costs of municipal schools, buying means of instructions and smaller investments to local governments from the budget year 2001. The total transferable cost is ca 1,4 billion kroons. Up till now the Government decided the size of teachers’ salaries but from now on the municipal council will establish the different levels of teachers’ salaries.

What will transferring of these functions give?
1) It will decentralise the decision-making and will make the responsibility more concrete. On the level of Parliament and central government should not be decided the things that are substantially of local nature.

2) It will help to balance the relations of ministerial (branch) and territorial management. At the moment the ministerial management prevails in public sector (financial) management, increases the number of ministerial regulations from which many of them will form the revenues and expenditures of local budgets. The substance of this tendency can be seen from the fact that the number of positions in budget implementation reports presented monthly to the Ministry of Finance have risen from 185 position in year 1996, 306 in year 1997, 548 in year 1998 to 574 position in year 1999. Although the growth of ministerial management is not the only reason of this tendency, the increase of several earmarked funds that take place through ministries has been characteristic to the relations of state and local government budgets during last years.

3) It will make more concrete the relations of financing and administration. Before 2001 local government administrated the schools but covered less than half of the costs. In 1999 the state financed the costs of secondary schools in total of 1,2 billion kroons through the local government budgets. The teachers’ salaries and social tax and management costs of municipal schools and buying means of instructions were reflected in the budget of the Ministry of Education.

Transferring all aforementioned costs to the local governments’ budgets will have following advantages:

- Financing system will be cheaper. In the system that existed till 2001 too many officials were occupied with the division of assignments, arrangement of budget implementation and reports of budget implementation. The school is a whole as service organisation but before 2001 there were two kind of employees – ones were civil servants because their salaries were financed from state budget and others were municipal employees. Necessity to manage two different cash-flows will disappear.
- Financing system becomes more transparent. The system that existed till 2001 was not absolutely transparent and didn’t answer to the requirements of municipality’s financial management, didn’t give an information about real cash-flows. For example it is possible to find out how much costs one pupil place in one or another school on two levels – at the school level or in the department of education. After the department of education the reports are divided by two – to local government will be given information about expenditures from local budgets and the Ministry of Education will be given information about expenditures from state budget.

From budget year 2001 all these expenses are given over to local government budgets by adding this sum to the local government grant fund. These sums are earmarked, i.e. they can be used only for teachers’ salaries and management costs of municipal schools, buying means of instructions and smaller investments.

The Ministry of Finance has made in my opinion quite a radical proposal as well. They proposed to divide the resources between local governments taking into consideration the total cost of all functions performed by certain local government. I don’t think this is a good idea while
• First, the meaning of local government will disappear while there exist wise persons on a central government level who can define what kind of functions local government has, how much they will cost and finance these accordingly.
• Second reason why it is not possible to compose the parcel of normative costs and functions of local government on central government level is a difference of functions between rural municipalities and towns and also difference of implementation of these functions. And from that comes the difference in the structure of budget expenditures. In general local governments spend to the education over 40% of total budget but there exist local governments who don’t spend anything for education because they don’t have schools, they buy this service from other local governments and these expenses are reflected under position “transfers to other local governments”.

2.2. Financing of local government functions

2.2.1. Structure of revenues

From the beginning of 1994 local governments receive main part of their revenues from taxes. There are state taxes (personal income tax, land tax and gambling tax) and local taxes.

State taxes:
• Personal income tax forms the largest proportion of local governments’ revenues. According to the Income Tax Law 44% from personal income tax goes to state budget and 56% to the budget of local government where the person is registered.  
• Gambling tax. 5% from gambling tax is transferred to the local government where the gambling site is registered and actually operates. Revenues from that tax are very small and mainly this tax is revenue basis for the large towns.  
• Land tax is the second most important tax in local governments’ revenue structure. Alongside with the local taxes the land tax composes that part of local governments’ revenues over which they have big enough autonomy. As the local government may set the tax rates and because 100% of land tax is transferred back to local governments budget, this tax has all the prerequisites the local tax must have. The absence of tax collecting capacity as well as large possibilities of tax evasion can be a reason why this is still the state tax.

Local taxes:
According to the Local Taxes Act the local government may impose on its territory following taxes:
1. personal tax;
2. sales tax;
3. boat tax;
4. advertising and announcement tax;
5. tax on closing the streets;
6. tax on motor vehicle;
7. tax on keeping of animals;
8. entertainment tax.
According to the Local Governments Organisation Act the municipal council may establish new taxes and change tax rates before the adoption of local budget or before the change in the local budget.

The Rural and Municipality and City Budgets and State Budgets Correlation Act established the principles of allocations to local budgets by the state. This Act will be invalid when new State Budget Act will be approved. According to the new act assignments to local governments can be of two different kind:

- through support fund (unconditional grants);
- single-purpose allocations (conditional grants);

By division of resources of this support fund are taken as a basis the expected incomes from state taxes and charges to local government budgets, number of inhabitants in a municipality and other specialities of municipalities.

Local governments get also grants from the state budget through the budget of ministries. In that case the transfers are expressed in the budget of ministry. These grants are frequently delivered in kind.

Unconditional grants

In addition to taxes the unconditional grants from state budget form the revenues of local government budgets. The rules of deliver of unconditional grants (central government doesn’t make any restrictions about the purpose of usage) are established by the Rural and Municipality and City Budgets and State Budgets Correlation Act (from 2002 it will be regulated by State Budget Act). It states the principles of appropriations to local budgets by state.

The purpose of the first type of grants is to supplement and equalise the revenues of local governments coming from the different revenue basis. Special general grant is delivered for regions located in specific geographical conditions (remote areas, island etc.) If local governments would have the total financial autonomy (i.e. the revenues will be formed only from their own incomes), they wouldn’t be able to offer all public services that are foreseen by the laws even if the income tax will be paid 100 %. During last years the share of unconditional grants in the revenues has decreased, on the other hand the share of transfers through ministries has increased.

The size and distribution of grant fund among local governments in the draft of state budget is determined by the agreement between the authorised representatives of local governments’ unions and the Government. If mentioned parties cannot come to the agreement, the Government itself will decide the size of grant fund in the draft of state budget and its distribution. In the distribution of grant fund between the local government the expected level of revenue from government taxes, from fees of mining the mineral deposits and of special usage of water, the number of permanent inhabitants in municipality and other special features of municipalities is taken into account.
From grant fund to local budget given grant is calculated in following way:

\[ T_n = (m \cdot a_k - a_n)^{0.9} \cdot c_n \]

where:
- \( m \) – coefficient of grant level (the standardisation coefficient)
- \( a_k \) – average level of revenues paid to local government budgets from state taxes and fees per one inhabitant in 2001 in Estonia (in EEK)
- \( a_n \) – level of revenues paid to local government budgets from state taxes and fees per one inhabitant in 2001 (in kroons)
- \( c_n \) – number of inhabitants in local government

Some economists have expressed their opinion about this formula and they have thought that this is not ready yet for usage. The formula includes measures that are difficult to determine. This formula cannot be used in a situation where local government can choose to buy the services from private sector or establish a municipal organisation.

The Ministry of Finance has prepared a new formula for local governments’ grants. In the present formula the state support was calculated as a presumed income of personal income tax per year per municipality. In the new formula it is planned to take into consideration the real amount of personal income tax paid to local municipality during last two years. The application of new formula would change considerably the proportions of distribution of grants in comparison with existing ones. According to the predictions the most will suffer the administrative units where unemployment rate has raised and revenues from income tax have decreased most quickly. The argument for applying the new system is that old system didn’t favour municipalities’ own activities in increasing incomes.

**Conditional grants**

The third source of revenues beside taxes and unconditional grants are conditional grants. There are various conditional grants dependent on which purpose the grant is targeted.

Conditional grants are used for financing certain items of expenditures, projects or programs. The general amount is defined as a rule by the central government departing from the national interests. This amount could depend also on the initiative of local government who might apply for the National Development Program that lists several subprograms. Conditional grants are delivered also for the social needs. The resources are given for the support of the less developed regions to make them capable to offer the public and social services prescribed by the law.
3. LOCAL GOVERNMENTS BORROWING

3.1. Limitations on municipal capital spending and borrowing


Borrowing for municipalities and taking of other financial obligations is the exclusive right of municipal council. Municipalities can take loans or issue obligations on following conditions:

1) Total of all unpaid loans and issued obligations and other liabilities coming from those together with loans to be taken and obligations to be issued may not exceed 75% of planned budgetary revenues in current year (conditional grants from central government are excluded);

2) Total of repayment costs of repayable loans and loan interests and obligations may not exceed during any budget year 20% of planned budget revenue in case new loans and issuing the obligations are considered;

3) The municipality can also take short-term loans for covering the current costs. These loans aren’t treated as loans mentioned in the clause 1 and 2, i.e. these restrictions don’t apply to short-term loans. Many municipalities take that kind of loans in May or June when people are going to vacations and vacation money has to be paid but the revenues hasn’t come to the budget yet. That kind of loans must be returned by the end of the budget year;

4) These restrictions (clause 1 and 2) are not relevant for loans that have state guarantee. The state guarantee is given to those foreign loans when a creditor demands state guarantee or requirement of state guarantee derives from the law. The state may give guarantee in total of 15% of budget income of current year;

5) Loan will be taken or obligations issued for investments foreseen in a municipal development plan;

6) Borrowing and taking other financial obligations is the exceptional right of the municipal council;

7) The government of municipality or town has to present a copy of loan contract or obligation issue to the Ministry of Finance during 30 days after concluding the contract. Ministry of Finance will check if the new loan fits into the frames of legally defined loan limit.

3.2. Reasons of failures of local government borrowing management
These restrictions enforced by laws are not able to regulate borrowing appropriately and do not assure that municipality will not go bankruptcy. The weak points in the legislation are following:

- Firstly, the limits of local governments’ loans are not strictly defined. The actual total amount of loans may be bigger than 75% of revenues of the budget year. Because the requirement of the 75% (from revenues) does not include loans with state guarantee and short-term loans. So, the total amount of municipality’s loans could exceed all the budget income of current year. The example is given by following table.

Table 1 Total loan of municipalities compared with planned revenues in November 1998

<table>
<thead>
<tr>
<th>Municipality</th>
<th>County</th>
<th>Planned revenues for 1998</th>
<th>Total loans and interest</th>
<th>Total loan from planned revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kehra city</td>
<td>Harju</td>
<td>10 706,50</td>
<td>19 975,202</td>
<td>186,57%</td>
</tr>
<tr>
<td>Võnnu</td>
<td>Tartu</td>
<td>4 156,70</td>
<td>7 209,463</td>
<td>173,44%</td>
</tr>
<tr>
<td>Võhma city</td>
<td>Viljandi</td>
<td>6 247,60</td>
<td>8 690,069</td>
<td>139,09%</td>
</tr>
<tr>
<td>Orava</td>
<td>Põlva</td>
<td>3 201,90</td>
<td>3 717,111</td>
<td>116,09%</td>
</tr>
<tr>
<td>Oru</td>
<td>Lääne</td>
<td>3 093,90</td>
<td>3 213,463</td>
<td>103,86%</td>
</tr>
<tr>
<td>Türi city</td>
<td>Järva</td>
<td>21 116,50</td>
<td>20 472,987</td>
<td>96,95%</td>
</tr>
<tr>
<td>Haapsalu city</td>
<td>Lääne</td>
<td>52 334,60</td>
<td>48 943,191</td>
<td>93,52%</td>
</tr>
<tr>
<td>Taebla</td>
<td>Lääne</td>
<td>8 919,20</td>
<td>8 335,410</td>
<td>93,45%</td>
</tr>
<tr>
<td>Räpina city</td>
<td>Põlva</td>
<td>11 484,60</td>
<td>10 585,345</td>
<td>92,17%</td>
</tr>
<tr>
<td>Jõelähtme</td>
<td>Harju</td>
<td>22 036,90</td>
<td>19 318,335</td>
<td>87,66%</td>
</tr>
<tr>
<td>Püssi city</td>
<td>Ida-Viru</td>
<td>12 831,30</td>
<td>10 790,000</td>
<td>84,09%</td>
</tr>
<tr>
<td>Maardu city</td>
<td>Harju</td>
<td>55 568,00</td>
<td>45 919,912</td>
<td>82,64%</td>
</tr>
<tr>
<td>Kullamaa</td>
<td>Lääne</td>
<td>5 052,50</td>
<td>4 040,669</td>
<td>79,97%</td>
</tr>
<tr>
<td>Mooste</td>
<td>Põlva</td>
<td>5 387,70</td>
<td>4 289,188</td>
<td>79,61%</td>
</tr>
</tbody>
</table>

- Secondly, the law doesn’t define clearly whether the ceiling of total debt includes only the repayments or also the interest payments;

- The law doesn’t regulate what can be done with municipalities who have difficulties with payments. LG can’t be in bankruptcy according to the Bankruptcy Law of Estonian Republic. But according to the Law of Taking Foreign Loans and Ensuring the State Guarantees to Foreign Contracts the guarantee (the government) has the right to demand compensation of losses of the guarantee and if the these will be not compensated, the state may initiate procedures of bankruptcy. The only law that considers the procedures according to which the LG debt must be handled is the Law on Correlation of the Municipal Budget and State Budget. According to the law if the municipality has financial obligations in front of state that the former cannot fulfil, then the central government has the right to reduce the state grants proportionally with the amount of the debt. The absence of such kind (grants for nursing homes, grants for pupils’ transportation expenses,
grants for investments etc.) of state grants may affect seriously the welfare of local citizens.

- Even though Estonian laws don’t permit LG to give guarantees to enterprises with LG share, these laws don’t forbid to subsidise them;
- The obligation to inform the Ministry of Finance (about the loan or issuing of obligations) has been interpreted by financial institutions (banks) as the specific silent guarantee to the loans of local government. Therefore banks have set the "special price" for municipal loans. Although it is not said in a law that the state gives a guarantee to local government loans, financial institutions have taken for granted that when local government occurs in financial difficulties, the state will help them out.

To the following table (Table 2) I have selected local governments that have the biggest problems and as you can see some of them have exceeded the given limits quite a lot. In addition to ignoring the established restrictions many local governments don’t inform the Ministry of Finance about taking financial obligations. From that we can draw a conclusion that established rules don’t work and lately there have taken place a lot of meetings in the Ministry of Finance where the problems and possible solutions were discussed.

Table 2
Local government loans (thous. EEK)

<table>
<thead>
<tr>
<th>Municipality</th>
<th>Revenues in 2000</th>
<th>Loans with interests</th>
<th>% of obligations</th>
<th>2001 repayments (%)</th>
<th>2002 repayments (%)</th>
<th>2003 repayments (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kehra city</td>
<td>15 633.2</td>
<td>13 319.8</td>
<td>85.20</td>
<td>18.82</td>
<td>18.82</td>
<td>19.02</td>
</tr>
<tr>
<td>Keila city</td>
<td>68 502.4</td>
<td>37 702.0</td>
<td>55.04</td>
<td>37.85</td>
<td>3.55</td>
<td>3.34</td>
</tr>
<tr>
<td>Keila parish</td>
<td>14 360.4</td>
<td>10 727.0</td>
<td>74.70</td>
<td>13.00</td>
<td>14.79</td>
<td>16.52</td>
</tr>
<tr>
<td>Paldiski city</td>
<td>20 082.0</td>
<td>13 632.1</td>
<td>67.88</td>
<td>17.41</td>
<td>15.86</td>
<td>14.48</td>
</tr>
<tr>
<td>Kärdla city</td>
<td>17 098.9</td>
<td>12 904.6</td>
<td>75.47</td>
<td>18.82</td>
<td>11.63</td>
<td>11.63</td>
</tr>
<tr>
<td>Avinurme</td>
<td>9 171.8</td>
<td>5 926.8</td>
<td>64.62</td>
<td>9.50</td>
<td>8.60</td>
<td>8.11</td>
</tr>
<tr>
<td>Püssi city</td>
<td>13 438.6</td>
<td>8 243.0</td>
<td>61.34</td>
<td>13.29</td>
<td>14.06</td>
<td>14.48</td>
</tr>
<tr>
<td>Haapsalu city</td>
<td>71 742.8</td>
<td>58 408.0</td>
<td>81.41</td>
<td>6.42</td>
<td>9.36</td>
<td>8.67</td>
</tr>
<tr>
<td>Ridala</td>
<td>12 354.6</td>
<td>7 944.0</td>
<td>64.30</td>
<td>11.93</td>
<td>10.87</td>
<td>10.20</td>
</tr>
<tr>
<td>Pärnu city</td>
<td>232 084.8</td>
<td>194 174.8</td>
<td>83.67</td>
<td>38.07</td>
<td>14.06</td>
<td>13.72</td>
</tr>
<tr>
<td>Põlva city</td>
<td>33 114.8</td>
<td>22 472.5</td>
<td>67.86</td>
<td>4.45</td>
<td>10.00</td>
<td>9.69</td>
</tr>
<tr>
<td>Räpina city</td>
<td>14 252.4</td>
<td>8 920.3</td>
<td>62.59</td>
<td>7.98</td>
<td>7.69</td>
<td>7.69</td>
</tr>
<tr>
<td>Kuressaare c.</td>
<td>74 607.0</td>
<td>44 436.3</td>
<td>59.56</td>
<td>5.26</td>
<td>12.85</td>
<td>11.83</td>
</tr>
<tr>
<td>Möösa küla</td>
<td>6 318.4</td>
<td>6 353.0</td>
<td>100.55</td>
<td>13.77</td>
<td>13.91</td>
<td>15.17</td>
</tr>
<tr>
<td>Viljandi city</td>
<td>97 339.2</td>
<td>75 911.3</td>
<td>77.99</td>
<td>6.73</td>
<td>10.41</td>
<td>10.47</td>
</tr>
<tr>
<td>Võhma city</td>
<td>7 939.5</td>
<td>12 642.0</td>
<td>159.23</td>
<td>17.22</td>
<td>18.65</td>
<td>18.49</td>
</tr>
</tbody>
</table>

There has been set a target: to achieve the balance of general government (state and local governments budgets) budget and to prevent the financial crisis situation of local governments that can occur when local governments take obligations over their capabilities.

Standards established by the law cannot establish a full picture about the LG debt. The repayment of most of the foreign loans may start several years later. But at the same
time 75% of own yearly revenues is for most of LG too small amount to make important investments.

As I mentioned above the Rural Municipality and City Budgets Act establishes the limits of borrowing but the act lacks the regulative mechanism that will guarantee keeping these limits. At the moment local government can exceed in the act established limits without being hindered and punished. The other problem is a lack of adequate statistics about local government loans and that complicates composing a substantial and profound analysis. The Ministry of Finance added to the report of 2000 a new form. From that we can see the obligations of loan and interest payments as of the end of 2000.

In the framework of existing restraints and procedures of approval by the Ministry of Finances LG in Estonia are completely independent to enter into the credit market, including foreign. In practice, Tallinn is the only one capable to go to the credit market and actually it went to the credit market (international credit market) twice – in 1994 and in 1998. The amount of obligations in 1994 was 60 million DEM and the fixed period was three years. In 1998 the amount of loan was 30 million DEM and the fixed period was five years. Last time Tallinn used the obligations with changing interest rate and the payback timetable.

3.3. Proposals for improving the rules of taking financial obligations

The proposal is to define exactly what kind of data is taken as basis for calculating the loan limits. It should be defined very clearly what is meant by financial obligations – loans, obligations, leasing, principal and interest payments etc. – and what is meant by revenues – i.e. is there any articles that should be excluded (for example from the year 2001 the teachers’ salaries were transferred to the local government budget but it hasn’t been decided to include them to the revenues that are basis for calculating loan limits or not. If these sums will be included then local governments can borrow even more but actually they won’t have resources for repayments because teachers’ salaries are ear-marked sums.).

There are different alternatives what exactly can be done. In the following section I will give a short overview.

Alternative I

Local governments will take loans first of all from commercial banks. Then:

• we have to reduce the valid limits. When calculating the suitable limits we definitely have to take into account the fact that the teachers’ salaries that were given to LG budgets from 2001 have increased the revenues remarkable.
• We have to establish the precontrolling mechanism, i.e. that local governments will present their loan applications to the Ministry of Finance for approval before concluding the contracts. From one point of view this will assure that the Ministry of Finance will know about all the financial obligations and can discover in a very early phase if some LG has broken rules and can take suitable measures to prevent
LG to conclude the contract. From other point this restriction will not be in accordance with an attempt to give local governments as much freedom as possible, i.e. decentralise the system and also the constitution says that local governments are independent units that have their own budgets.

**Alternative II**

If we don’t apply precontrol mechanisms we should establish responsibility for breaking the limits intentionally and for presenting wrong data.

- stemming from administrative reform only general principles of borrowing will be prescribed by law and to the Government will be given a right to establish the limits, presenting and proceeding loan applications and the rules of registration of bond issues.
- To improve the follow-up control it should be considered to integrate the databases of local government loans of commercial banks with databases of Ministry of Finance
- To prescribe uniquely in the Rural Municipality and City Budgets Act that the state doesn’t guarantee local government loans. Probably after that financial institutions will look more carefully will the local government be able to pay back a loan and interest and how many other loans does it have.

**Alternative III**

Local governments don’t have or have restricted access to the loan market of commercial banks and all the borrowing will take place through Treasury.

- To establish the total sum of loans of public sector every year in a state budget.
- To compose a loan committee in the Ministry of Finance that will look through the local governments’ loan applications.
- To establish in a law or in another juridical act the criteria for assessing the loan applications and also the rules for proceeding these applications.

By the third alternative can rise the juridical argument are these principals in correspondence with the article 9 clause 8 of the Harta of European Municipalities. I think this depends on interpretation. But article 9 clause 8 says the following: “Local authorities have an access to the national capital market within the law if they want to take a loan for capital investments.”

All these were proposals for improving the system of local government borrowing. Next I will give a short overview of proposals that have already been presented to the Cabinet and should be effective from 2002:

1. In a new State Budget Act there is a clause according to which the Government has a right to reduce the allocations from the support fund to the local government if the latter has borrowed more than was allowed according to the rules. The allocations can be reduced in a sum that corresponds to the sum that was borrowed over the limits.
2. With new State Budget Law (effective date of this act should be 1st of January 2002) will be enforced a new classification of revenues and expenditures. This classification will also be compulsory to all local governments. According to this
classification all loans, foreign and national aid, investments will be part of budget. There won’t exist any extra-budgetary funds anymore. All financial transactions (taking and giving loans, interest payments, buying and selling shares etc.) will be reflected in a budget. A new classification should give a total overview of finances.

3. It was proposed to change the section 8 in the The Rural Municipality and City Budgets Act in the following way: “Total of all unpaid loans and issued obligations and other liabilities coming from those together with loans to be taken and obligations to be issued may not exceed 55% of planned budgetary revenues in current year (conditional grants from central government are excluded);”

4. It was proposed to supplement the section 8 with subsection 9 in the The Rural Municipality and City Budgets Act: “The Government has a right on a proposition of Minister of Finance to stop the payments from the support fund to local government if the Ministry of Finance will disclosure that local government hasn’t presented the copy of loan contract or registration of obligations in the Securities Inspectorate of Estonia to the Ministry of Finance.

5. It was proposed to change the section 375 in the Code of Administrative Infraction: “There will be designated a pecuniary penalty in an amount from 50 to 200 daily salary if there occurs infraction of requirements of State Budget Act or Rural Municipality and City Budgets Act”.

3.4. Regulating the financial crisis situation of local governments

Regulating the borrowing activities of local governments is connected with regulating the financial crisis situations or so called “bankruptcy” of local governments.

As I mentioned above the law doesn’t regulate what can be done with municipalities who have difficulties with payments. LG can’t be in bankruptcy according to the Bankruptcy Law of Estonian Republic. But at the same time there have been several situations when local governments have occurred in critical financial situation but as there were not any mechanisms for regulating the whole situation the Government has dealt with all these cases separately. The interference of Government has first of all offered one-time solutions.

In October 2000 the Ministry of Interior, taking into account the advises of the Ministry of Finance, presented to the Cabinet the draft of Stabilisation and Guaranteeing the Succeeding of Rural Municipalities and Towns Economy. The aim of this law is to prescribe the activities what should be done when the local government is in financial difficulty. There is also given a definition what is financial difficulty. This draft doesn’t define yet the conditions of local government bankruptcy but I think it’s still one step further in defining the financial crisis situation.

In Estonia there did not exists the special fund for local governments that are in the financial difficulties. These municipalities were financed from the reserve fund of Government. Every year the money was transferred to this fund from state budget.

The new Act of State Budget was enforced from 2001. On the one hand, it was formed the Stabilisation Fund of Local Governments – the reserve fund developed by
the local governments themselves where municipalities could receive the emergency help. On the other hand, at the same time the rules for borrowing become more restrictive for local governments.

According to the draft law, the reserve is a common property of local governments that is formed by local governments’ payments and from which the disbursements will be made if the financial difficulties occur. The difficult financial situation is defined as a situation where a municipality can’t pay off the debts and fulfil the tasks because tax revenue has been less than expected or expenses are much higher than revenues. In every budget year every municipality has to pay to this reserve at least 2 % of the expected revenues of budget year till its part forms at least 5 % of annual revenues. After passing state budget the fund can start its work already from the year 2001.

If the proportion of local government in this fund raises over 5 % of its annual revenues (because of voluntarily made payments or decrease of budgetary revenues), then the repayments won’t be made to this local government. After the disbursements to local government in case of emergency, it will start to return the resources in the next budget year. Annual return has to form at least 2 % of annual revenues until all money received by the local government has been paid back and its proportion in the reserve will form again at least 5 % of annual revenues.
CONCLUSIONS

In my presentation I tried to give an overview of present situation of local government budgets and of problems connected with budget. Mainly I concentrated on two themes: local government functions and its financing and borrowing of local governments.

At the moment there is quite a lot of problems in these fields. From one side the Government tries to decentralise the management of local governments and give as much autonomy as possible but from the other side there is lack of professional and managerial skills on local government level and very often they cannot cope with additional responsibilities. They lack skills in financial analysis (debt financing) mission driven budgeting, long-term fiscal planning, managing finance in the context of high inflation, policy development and general management.

As I mentioned in my presentation the Government is dealing with the shortcomings of local government financial management and I think that changes in State Budget Act and in other laws will improve the situation remarkable. One of the problems of local governments has been their capacity. The only way to increase the capacity up to the minimal level becomes the amalgamation. Currently the Government prepares the amalgamation of local government units and around 100 units are planned to remain after the amalgamation.

Also the administrative reform should improve the situation. One of the aims of the reform is to improve the mechanism of local government budget preparation. To have a control over their expenditures is a sign of real local government. One of the main aims of local government budget preparation is to raise the independence of local governments by decreasing the share of grants from state budget and by increasing the share of local taxes, user charges and fees and state taxes percentage. It will be also important to increase the stability of local government revenues that will create the prerequisites for a long-term planning of expenditures.

The mechanisms of local government budget preparation should be rearranged in a way that the local government will have more interest in economic growth in local
government. But at the same time the responsibility for the usage of budget resources should be increased.

In the interest of one of the central government tasks – to maintain the macroeconomic stability – is to guarantee the balance of aggregated budget and fiscal stability. For that it is important to achieve a better overview of local governments’ fiscal situation, especially of liabilities, in order to avoid crisis situations or to interfere in solving such situations on time.

LITERATURE:

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