Overview of the use and preservation of state assets in 2012–2013

Summary of Problems in the Development and Economy of Estonia by the National Audit Office

Preface

The National Audit Office prepared this year's review of the situation in the development and economy of Estonia at a time when more and more people of Estonia have started to acknowledge the fact that the image of the state we would like to maintain and the state we can actually afford to maintain are not overlapping. For the first time, the National Audit Office presents a more thorough and generalised overview of our nation's state of affairs and what lies ahead so as to ensure that the future is not too unexpected. As an objective analyst the National Audit Office can give society, those elected and those to be elected a balanced observer's view of the situation without adding any black or rose-tinted undertones.

Looking at the way Estonia's economy, finances and people have been doing, I see that despite the economy recovering from the recession of 2009 and public accountancy being in order, many working people do not feel that their standard of living has improved. I mean their real lives – not the lives they supposedly are living based on the statistical average.

In addition to working people, pensioners continue to find it tough as well. Although the figures of pension growth look good, this growth is almost unnoticeable as an actual addition to the income, as the cost of living is rising at the same time. Access to medical care hasn't improved either. People are moving to cities or foreign countries in their search for a better life and self-realisation. Administering the ever more sparsely populated rural areas and advancing the lives of those who have stayed there is therefore becoming increasingly complicated.

Society expects the patience and austerity demonstrated at the height of the recession to be converted into a palpable improvement in their lives, and they expect it to happen in the next few years – not in some obscure and distant future.

Despite its small public debt, very nearly balanced budget and the existence of reserves, covering constantly increasing social expenses is a struggle for Estonia. The fiscal space left after payment of pensions and health care is limited. This means that other areas of activity – especially those that affect the future of the state – have to settle for less money or smaller increases in expenses. The state is able to make investments mainly with the support of foreign financing, and once they're cut, the investments will also dry up. Our dependence on foreign aid is also evidenced by the small number of investments planned for the next few years, as the money from the previous European Union budget period has been disbursed and launching payouts from the next period funds will take a couple of years.

The reality in Estonia is that both state and local governments will find coping with their tasks increasingly difficult in the long term. The challenge we're facing is how the economy can earn enough income for society and the State Treasury in a situation where the number of working people is decreasing considerably. Pressure to increase social expenditure is increasing at the same time. Studies have indicated that Estonia's pension and health care systems are not sustainable in these conditions in the long term.

We have been building our independent country for more than twenty years now. We've often had to make decisions quickly, without spending too much time on assessing their potential impact, on broad-based discussions and coordination of activities between the different areas of activity of the state and within the political establishment itself. These fast and misconceived decisions have not always been made because of external pressure (especially in recent years), but because of an unwillingness or inability to consider matters in depth. These circumstances in turn have left their mark on the quality and preparation of the decisions. There has been no comprehensive or systematic plan for the advancement of life in Estonia.

However, the demographic challenges that Estonia is facing force the state to plan its development comprehensively and to assess its options critically. In order to do this, it is necessary to take some time, look into the mirror and ask oneself about our capability to meet expected obligations towards our citizens in the long term. We no longer have to ask whether or not we can carry on as usual. It is important that we do not delay in making serious reform choices and decisions until it's too late and we're no longer able to influence processes that have started developing on their own.

In my opinion, we should also find answers to the following questions when planning the further development of the state and local authorities: 1) What benefits does the public sector offer people? 2) What is the minimum standard of those services? 3) How much does offering the benefit cost, who pays for it and where does the money for this come from? 4) Does the service need to be provided for people by the state or the local government?

Since people currently receive most services and public benefits via their local government, it is important to look at the state and local government's functions and revenue/expenditure as well as the selection of services they offer comprehensively and in confluence before decisions are made. This means that reforms of major areas of expenditure and the services provided must be agreed on alongside local government reforms.

I would go so far as to claim that local governments are about ten years ahead of the state's development trends. What I mean is that everything we see happening in local governments today, all these different difficulties and challenges, may hit the state as a whole, and this may happen sooner than in a decade's time. This means that the state's major structural reform areas are not the only aspects that need to be reviewed:

this also applies to the services provided by the state on a broader scale, as well as the quality and/or accessibility of those services which cannot always be guaranteed in real life.

In order to ensure that these decisions – which Estonia needs – are made and also implemented, we need broad-based consensus: on the one hand, we need to be prepared to openly admit our problems and failures; on the other, we need a constructive mind-set that helps us work together and direct our energy towards finding the best solutions, instead of focusing on issues of little importance and attacking others, thereby increasing the gap between society’s expectations and reality even further.

The decisions that need to be made are not easy, but we have no choice – we must move from a world of over-dimensioned expectations to the real world. In other words, we have to see what we can leave undone and what we can do differently, and we also have to take steps to generate ‘new’ revenue in the state budget by looking for brave and original public policy solutions that are also reasonable and well-functioning.

To avoid getting stuck in the domestic context when looking for solutions to our problems, we have to continue looking at everything on a broader scale – the scale of European Union and world development, considering long-term interests and not proceeding from single, short-term considerations alone.

Given all of these economic and organisational problems of the state that Estonia is already facing and will increasingly face in the future, it makes sense to start discussions now and talk about what we have to do, keeping in mind the governance axis, starting with the state and ending with the local government. In other words, we have to figure out which functions, considering our capabilities, could be performed domestically and which could be delegated with their budgets to the European Union level. And this discussion will certainly benefit from a pragmatic, rational and prejudice-free attitude – the kind provided by the National Audit Office.

Alar Karis
Auditor General of Estonia

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State assets and their use

1. Using taxpayers' money for the advancement of life in Estonia is a task of the Government of the Republic. In 2012 the government had 7.6 billion euros[1] at its disposal with the consent of the Riigikogu to be used to improve people's standard of living, look after their security and contribute to the development of society in other ways. This year, the amount of state budget that the government can use is slightly larger, i.e. *ca* 7.7 billion. The ministers and the government have prepared state budget explanatory memoranda and development plans that explain how the government plans to use the money, what public services will be offered to the taxpayer and what results it is seeking to achieve.

Read more

in the state budget explanatory memorandum on what the state will spend budget funds on in such areas as education, health and the employment market in the present year (www.fin.ee/riigieelarve-2013).

2. The government is expected to achieve its goals and use the money successfully, but in doing so it must also use the money lawfully. The National Audit Office is obliged to help the public understand how the governors of the state have coped with their duties: whether taxpayers' money has been used successfully, lawfully and in a manner that the public can understand. The National Audit Office conducts performance, compliance and financial audits for this purpose.

3. The National Audit Office checks every year whether state agencies have used taxpayers' money for the activities prescribed in the budget, used state assets prudentially and recorded their activities in accounting as required. The National Audit Office gives an opinion on the use of money by the state as a whole, all ministries and constitutional institutions every year. The reports are submitted to the Riigikogu and they can be read on the website of the National Audit Office.

The government has mostly used taxpayers' money lawfully

4. The National Audit Office is of the opinion that in 2012 most state agencies performed important economic transactions on the basis of law, i.e. they spent money in the manner prescribed in the State Budget Act. However, some mistakes are made year in, year out. For example, ministries still assume long-term obligations for the state which they have no right to assume pursuant to the State Budget Act.

Long-term obligations valued at *ca* 300 million euros have been assumed without the permission of the Riigikogu

5. The State Budget Act says that state agencies may take out loans, use capital lease and assume other long-term obligations only if the Riigikogu has granted permission for this when approving the budget. However, ministries have ignored this requirement. They have entered into long-term lease contracts that cannot be terminated and that state agencies can terminate early only if they pay all lease payments, the residual value of the leased object and the financing expenses to the lessor. The value of such unlawful obligations assumed on behalf of the state as at the end of 2012 is 296 million euros, which is 19 million less than the year before. However, the breach remains a serious one. Although the National Audit Office highlighted this problem and possible solutions in previous years, incl. last year, and the Ministry of Finance promised to provide clearer

[1] State budget revenue with transferable taxes for 2012 and 2013 approved by the Riigikogu. Transferable taxes are taxes planned in the state budget as both revenue and expenditure and other charges collected by the state and transferred to the person determined in legislation.

regulation of the assumption of long-term obligations, this has yet to be done.

6. There have been other cases where taxpayers' money and state assets have not been used prudently. The National Audit Office is of the opinion that state agencies have not always acted on the principle that state assets must be handled in a manner that increases benefits and prevents damage. The manner in which the Road Administration has granted the use of quarries to companies is an example of this. The National Audit Office is of the opinion that the Road Administration has entered into contracts that are unfavourable for the state, because it has assumed obligations for the state that should not be assumed and waived the income the state could have earned from granting the use of the quarries. The Defence Forces have continued to breach the principles of the State Assets Act by granting the use of state-owned housing to persons who are not entitled to this by law, or rented out the premises on unreasonably favourable conditions.

7. The most effective use of taxpayers' money is also threatened by breaches of requirements in public procurements. Although the National Audit Office is of the opinion that ministries have generally observed the Public Procurement Act and the situation has improved compared to previous years, there are still mistakes that have been made. For example, six of the 11 ministries failed to organise procurements as required by law. The documentation requirements of public procurement were often erred against, misleading information was given in the Public Procurement register, contracts were not made in writing or they were entered into on terms and conditions differing from those given in the procurement notice.

Organisation of state accountancy has improved

8. The level of accounting in ministries has improved and become more uniform. The National Audit Office found that the 2012 annual accounts of the state were correct in all material respects and have a true and fair view of the state's financial status, performance results for the year ended and cash flow of the state.

9. You can read the observations made by the National Audit Office about the state's annual accounts, incl. the budget implementation report and legibility issues of the State Budget Act, the increase in rent prices faced by state agencies etc. in the audit of the National Audit Office entitled 'Accuracy of annual report 2012 and legality of transactions of the state' and on pp. 142–157 of this overview.

Health of the state economy and public finance

10. In 2012 the economy of the 27 European Union Member States (EU 27) and the eurozone went into decline again after a short and modest recovery from the global financial crisis. The economy of the EU 27 demonstrated a 0.4% decrease in 2012 (see also Table 1). The economy of almost half of the Member States was in decline. The economy of the European Union recovered somewhat in Q2 of this year, but forecasts show that it will once again shrink in the present year.

11. An uncertain economy means that the revenue of the state is poor and that it will struggle with the performance of the obligations assumed in better times. Last year, Germany was the only country in the EU 27 that managed to earn as much money as it spent and the budgets of all other countries were in deficit, which in the EU 27 as a whole comprised 4% of the community's gross domestic product (GDP). Although the total deficit is smaller than in 2011, money still had to be found for expenditure that exceeded revenue. As such, the debt burden of the EU 27 grew even further, reaching 85% of GDP.

Estonia has coped well with the crisis compared to Europe

12. Recent developments indicate that the European economy has not yet overcome the financial crisis that started more than five years ago and it is still necessary to find ways of giving the economy sustainable momentum despite large public debt and to avoid deterioration in people's standard of living. Economists disagree about possible solutions to the crisis, but at the international level Estonia is considered a good example of how to combat the crisis.

Estonia's gross national product is bigger than during the boom

13. Based on the 'big' indicators of public finance and the economy, which are predominantly observed in Europe and which form the basis of opinions, we can say that Estonia has recovered from the crisis. Moreover, in several economic aspects Estonia has exceeded the results achieved in the years of rapid growth, i.e. during the boom.

14. The most general indicator used to compare the economies of countries, i.e. gross domestic product, increased less in Estonia in 2012 than in 2011, but the only European Union Member State to do better than 3.9% was Latvia (5.0% increase). The economic growth achieved in 2011 was 6.9%, which no other Member State managed to surpass (see also Table 1).

Table 1. Real GDP growth rate in Estonia and European Union from 2009–2012 (%)

Real GDP growth	2009	2010	2011	2012
Estonia	-14.1	2.6	9.6	3.9
EU 27	-4.5	2.0	1.7	-0.4
Lithuania	-14.8	1.6	6.0	3.7
Finland	-8.5	3.4	2.7	-0.8
Sweden	-5.0	6.6	2.9	1.0
Latvia	-17.7	-1.3	5.3	5.0

Source: Eurostat

15. In 2012 the Estonian economy reached a stage where the monetary value of goods and services produced exceeded the level achieved at the peak of the boom. Whilst GDP comprised 16.2 billion euros in 2008, the same indicator in 2012 was 17.4 billion. It is true that the calculation is given in current prices, i.e. the price increase in goods and services has also had an impact. However, Estonia's GDP is also catching up with the peak of the boom in fixed prices. In the fixed prices of 2005 Estonian GDP comprised 13.2 billion euros in 2007 and 12.7 billion euros in 2008, but in 2012 it once again reached 12.7 billion euros after a period of decrease.

Export volumes are larger than at the time of rapid growth

16. Exports of goods and services played an extremely important role in the recovery of economic growth from the crisis. Exports also decreased at a time when private consumption and investments underwent a sudden decline, but this decrease was smaller and it prevented the Estonian economy from sinking into even deeper decline. Exports of goods and services started to increase rapidly in 2010 and 2011 and became the engine of economic growth in those years. Export volumes already exceeded the peak of the boom in 2011 and although growth in exports has slowed considerably since then, the volumes at current prices considerably exceed the level of 2008 (see also Table 2).

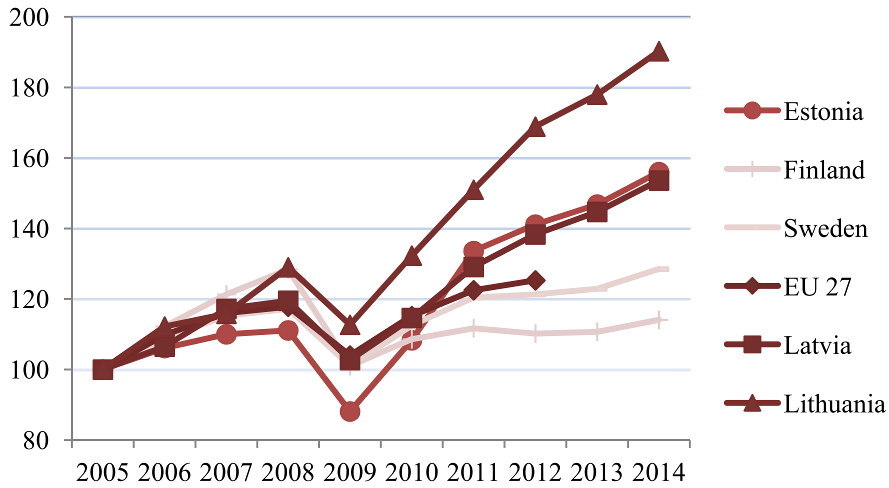
Table 2. Export volumes of Estonian goods and services from 2008-2012

	2008	2009	2010	2011	2012
Exports (billion euros)	11.5	8.9	11.4	14.7	15.8
Increase compared to previous year (%)	7.0	-22.6	27.6	28.9	7.5

Source: Eurostat

17. Estonia's export growth since the crisis has also been higher than the EU 27 average and the growth achieved by our main trade partners (see Figure 1).

Figure 1. Estonia's export growth compared to EU 27 average (base year 2005 = 100%)*



* The figures given for 2013 and 2014 are a forecast.

Source: Eurostat

18. The recovery in economic growth that was supported by exports increased people's sense of security about the future to some extent, thereby boosting private consumption. Domestic consumption and investments made with foreign support and the proceeds from quota sales were the two biggest driving forces behind economic growth in 2012 in addition to exports.

19. Economic recovery following the crisis of 2009 also reduced unemployment. Recent data indicate that the number of working people is almost as high as during the boom. While the number of employed people was 656,000 in 2008 and 571,000 in 2010, the same figure as at Q2 2013 was 645,000. Unemployment dropped from 16.9% in 2010 to 10.2% in 2012 and 8.1% in Q2 2013, and it will have decreased even further by this autumn. The improvement in the situation on the labour market has also increased people's income: the average gross wages in 2012 amounted to 887 euros, an increase of 5.7% compared to the previous year. According to the forecast of the Ministry of Finance, average wages should increase to 940 euros this year.

State budget revenue has increased year on year

Budget position of the government sector – the difference between the government sector's total revenue and total expenditure

20. The wealth of the state depends on the state of its economy. The initial indecision of the government on how to react to the signs of a global economic crisis was replaced with forceful cost-cutting in the state budget and a search for extraordinary revenue in the last few months of 2008 and in 2009. The budgetary position of the government sector improved by *ca* 1.3 billion euros in just a couple of months by cutting costs, raising taxes, increasing the dividends from public undertakings and selling state assets.

21. As a result of this, state budget revenue did not decrease even when the crisis hit rock bottom and the economy shrank by *ca* 14%. The amount of money collected in the state budget in 2009 was 60 million euros more than in 2008. An increase of a couple of per cent also continued in 2010 and 2011. State budget revenue started to grow more quickly as the economy recovered and the amount received in the state budget in 2012 was 6.4 billion euros (without transferable taxes), which is a billion euros more than in 2008.

22. Although the government sector did not manage to cover all of its expenses with current revenue, its budget deficit in 2009 was relatively modest compared to the rest of Europe. Whilst the economy of the EU 27 decreased by 4.5% in 2009 and the consolidated budget was in deficit by 6.9%, the budget deficit of the Estonian government sector comprised 2% in an economic decline of 14.1% (see also Table 3). The small deficit at the time of the crisis and achieving a budget surplus in 2010 and 2011 indicated that the Estonian government saw a strict budgetary policy as its priority. No other EU Member State managed or sought to achieve such forceful savings.

Table 3. Budgetary position of government sector in Estonia and European Union Member States from 2009-2012 (% of GDP)

	2009	2010	2011	2012
Estonia	-2.0	0.2	1.2	-0.2
EU 27	-6.9	-6.5	-4.4	-4.0
Finland	-2.5	-2.5	-0.8	-1.9
Sweden	-0.7	0.3	0.2	-0.5
Latvia	-9.8	-8.1	-3.6	-1.2
Lithuania	-9.4	-7.2	-5.5	-3.2

Source: Eurostat

The budget deficit is the smallest among the EU 27

23. The budget of the Estonian government sector (including proceeds from sales of unused national emission quotas due to the principles of writing off) once again fell into deficit in 2012, but this deficit was the smallest among all EU Member States. The total deficit of the EU 27 comprised 4% of the community's GDP and 16 of the 27 countries exceeded the permitted deficit limit (3% of the Member State's GDP).

24. Estonia financed expenditure that exceeded revenue for 2009–2012 through reserves collected in earlier years and loans. The budget deficit in 2012 was also covered by using reserves and loans.

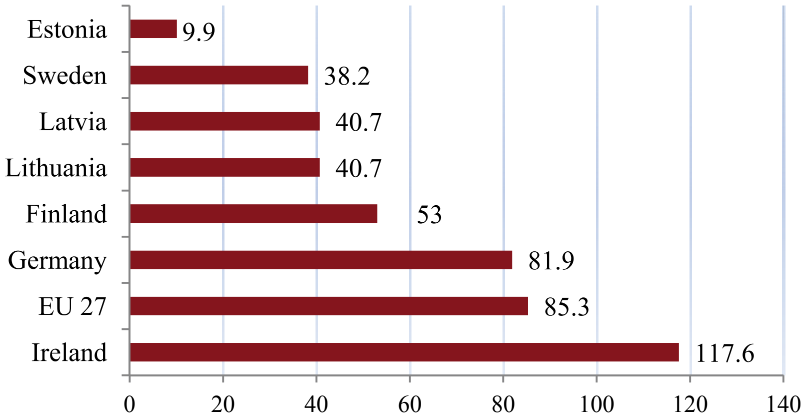
25. However, loans are not used to cover state budget expenditure that exceeds revenue alone. Money must also be found (from reserves or by borrowing) for expenses that are not expenses pursuant to state budget accounting policies, but still require money from the State Treasury, such as increases in the share capital of public undertakings or other financing transactions.

26. The debt burden of the Estonian government sector may also increase without the state taking out any loans itself, but as a result of the loan guarantees granted to others. The debt burden of the Estonian government sector therefore increased by *ca* 725 million euros in 2012, mainly as a result of the increase in the loans issued by the European Financial Stability Facility (EFSF), which Estonia has agreed to guarantee. The obligation to the EFSF assumed by Estonia increased the state's debt burden in 2012 by an estimated 355 million euros. The second main reason why Estonia's debt burden increased suddenly in 2012 was the drawdown of the loan earlier approved by the European Investment Bank to co-finance projects carried out with EU support.

Public debt is the smallest in the European Union

27. Although the debt burden of the state of Estonia has more than doubled compared to the times before the crisis and reached 1.7 billion euros by the end of 2012, the public sector debt burden remains the smallest among all European Union Member States (see also Figure 2).

Figure 2. Debt burden of Estonia's government sector compared to EU Member States in 2012 (% of GDP)



Source: Eurostat

The state still has reserves

28. At the end of 2012 the state's reserves were as large as its debts, comprising 9.9% of GDP or *ca* 1.7 billion euros (the reserves of central government, local authorities and social insurance funds in total). The State Treasury managed *ca* 1.5 billion of these reserves, although this money is not at the full and free disposal of the Government of the Republic either. Bringing the available funds of the Estonian Unemployment Insurance Fund and the Estonian Health Insurance Fund to the state's cash reserve has helped maintain the liquidity of the State Treasury. The cash reserve therefore increased by 500 million in 2012 compared to 2011, although the money still belongs to the Health Insurance Fund and Unemployment Insurance Fund. The amount of the government's own available funds that have not been allocated for a specific purpose and can be used to cover all public expenditure has decreased considerably according to recent data. The central government reserve decreased by 122 million (i.e. almost half) to 151 million in the first five months of 2013 (see also Table 4).

Table 4. Reserves managed by State Treasury (million euros)

Name of reserve	Market value		
	31.12.2011	31.12.2012	31.05.2013
Stabilisation Reserve Fund	333	347	358
State's cash reserve, incl.	605	1 106	1 004
▪ state	247	273	151
▪ ownership reform reserve fund	31	33	11
▪ money of Estonian Health Insurance Fund*	164	204	179
▪ money of Estonian Unemployment Insurance Fund**	–	472	500
▪ foundations and European Commission	162	124	164
reserve capital of Health Insurance Fund*	6	–	–
cash reserves of Health Insurance Fund*	27	–	–
reserve capital of Unemployment Insurance Fund**	26	–	–
TOTAL	997	1 453	1 362

* The legal reserve and cash reserve of the Health Insurance Fund were added to the state's group account in late 2011 and early 2012.
** The legal reserve of the Unemployment Insurance Fund was added to the state's group account in early 2012. This is why the money of the Health Insurance Fund and the Unemployment Insurance Fund is indicated in two rows starting from 2012 instead of by separate reserve capital funds and other reserves.

Source: Ministry of Finance

29. Secondly, although the reserves managed by the State Treasury decreased somewhat in the first half of 2013 due to the need to cover the state's current expenses and the loan granted to Estonian Air from the ownership reform reserve fund, the State Treasury still has a little over one billion euros of reserves at its disposal.

30. All in all, the state of Estonia's public finance is undoubtedly good compared to the rest of Europe. According to the three main measures used to rate the status of public finance in the European Union (balance between revenue and expenditure, public debt and reserves), Estonia has overcome the crisis as a strong country and its virtually balanced budget and low debt burden distinguish it from other European countries that are struggling with the debt crisis.

31. Many major economic parameters used to compare the economic status of countries at the international level also indicate that Estonia has overcome the crisis. The monetary value of the goods and services produced in the state is higher than ever before and the state is also managing to sell more of its products to other countries than ever before. The GDP of Estonia has surpassed the peak of the years of rapid growth and its export volume is considerably higher than during the boom.

The state is successful, but how have the people living here benefited from this?

32. Although the economy and finance of Estonia are recovering from the global crisis well and we are considered successful, have the people living here benefitted from the state's success in any way? Is this success as great or likely to be as enduring as the data of the Statistical Office of the European Communities suggest? What are the development challenges faced by Estonia's economy, finance and society? This is analysed and described in the following chapters.

Life of Estonian people

33. The goal of Estonia's governments since the country regained its independence has been to help it catch up to developed countries and to increase the wealth of the state and people to the level of rich European countries. Seeing that the country's public finance has done better during and since the crisis than that of other countries, that production volumes have surpassed those of the boom years and that export figures are setting new records, it would be appropriate to assume that the life of Estonian people has also improved considerably compared to the rest of Europe.

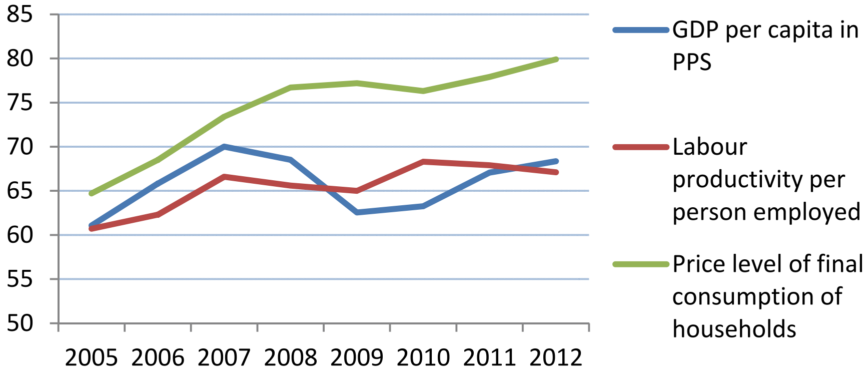
Prices in Estonia have rapidly caught up to the European average, but the purchasing power of Estonian people has not

34. Estonia's purchasing power, price level and labour productivity are compared to see how close Estonia has come to the average of the European Union Member States. The Ministry of Finance, for example, also uses these three components in its economic forecasts.

The purchasing power of Estonia has grown very little and the pre-crisis level has not been achieved

35. International statistics indicate that the purchasing power of Estonian people has increased somewhat in recent years but still comprises just 69% of the EU 27 average and has not reached the level it was at before the crisis, when it comprised 70% of the EU 27 average (see also Figure 3). The purchasing power of Latvians is smaller than that of Estonians, but Lithuania overtook Estonia last year in terms of this indicator.

Figure 3. Estonia's price level, purchasing power of people and productivity compared to European Union Member States (EU 27 = 100%)



Source: Eurostat

Estonia's price level is 80% of the EU average but the purchasing power of Estonians is just 68%

36. Whilst the purchasing power of Estonian people has not come closer to that of the average European, prices here have risen considerably more quickly than the European average. Whilst the purchasing power of Estonians in comparison with the European average and the years before the crisis (2007) has decreased somewhat, the price level has risen by 7%, reaching 80% of the EU 27 average in 2012. The price increase in Estonia exceeded the European Union average considerably from 2010–2012. The only country where the consumer price index increased faster than here in 2011 was Romania.

Home expenses have increased the most

37. According to Statistics Estonia, prices in Estonia increased in 2012 mainly as a result of the increase in the prices of electricity, thermal energy and heating, growing by 11.4% over the year and representing more than half of the increase in the consumer price index. The prices of motor fuel as well as food and non-alcoholic beverages also increased considerably, by 9% and 3.8% respectively.

38. The rapid price increase has also continued in 2013: in the first eight months of the year in a year-on-year comparison the increase was *ca* 4%, representing one of the fastest price increases in the European Union. The price increase in the EU 27 comprised 1.5% at the beginning of August, but according to Eurostat the increase in Estonia at the same time was 3.6%. According to Statistics Estonia, the price increase decreased to 2.1% in September in a year-on-year comparison, and housing expenses were those that increased the most (8.4%).

39. Although the wages of Estonians have never been as high as they are now (gross wages reached the level of 887 euros as the average for 2012), they are still just 7% higher than five years ago. The average net monthly wages of Estonian people compared to 2008 have increased by 36 euros.

Prices have risen more rapidly than wages

40. Even this small increase in wages has been largely eaten up by the fast price increase. In 2011 the wage increase started to exceed the price increase again after a number of years, but real wage increase has been small (0.9% in 2011; 1.7% in 2012), and compared to the time before the crisis prices have increased more rapidly than income. While average net monthly wages have increased by *ca* 5% compared to 2008, the price increase has reached *ca* 12%.

The minimum wage is among the lowest in Europe

41. The amount of the minimum wage in Estonia did not change from 2008–2011 and remained at 278 euros. The minimum wage was raised by 12 euros in 2012 and has amounted to 320 euros since 2013. The only European Union Member States where the minimum wage is lower are Bulgaria, Romania, Latvia and Lithuania.

The old-age pension has increased by 34 euros on average in four years

42. The situation of pensioners is no better than that of working people. The average old-age pension has increased more (relatively) than wages compared to 2008 (net wages *ca* 5%, average old-age pension *ca* 12%), but in absolute amounts the increase in pensions has been smaller than that in net wages. Whilst average net monthly wages have increased by 36 euros in five years, the average old-age pension in 2012 was 34 euros more than in 2008. The average pension increased by 26 euros in the same period (see also Table 5). The Government of the Republic has promised a 5.8% pension increase with the state budget for 2014.

Table 5. State pensions from 2008-2012 (euros)

	2008	2009	2010	2011	2012
Average pension	250.5	270.4	271.7	270.6	276.6
Average old-age pension	278.4	301.3	304.5	305.1	312.9
Average disability pension	165.9	178.7	178.9	177.1	180.7
Average survivor's pension	134.0	144.9	146.1	149.4	151.0
Average national pension	94.1	102.3	103.0	102.7	104.4

Source: Statistics Estonia

43. The situation of young people is complicated because of high unemployment. Unemployment among people aged 15–24 before the crisis (2008) was 12%, but in 2012 this level of unemployment was twice as high as the general unemployment rate, i.e. 20.9%. However, the situation of youth employment in the European Union is even worse: the average unemployment rate among young people in the EU 27 in 2012 was 22.8%, incl. 55.3% in Greece, 53.2% in Spain and 43% in Croatia.

44. Despite the recovery in employment and the alleviation of unemployment compared to 2009–2011, the continuously high long-term unemployment rate remains a major problem on the Estonian labour market and a circumstance that affects how people are able to cope with their lives. As at 2012, more than half of all unemployed people (54.1%) had been looking for a job for more than a year without finding one.

45. The long-term unemployed or people who had been looking for a job for at least a year comprised 31% of all unemployed people in 2008. The long-term unemployment rate in Estonia in 2012 was 5.5% whilst the EU 27 average was 4.6%. 24,000 people had been unemployed for a very long time, having been looking for a job for more than two years without success. Long-term and youth unemployment are problems that have also been highlighted by the European Commission in its recommendations to Estonia about planning the use of foreign funding for the period 2014–2020.

The number of Estonians living in absolute poverty is higher than the European average

Relative poverty rate – the rate found by comparing the income of households with a certain average level of society. Households living below this rate live in relative poverty.

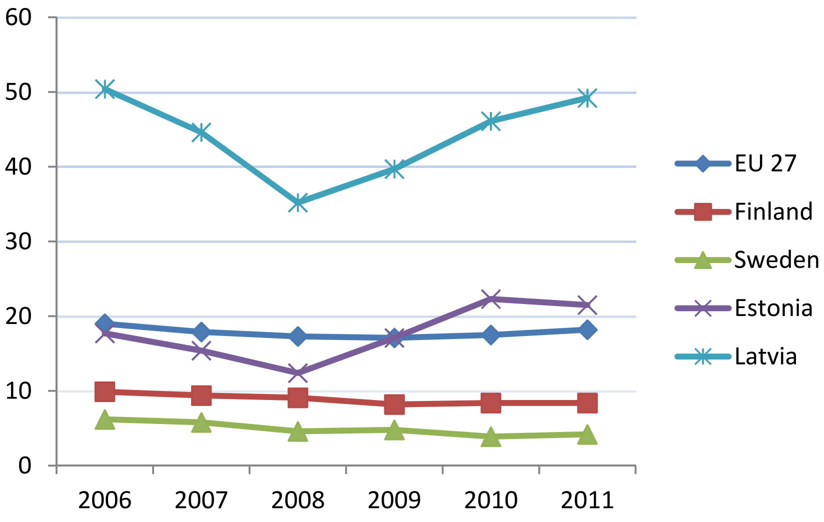
46. Having no work puts a person at great risk of material difficulties and poverty. According to Statistics Estonia, 55.5% of unemployed people lived in relative poverty in 2011. 32.6% of single-parent households lived in relative poverty. 17.5% of the entire population of Estonia lived in relative poverty in both 2011 and 2012, which is more than the average of the European Union Member States (16.9%),

47. The European Commission also uses the Material Deprivation Rate to compare the situation of Europeans. The indicator consists of nine components and the aspects considered include whether or not people can afford to keep their home adequately warm, eat regularly, go on holiday, afford elementary household appliances (television set, washing machine et al.) and so on.

48. The most recent data indicate that one-fifth of Estonians live in material deprivation. The situation is even worse in Latvia and in most 'new' European Union Member States. The situation is considerably better in eurozone countries, Estonia's neighbouring countries (Finland

and Sweden) and European Union Member States on average (see also Figure 4).

Figure 4. Share of population living in material deprivation in Estonia (% of population)



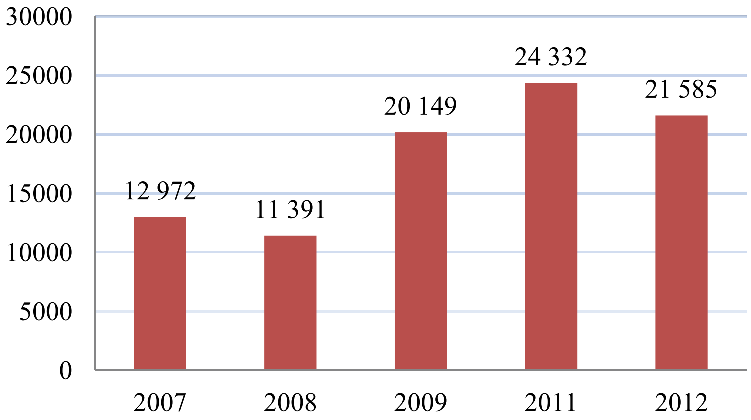
Source: Eurostat

49. According to the European Union the share of people living in material deprivation in Estonia in 2011 was 0.8% lower than the year before, but still *ca* 10% more than before the crisis. The situation of Sweden and Finland has improved in terms of this indicator compared to 2008.

The number of families in need is twice as high as before the crisis

50. The number of households in need decreased somewhat in 2012, but there are still almost twice as many families who need subsistence benefits than there were before the crisis (see also Figure 5).

Figure 5. Number of families who received subsistence benefits



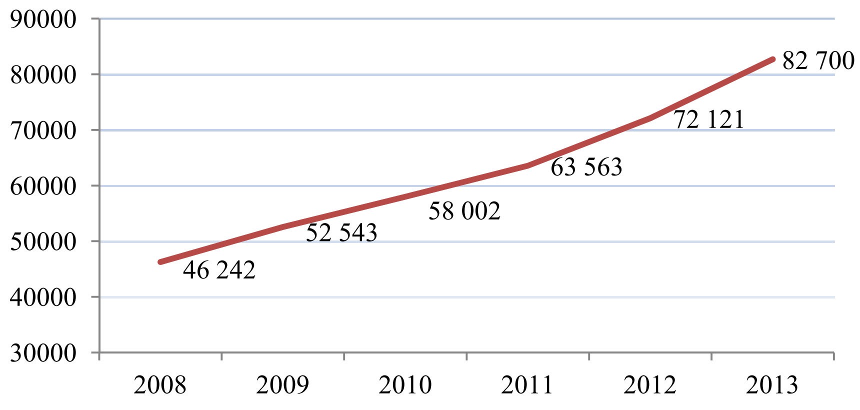
Source: Statistics Estonia. The database of Statistics Estonia contains no information about 2010 due to migration to a new database.

51. A little over 11,000 households received subsistence benefits in 2008, but this number increased by 10,000 in 2012. There were even more families on subsistence benefits in 2011: more than 24,000.

People are leaving Estonia

52. Studies in Europe have indicated that the situation on the labour market is the main factor that forces people to move to another country. Low wages and purchasing power that does not grow are probably also some of the reasons that have forced Estonian people to live and work abroad. The number of Estonian citizens living abroad has doubled in the last five years. The data of the Population Register indicate that *ca* 83,000 Estonian citizens lived abroad as at the end of 2012 (see also Figure 6). The actual number may be even higher, as some people who have emigrated may not have confirmed it officially.

Figure 6. Number of Estonian citizens living abroad (as at start of year)

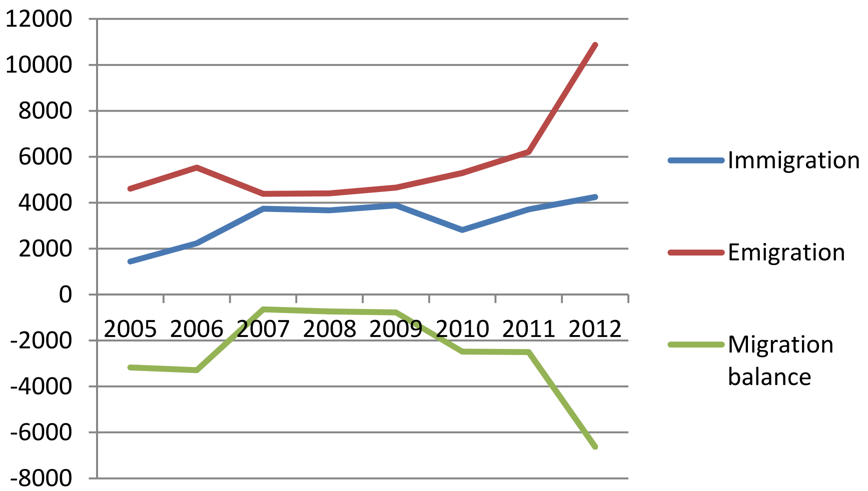


Source: Population Register

More and more people are emigrating from Estonia

53. It is remarkable that the sudden increase in emigration did not occur during the most difficult years of the recession (2009–2010) but in the last couple of years. 5,000 people emigrated from Estonia in 2009; in 2012 this figure increased to 10,800 people. A little over 4,000 people immigrated to Estonia, meaning that the migration balance in 2012 was negative by *ca* 7,000 people (see also Figure 7). The main countries that Estonians emigrated to were Finland, Sweden, Norway and the United Kingdom.

Figure 7. Immigration to and emigration from Estonia and migration balance (people)



Source: Statistics Estonia

54. The sudden increase in emigration in 2012 suggests, on the one hand, that people do not find the decision to move to another country an easy one to make and that they need time to obtain clarity about their options. On the other hand, the acceleration in migration may indicate that people are disillusioned about the extremely slow rate of improvement in their lives. Emigration may also have increased on account of people joining their family members who have gone to work in another country. Bringing people who have left Estonia back to the country is even more difficult in this case.

People are leaving rural areas

County centres — 15 local authorities with 666,643 residents

Local authorities surrounding centres — 43 local authorities with 252,560 residents

Remaining local authorities — 168 local authorities with 398,802 residents

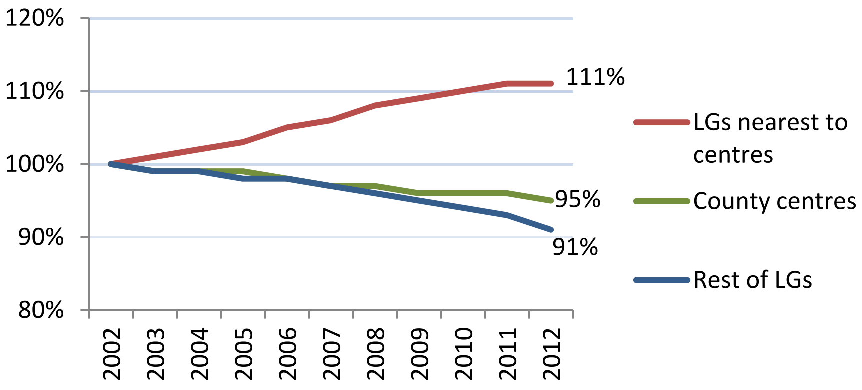
55. As an alternative to leaving Estonia, people have also moved from rural areas to cities in search of better working conditions and opportunities for self-realisation. As a result of internal migration, the population of at least 11 counties has decreased by more than 10% in the last ten years. Also, people are not moving into county centres in Estonia in search of work, but mainly to Tallinn or Tartu. Whilst people prefer to work in big cities, they would rather live in municipalities close to the cities. This is why the population of local authorities nearest to centres has increased (on average by 13% in ten years) while there is not a single county centre that has not lost residents (average loss: 9%).

All local authorities in Jõgeva, Järva, Lääne-Viru and Valga counties have lost working-age people in the last five years

56. People move to places where they can find work and income. Harju County is the only one where the number of working-age people has increased in half of local authorities and decreased in the other half. In all other counties there are more local authorities whose working-age population has decreased.

57. Only the local authorities that surround centres (mainly Tallinn, Tartu and Pärnu) have gained working-age people whilst county centres and all other local authorities have lost them (see also Figure 8).

Figure 8. Change in number of working-age people (%; base year 2002 = 100%)



Source: Statistics Estonia

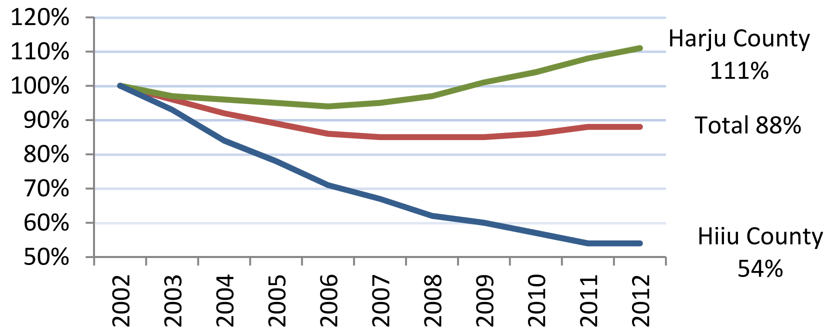
Harju County is the only one in which the number of children is higher than ten years ago

58. Working-age people leaving and negative natural population growth mean that the number of elderly people has increased in rural areas while the number of children and young people has decreased. Since the number of children in Estonia has decreased by *ca* 12% in ten years, the share of people up to 14 years of age in the population has decreased in rural areas, in local authorities surrounding centres and in all other local authorities. If we leave out county centres and surrounding municipalities, there were 30% fewer children living in other local authorities in 2012 than in 2002.

There are 50% fewer children living in Hiiu County than there were ten years ago

59. Harju County is the only county where the number of children has increased in the last ten years. The number of children living in Hiiu County at the end of 2012 was half that of ten years ago (see also Figure 9).

Figure 9. Change in number of children up to 14 years of age (%; base year 2002 = 100%)



Source: Statistics Estonia

60. The share of the elderly, however, has grown in rural areas, especially in 'rural' local authorities. The average share of the elderly is 17% in country centres and surrounding municipalities and *ca* 22% in other local authorities. The county with the smallest share of elderly people is Harju County (15%); in many others it is more than 20%.

61. Compared to OECD countries, internal regional socioeconomic development differences in Estonia are great considering the small size of the country. The ability of rural areas to provide services to local people and invest in the development of the local authority is also different. On the one hand, this is one of the reasons why young and working-age people are leaving rural areas; on the other, these changes in the location of the population deepen development differences even further.

The differences in the economic development of regions are vast

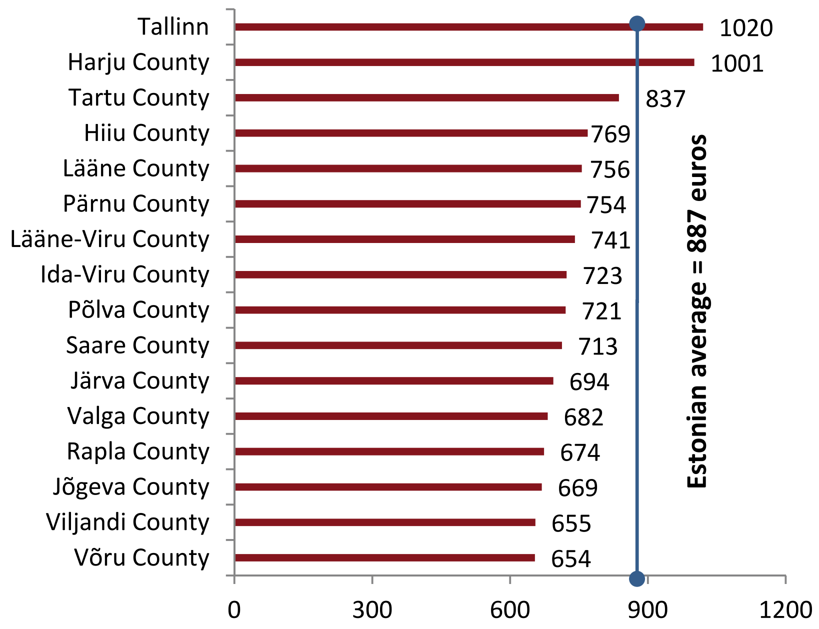
62. Economic development in various regions is vastly different. Most economically active companies are based in Harju and Tartu counties. Gross domestic product per capita only exceeds the average of the state in Harju County (151%) and Tartu City (102%). GDP per capita in Põlva, Valga and Jõgeva counties is below 50% of the Estonian average.

63. 62% of all companies in Estonia and more than half of all exporting companies (55%) – which comprise two-thirds (65%) of total Estonian exports – operate in Harju County. Companies based in Harju and Tartu counties comprise *ca* 75% of all economically active companies in Estonia.

Wages are higher than average only in Harju County

64. The number of wage earners has increased again since the recession. However, the number of wage earners in local authorities surrounding centres has increased by *ca* 25% more than in other local authorities in the last ten years. The average gross income in the other local authorities has increased even more rapidly than in county centres and surrounding municipalities in recent years, but the gap between poorer and richer local authorities remains vast. Harju County is the only one where wages are higher than average (see also Figure 10).

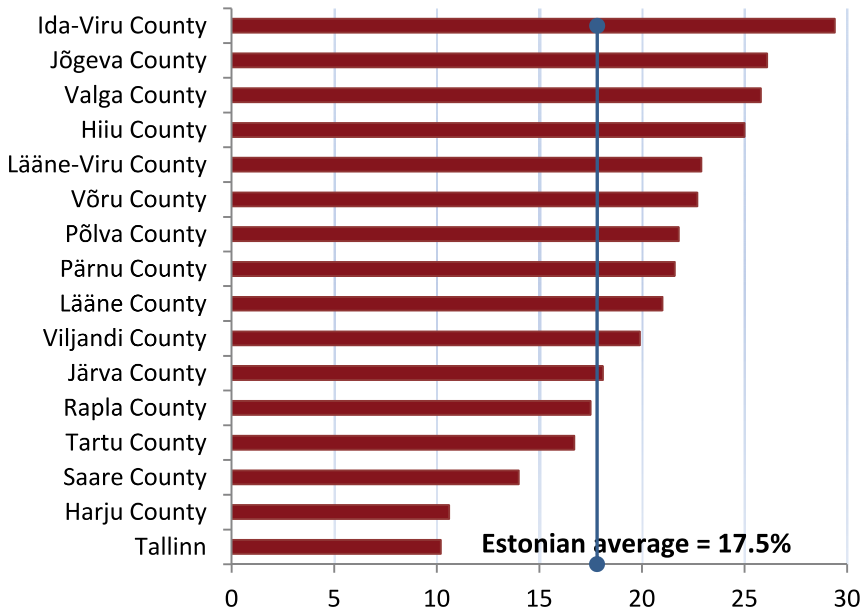
Figure 10. Gross wages in 2012 by county and comparison with Tallinn (euros per month)



Source: Statistics Estonia

65. The vast gaps in income also mean that there are regional differences in how well people are able to cope. The number of people living in poverty is different in different regions: 10% of people in Tallinn lived in relative poverty in 2011, but the same indicator in north-eastern Estonia was 30% (see also Figure 11).

Figure 11. Share of people living in relative poverty by county and compared to Tallinn (% of population)



Source: Statistics Estonia

A quarter of all people live in relative poverty in four counties

66. Over the years, the share of people living in relative poverty has been smallest in Harju County (10.6%). More than a quarter of the population live in relative poverty in Ida-Viru, Valga, Jõgeva and Hiiu counties.

67. It is obvious that the development differences of Estonian regions are vast. This can also be seen in how people are able to cope. Coping is mostly related to whether a person has a job, how much they earn etc. Development differences have forced people to look for better opportunities for self-realisation in cities and surrounding local authorities, which worsens the situation of counties that lose even more people.

The state is doing better than its people

68. Analysing the coping indicators of Estonian people reveals that despite the success attributed to public finance and the state's economy and international recognition of the way we coped with the crisis, the state's success has not reached the people living in the country. Prices have risen more quickly than incomes and the wealth of Estonians compared to the average European remains at the same level as five years ago.

69. People have moved from rural areas to cities or even foreign countries in their search for better working conditions and opportunities for self-realisation. Emigration from Estonia has accelerated in the last couple of years – at the end of 2012, almost 83,000 Estonian citizens were creating added value and paying taxes abroad.

70. The emigration of working-age people from Estonia and their relocation within Estonia at a time when the population continues to decrease and age means new challenges and risks for the development of the country at the local community level and for the state as a whole. The development risks of Estonia are discussed in the following chapter.

Sustainable development challenges facing Estonia

The economy has grown less than expected, export growth has stalled and labour productivity has decreased

71. As described in previous chapters, the purchasing power of Estonians has not returned to the level of the pre-crisis years despite the country achieving the fastest economic growth in Europe since the crisis. An increasing number of people are looking for better living conditions abroad and the population in rural areas is decreasing as people move to cities. The average Estonian is still poorer than the average European.

Export growth has stalled

72. The fact that Estonia's economy has begun to lose momentum in 2013 is therefore an even bigger concern. Instead of the 9.6% in 2011 and 3.9% in 2012, the economy only grew by a little over 1% in the first half of 2013. The deteriorating economic condition of our trade partners is the main reason for this slowdown in economic growth. Exports, which have so far been the driving force behind recovery from the recession, have started to decrease due to a reduction in orders from Finland, Sweden and Russia. According to Statistics Estonia, exports decreased by 9.9% in

July 2013 on a year-on-year basis. The value of goods and services exported in the first seven months of 2013 was *ca* 150 million euros less than in the same period last year.

Read more

about the problems of export statistics in the National Audit Office's audit report entitled 'Border crossing of goods and cargo at the land border between Estonia and Russia'.

73. Estonia is very vulnerable to changes in the economic status of its trade partners, as most of its exports stem from cheap subcontracting done for Scandinavian companies. However, we must bear in mind that in the international production chain, subcontracting is often based on cost advantages, which means that the less our work costs our partners the bigger our exports will be in the current economic structure. This structure creates a 'glass ceiling' for improvement in the standard of living, while the cost advantage achieved through the use of cheap labour actually means competing via poverty.

74. In the analysis of the partnership agreement prepared for the use of the support granted by the European Union in the period from 2014-2020, the Ministry of Finance highlights the lack of exporting companies and basing exports on the provision of cheap contracting as major development risks for Estonia. *Ca* 16% of all Estonian companies operate on foreign markets. Less than one-tenth of Estonia companies – which provide three quarters of total exports – have great export potential.

Cheap goods remain the main export articles

75. The Ministry of Finance says that although export volumes have increased greatly since the recession, the share of Estonian exports in the value chain of exporting sectors has not increased equally, which in reality reduces the potential of exports as the engine of the economy. The exporting of products and services of greater added value is not increasing due to limited marketed skills, poor knowledge of consumer markets and a limited contact network abroad.

Wages can only grow sustainably if the productivity of workers also grows

76. However, offering cheap goods, services and subcontracting alone does not make one rich. The welfare and wages of Estonian people (incl. those working for the domestic market and not participating in the generation of exports) are determined by the place Estonia manages to gain in the 'international division of work' and the price for which it sells its goods and services. Increasing the wages of Estonian people is the only sustainable option for increasing the international competitiveness of companies and the productivity of workers.

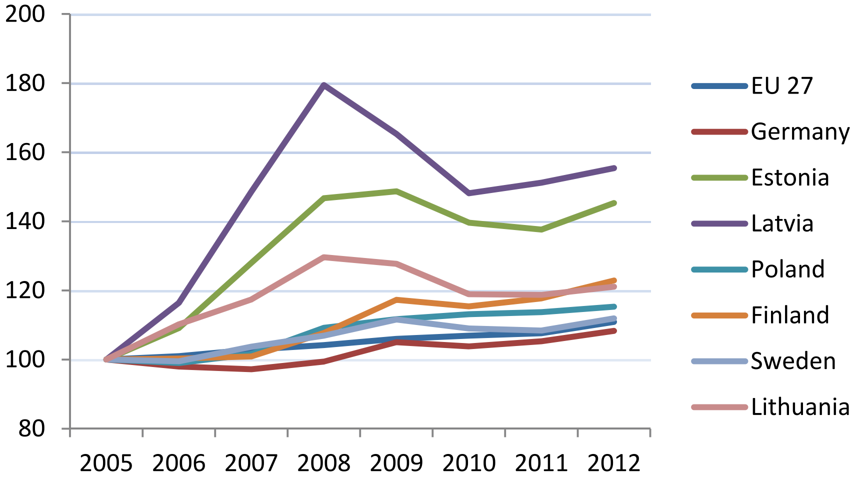
The productivity of Estonians has decreased over the last couple of years compared to the average European

77. Estonia's labour productivity per worker has essentially not increased at all in comparison to the EU 27 average over the last seven years. Whilst productivity comprised 66.6% of the EU 27 average in 2007, the same indicator in 2012 was just half a per cent higher. In 2011 and 2012, productivity actually decreased – in 2010 it comprised 68.3% of the EU 27 average (see also Figure 3). The productivity of the manufacturing industry in Estonia only comprises 51% of the EU 27 average. Exported products are also mostly produced by areas of the manufacturing industry where productivity is below average.

Unit labour costs – the ratio of labour costs to productivity characterising the labour costs incurred in the creation of a state's GDP

78. As labour productivity has virtually not increased at all in recent years, there is the risk that even the small wage increase in recent years has damaged the competitiveness of companies and that, in the long run, a wage increase of even a couple of per cent would not be sustainable without an increase in productivity. Unit labour costs have increased more rapidly in Estonia in recent years than in Europe on average (see also Figure 12).

Figure 12. Change in unit labour costs (%, base year 2005 = 100%)



Source: Eurostat

79. We cannot rely on cheap production if we want to increase the wealth of the Estonian state and people, but we have to increase the added value generated by Estonian companies. On the other hand, unlike in the period before the crisis it is important to use the loans currently obtainable at low interest rates to boost companies' productivity and competitiveness.

80. The creation of more expensive products and services calls for investments in research and development, innovation and product development, incl. design. The problem is that people in Estonia do not see that business success is possible by investing in research and development.

81. One of the reasons why research and development are not considered important is that there is no 'demand' for it – in the international production chain, Estonian companies operate as performers of work that does not require much knowledge. Estonian companies lack the experience, money and knowledge required for the development and marketing of innovative products and service, with the focus of attention on perfecting the production process rather than perfecting the product. This is why it is necessary to continue paying attention to boosting cooperation between researchers and entrepreneurs and improving cooperation between entrepreneurs. Increasing added value in 'traditional' economic sectors which create little added value but provide employment for many people is likewise a potential source of economic growth.

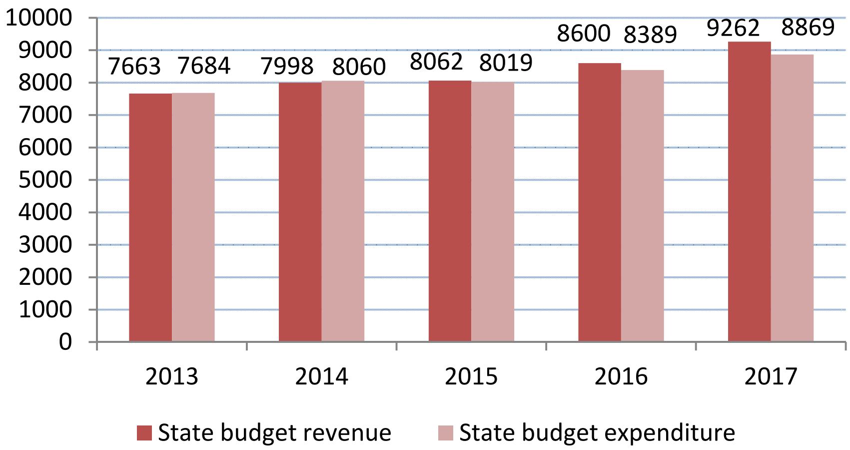
82. However, the current situation is that Estonia's economic growth proved to be a negative surprise to analysts in 2013. Instead of the 3% forecast by the Ministry of Finance in spring, the economy only grew by 1.1% in the first quarter and 1.3% in the second. In its most recent forecast the Ministry of Finance halved its growth expectations to 1.5% in 2013. The economic growth forecast by the Ministry of Finance for 2014–2017 is 3.5–3.8%.

Economic growth was slower than expected, which means less revenue for the state

83. Economic growth, which was slower than expected, has not yet reduced the state's revenue, which so far has been received as forecast by the Ministry of Finance for 2013. However, if growth remains around one per cent in the second half of the year, this may mean a serious backlash for the State Treasury.

84. The deepening economic stagnation in Europe and the deterioration of the situation among Estonia's trade partners would also place a question mark over growth in state budget revenue next year. In the State Budget Strategy 2014–2017 the Ministry of Finance has forecast that the revenue received by the State Treasury in 2014 will exceed the revenue of 2013 by 1.2%. The Ministry of Finance foresees the most significant revenue growth in the last year of the forecast, i.e. 2017 (see also Figure 13).

Figure 13. State budget revenue and expenditure 2013–2017 (million euros)*



* The Ministry of Finance has also recognised transferable taxes in state budget revenue and expenditure since 2013.

Source: State Budget Strategy 2014-2017, Summer 2013 Forecast of the Ministry of Finance and Explanatory Memorandum to the 2014 State Budget Act

85. Receiving less revenue than expected would mean the government having to find ways of cutting budgetary expenditure or covering expenditure from reserves or by borrowing money. However, options in terms of cutting costs are limited: most budget expenditure arises from law; the state's investments have already been reduced; and there will be a pause of at least a couple of years in the use of European Union funding, which the state has dipped into to cover its everyday expenditure.

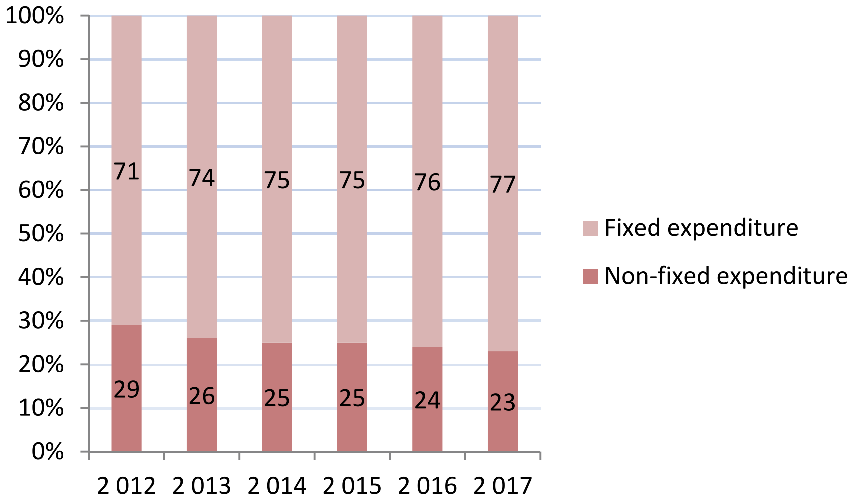
Most public revenue is reserved

86. Even if Estonia's economic growth does pick up in the coming years and state budget revenue is received as planned, there are several risks in public finance that may curb the sustainable development of Estonia.

87. First of all, the majority of state budget expenditure consists of expenditure that is determined by law or fixed in another manner and that is therefore difficult to change. This is the expenditure that the state must finance in order to perform its existing obligations and that generally does not support the state's competitiveness (except foreign funding).

88. The share of such fixed expenditure in the state budget has increased constantly. This expenditure has grown more quickly than public revenue, and according to the estimates of the Ministry of Finance it will continue to increase in the coming year. In 2013 fixed expenditure comprises 74% of the state budget, but in 2017 it will already account for 77% of the budget (see also Figure 14).

Figure 14. State budget expenditure structure 2012–2017* (% of total expenditure)



* The figures given for 2014–2017 are a forecast.

Source: State Budget Strategy 2014–2017

89. The majority of fixed expenditure consists of social expenditure or money spent on pensions, health insurance, family allowances etc. These already take up almost half of the state budget (see also Table 6).

Table 6. Social and health expenditure in state budget 2012–2017*

	2012	2013	2014	2015	2016	2017
Social and health expenditure (million euros)	3,274	3,430	3,.509	3,725	3,911	4,032
Share of state budget (%)	44	45	44	46	47	46

* The forecast is given for 2014–2017.

Source: State Budget Strategy 2014–2017

90. The Ministry of Finance has also admitted in the State Budget Strategy 2014–2017 that "when we look at planned budget expenditure from the point of view of flexibility, forecasts indicate that the situation will get worse rather than better, as the share of 'available funds' is decreasing".

Little money is left to support the state's development in light of increasing social expenditure

Many areas of activity of the state are likely to have to cope with less funding in the future in order to find money for social expenditure

91. Since the government's goal is to have a budget that is balanced and in surplus, other areas will have to cope with less funding or settle for small growth so that social expenditure can be covered. The forecast of the Ministry of Finance actually shows that half of the state's areas of activity will have to cope with less funding in 2016 than in 2013, or settle for a small increase in expenses (see also Table 7).

Table 7. Budget position of public sector by area of government (million euros)

	2013	2016*	Change 2016 vs. 2013
General public sector services	579	616	37
National defence	362	440	78
Public order and security	398	374	-24
Economy	815	792	-23
Environmental protection	127	66	-61
Housing economy and utilities	272	0	-272
Health	959	1,122	163
Leisure, culture and religion	308	330	22
Education	1,140	1,078	-62
Social protection	2,281	2,662	381
TOTAL	7,241	7,480	239

* The figures given for 2016 are a forecast. Does not include European Union support from 2014–2020 period.

Source: National Audit Office based on data of the Ministry of Finance (State Budget Strategy 2014–2017, p 47)

92. According to the forecast of the Ministry of Finance, the expenditure that will see the most growth is social and health expenditure: 544 million euros in total. Although the state will receive *ca* 400 million euros in social tax, the money will not be enough to cover this expenditure. The last time social tax was sufficient to cover all social expenditure was in 2007. In the years since then, the state has had to find extra sources from other revenue and the Ministry of Finance is of the opinion that the deficit will increase every year in the future.

93. The forecast of the Ministry of Finance does not include European Union funding for the period from 2014–2020, which is why the decrease in financing may not be as extensive or hit as many sectors as suggested in Table 7. However, any significant use of European Union funding for the new period is unlikely to start before 2016, meaning that there will be no extra money for the areas of environmental protection, the economy, public order and security, education, the housing economy and utilities in the coming years. Table 7 also indicates that the development of said areas largely depends on whether there is any EU money.

Despite the rapid increase in social expenditure, pensions have yet to increase and access to medical care has not improved

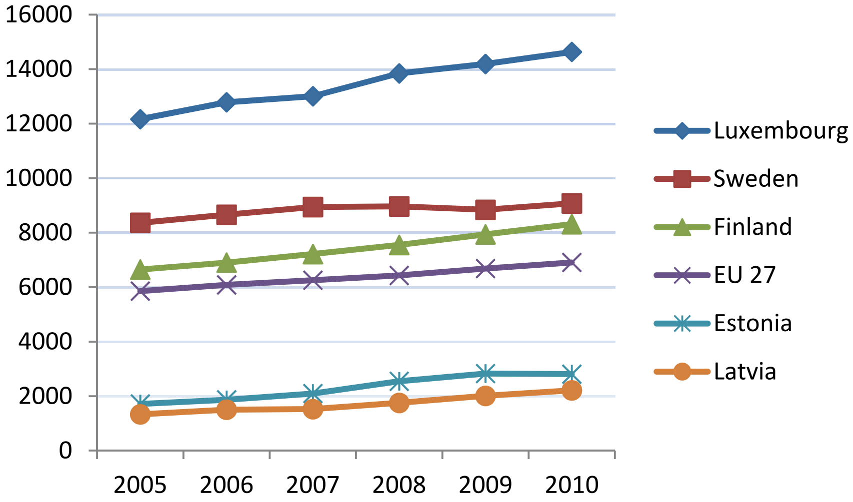
Estonia spends almost half of the state budget on the social sphere, but social benefits remain among the smallest in Europe

94. Although increasing social expenditure is a burden on the state budget of Estonia and the state spends almost half of all revenue it earns on the social sphere and health insurance, this does not mean that we spend more than other European countries. On the contrary – European Union Member States spend more on social protection on average than Estonia both in absolute terms per capita and as a ratio to GDP.

95. The amount of social benefits per capita in Estonia, incl. age-related benefits, is less than half the European Union average. In 2010 social expenditure per capita in Estonia amounted to 2,800 euros, while the European Union average was 6,900 euros. The countries where social benefits were even smaller than Estonia were Bulgaria, Romania, Latvia and Lithuania (see also Figure 15).

96. The share of social expenditure in GDP in Estonia is also one of the smallest in the European Union; only Latvia, Bulgaria and Romania spent less.

Figure 15. Social protection benefits per capita (euros per year)



Source: Eurostat

97. The rapid increase in social expenditure and its large share in the state budget have not brought about any significant pension increases or improved access to medical care. The average pension has increased by 34 euros in five years; the average old-age pension by 26 euros. The average disability pension has increased by 15 euros and the survivor's pension by 17 euros. The social tax collected by the state has not been sufficient to cover pensions. As small as the pensions are, the state still has to use more and more of its other revenue to pay them. According to the forecast of the Ministry of Finance, the state will have to find *ca* 500 million euros for the payment of pensions from revenue other than social tax in 2017. Research indicates that the Estonian pension system is not sustainable in the long term (see more in the chapter 'The pension policy of the state – postponed decisions').

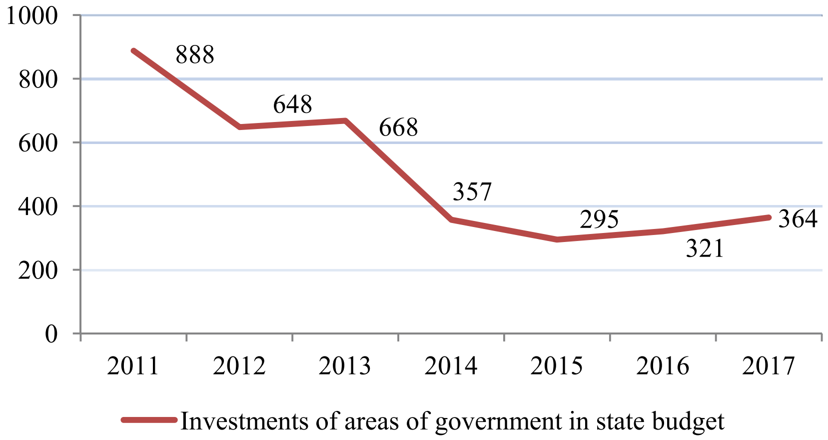
98. Analysts and the World Health Organisation, for example, do not see the Estonian health system as sustainable either. Health expenditure has increased year on year and is now one of the biggest expenditure items in the state budget – but despite this, access to medical care has deteriorated.

99. The National Audit Office wrote about the deterioration of access to medical care last year and highlighted the increase in the number of ambulance calls and visits to emergency medicine departments in addition to long queues for treatment. The general standstill in the sector has deepened these tendencies considerably in the last year and the situation is unlikely to improve in the near future. Considering the decisions that were made when doctors went on strike, which lengthened the time allocated for appointments and increased the wages of health care professionals, it is impossible to invest any significant amounts of money in the improvement of access to medical care.

There are no investments without foreign support

100. The fact that there is little money left for other things after the payment of increasing social expenditure is also illustrated by the state's investment activities. Investments by area of government from the state budget will more than halve by 2015 compared to 2013. Investments of areas of government from the state budget comprised 888 million euros in 2011, but this will decrease to 295 million euros by 2015 (see also Figure 16).

Figure 16. Investments of areas of government in state budget (million euros)*



* Includes European Union support for the periods 2007–2013 and 2014–2020, but does not include investments made on account of proceeds from sales of CO_2 quotas or investments made by Riigi Kinnisvara Aktsiaselts (State Real Estate Ltd). The figures given for 2014–2017 are a forecast.

Source: State Budget Strategy 2014–2017

101. The main reason for this decrease is that since the option to use European Union funding became available, Estonia has mostly used EU money to make its investments, but the money for one budgetary period will have been spent in the period 2014–2017 and spending the money for the new period has not yet started. Similar to the level of state, local authorities also make most of their investments with the help of European Union funding (see also Article 123 of the report).

102. The situation with investments clearly indicates that European Union funding/financing is basically the only development money that Estonia has and that the budget decrease between two financing periods is largest in sectors that have so far been primarily financed through foreign support (environmental protection, the housing economy and utilities and the economy – see also Table 7).

103. It is difficult to forecast the impact on the state's long-term development of a situation in which the state's revenue is mostly used to cover obligations already assumed and social expenditure, leaving little money for investments and other sectors. Estonia must also consider the possibility that it may not receive the same amount of support from the European Union in 2020 and thereafter, so that it will have to make the necessary investments from its own revenue. However, Estonia's development challenges will become even more serious after 2020, as the population decreases and ages at an increasingly faster pace.

A decreasing and aging population increases the seriousness of the state's developmental challenges

104. The rate at which the population of Estonia is decreasing and aging is one of the fastest in Europe. Natural population growth since the country regained its independence has been positive just once – in 2010 there were 35 more births than deaths.

Ten people leave the labour market and only eight enter it

105. The employment rate must keep increasing in order to maintain economic growth and guarantee the sustainability of the social insurance system in a situation where the population is rapidly aging. According to the forecast of the Ministry of Finance, the employment rate will continue to grow for the next couple of years before peaking in 2015 and then starting to fall due to the decreasing number of working-age people.

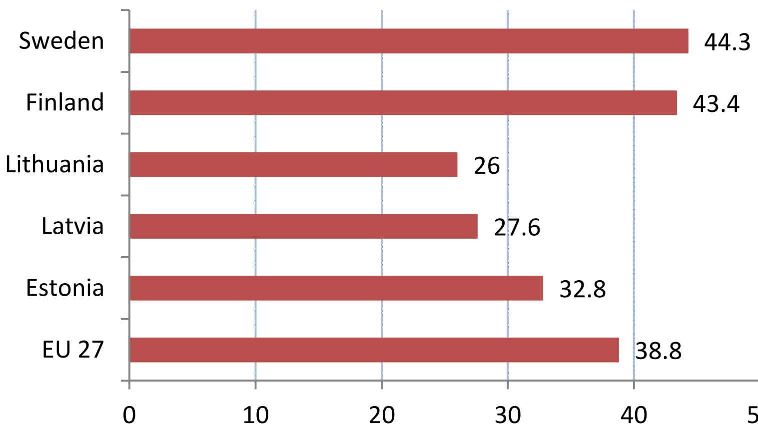
106. The changes in the population mean that the quantity of people leaving the employment market in 2015/2016 due to age will exceed the quantity entering the labour market by 20%. This will increase the burden on the working population in supporting those who do not work.

Pressure to increase social expenditure grows every year

107. Population decrease and aging will create additional difficulties for the state's economy and public finance. Estonian companies need to figure out how to earn revenue for themselves, society and the State Treasury while the number of working-age people keeps decreasing. At the same time, pressure to increase state budget expenditure will keep growing, especially with regard to social expenditure. If the working-age population and/or productivity do not grow significantly in the near future, the state's tax revenue, investment opportunities and capacity to maintain investments already made will also decrease in the long term.

108. Using extensive tax hikes to avoid a decrease in revenue is also complicated, because the general tax burden in Estonia is already almost equal to the average in European Union Member States. Also, the tax burden in Estonia has increased in recent years compared to the EU 27 average and also compared to Latvia and Lithuania (see Figure 17).

Figure 17. Tax burden in European Union in 2011 (% of GDP)



Source: Eurostat

109. Whereas the tax burden in Estonia increased by 1.5% from 2007–2011, the EU average decreased by 0.5%. In Lithuania and Latvia, the tax burden decreased by more than 3% at the same time.

110. The tax burden in Estonia is slightly lower than the European Union average, mainly due to low capital taxes. Consumption taxes exceed the same taxes in the EU 27 by almost a third and the rate of labour taxes comprises 101% of the European Union average. More than half of people's wages go on taxes (see also Table 8).

Table 8. Estonian tax rates compared to EU 27 average (%)

	2007	2008	2009	2010	2011
Estonian consumption tax rate as % of EU 27 average	117.4	107.1	136.1	128.9	129.9
Estonian labour tax rate as % of EU 27 average	94.4	93.6	98.9	103.9	101.2
Estonian capital tax rate as % of EU 27 average	32.2	40.5	61.6	41.7	33.3

Source: Eurostat

There is not a lot of room to increase consumption and labour taxes in order to boost state revenue

111. As the state presently earns most of its tax revenue on labour and consumption, the decrease in employment and purchasing power will also reduce state revenue. (Income decreases at retirement age, which means that consumption is also likely to decrease or start slowing when the number of retired people grows.)

112. However, consumption taxes and labour taxes in Estonia are already higher than the EU average, which is why increasing taxes in these areas would be difficult without damaging competitiveness or compromising on people's standard of living. One way of guaranteeing sustainable development proffered in discussions is the idea of shifting the tax burden from consumption and labour to capital.

Local authorities face bigger development risks than the state

113. The question of where to find money for the maintenance of the state in 10, 20 and 30 years' time does not concern the state or the government alone. Differences in regional development, changes in the location of the population that have already occurred and will occur in future and the local authority financing system established by the governors of the state place a bigger question mark over the sustainability of local authorities than on the functioning of central government.

114. The tendency of working-age people to move to cities and municipalities surrounding cities has already deepened the differences in the revenue of local authorities and this gap will keep growing. With the number of people entering the labour market forecast to be 24% lower than the number leaving it in ten years' time, the situation in rural areas will be even worse.

115. The decrease in the number of working-age people in rural areas has unfortunately deepened every year. While the number of people leaving the labour market in local authorities nearest to centres will exceed the number of people joining the market by *ca* 15% in ten years' time, the same indicator in the remaining local authorities will be twice as bad – 30%.

116. In the current local authority financing system of Estonia the revenue of local authorities depends largely on the income of the people living in the local authority unit and the budgets of local authorities are more sensitive to changes in the income tax of people than the state budget. Tax revenue comprises *ca* 52% of the revenue of local authorities and consists almost entirely of personal income tax (91% of all tax revenue).

Only three counties received more revenue than in 2008

117. As a result of the recession and the relocation of the population, revenue in half of all counties has increased compared to 2007, but only three counties received more revenue than in 2008. The counties that have lost more revenue on average compared to 2007 are the local authorities of Hiiu (8%) and Jõgeva (11%) counties. An analysis of changes in revenue based on the location of the local authorities indicates that although the total revenue of local authorities in 2012 was 11% higher on average than in 2007, revenue only increased in county centres (15% on average) and surrounding local authorities (24% on average). The revenue of all other local authorities has decreased continuously (see also Table 9).

Table 9. Change in total local authority (LA) revenue by local authority type

	Number of people	Average total revenue (euros)	Change in average total revenue compared to 2007 (%)					
		2012	2007	2008	2009	2010	2011	2012
LAs nearest to centres (43)	252,560	5,933,622	100	111	100	98	103	124
County centres (15)	666,643	50,484,800	100	114	101	102	104	115
Remaining LAs (168)	398,802	2,443,541	100	113	99	94	99	97
Total	**1,318,005**	**6,296,162**	100	113	100	99	102	111

Source: National Audit Office on the basis of data from the Ministry of Finance

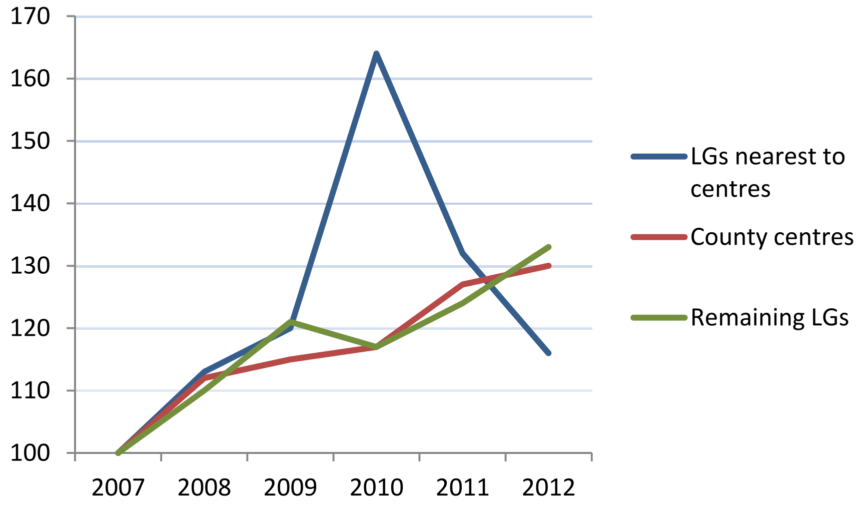
Revenue per capita varies greatly in local authorities

118. The average tax revenue per resident in local authorities underscores the inequality between regions. In 2012, this revenue was highest in Harju County (633 euros) and smallest in Valga (410 euros), Jõgeva (416 euros) and Võru (417 euros) counties. The differences range from more than 800 euros in Harku and Viimsi municipalities to 200 euros in Piirissaare and Peipsiääre municipalities.

The social expenditure of local authorities has increased

119. Population aging and the decrease in income during the recession have also increased the social expenditure of local authorities. The expenditure of all local authority types has increased compared to 2007, but this increase is slightly smaller in county centres and surrounding local authorities.

Figure 18. Social welfare expenditure per person by local authority (LA) type (%; base year 2007 = 100%)



Source: National Audit Office on the basis of data from Statistics Estonia

120. Compared to 2007 social welfare expenditure has increased by 30% in county centres, 16% in local authorities nearest to centres and 33% in all other local authorities. It is remarkable that local authorities nearest to centres cut their expenditure as the recession abated, but the expenditure of county centres and the remaining LAs has continued to grow.

Local authorities invest less and mostly use foreign funding

121. The investments of local authorities have changed similar to those of the state. Investments per resident have decreased on average in two-thirds of all counties compared to 2007; there are only six counties where investments per resident have increased.

122. The investment capacity of regions is also different. One can see that investments per resident made by county centres in 2012 comprised just 55% of the investments made in 2007. Local authorities nearest to centres, however, invested 9% more than in 2007.

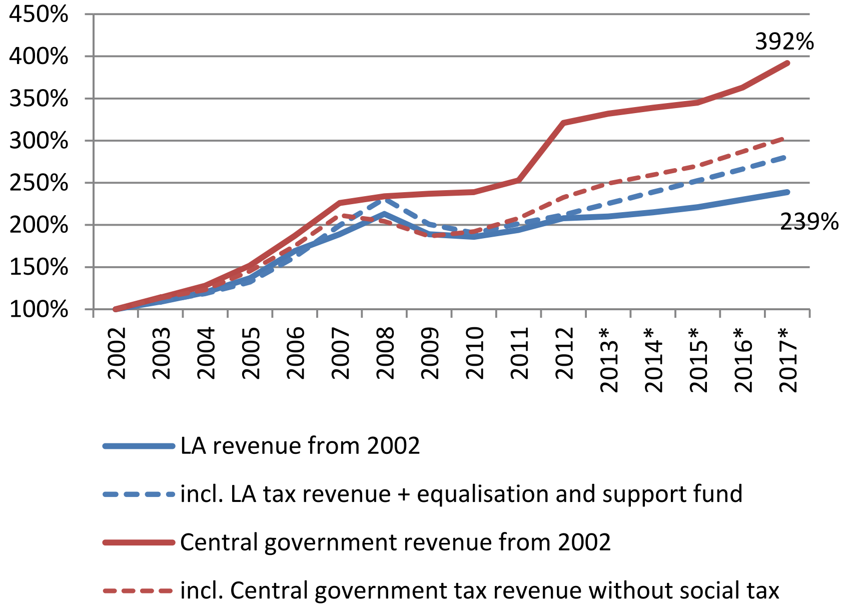
123. Since the recession, local authorities have made most of their investments with the support they have received, the majority of which has come from the EU support allocated to Estonia and other foreign aid. In the period from 2004–2008 support covered *ca* one-third of investments, but its share has increased significantly since 2009 and reached *ca* two-thirds in the last couple of years. This has been the case in the majority of local authorities. The limitation established on local authorities due to the recession in 2009 – which only allowed them to borrow money for the use of EU funds or other foreign aid – had an impact on this.

124. Although the financial position of local authorities has improved compared to the years of recession (with investment capacity starting to recover and the number of LAs struggling with debt having decreased), local authorities in their present financing system are even more vulnerable than the state, i.e. central government, to changes in the economic environment and population.

Local authority revenue increases considerably more slowly than public revenue

125. This is clearly illustrated by the difference in the revenue increase of the state and local authorities in the last ten years. Whereas public revenue has increased by 312% compared to 2002, the revenue of local authorities has risen by 208%. According to the forecast of the Ministry of Finance, this gap will grow further – public revenue will have increased by 392% by 2017, compared to 239% for local authorities (see also Figure 19).

Figure 19. Increase in public and local authority revenue from 2002–2017



* The figures for 2014–2017 are a forecast, see http://www.fin.ee/doc.php?108331.

Source: Ministry of Finance

126. A comparison of the revenue and expenditure of the state and local authorities reveals that the share of local authorities in GDP is decreasing each year. While the state's share in GDP rose from 30% in 2002 to 44% in 2012, the share of local authorities decreased from 9% to 8% over the same period and will decrease further in the coming years. This trend indicates the desire of the state governors to reduce the role of local authorities and govern society's development centrally. At the same time, it remains unclear which tasks must be performed by the state or the central government and which by local authorities (see more in the chapter 'Local authorities – the state has not sought to deal with intrinsic problems').

The capacity of local authorities to provide services to people varies greatly and the gap is widening

127. It is clear, however, that changes in the population are setting challenges for local authorities that are at least as great as those of the central government. Changes in the location of the population have widened the gap in regional development and potential, while demographic changes are further aggravating problems related to the capacity of local authorities. Not all local authorities are able to perform the tasks assigned to them, or only perform some of these tasks; many do not offer public services at a good level; and the fragmented organisation of local authorities also curbs the development of larger local authorities.

What kind of state can and do we want to maintain?

128. The state may not be able to provide all services at the current volumes under conditions of an aging and decreasing population. At the level of both state and local government, we must find an honest answer to the questions: What kind of state can and do we want to maintain?

What services should be provided to people in the long term, in what volumes and by whom? We must agree again on the public benefits the state should offer, to whom it should offer them and in what amount. We must also clarify the extent to which local authorities are the intermediaries of public authority or advancers of local life, and based on this agree on the financing of local authorities.

The sustainable development of the state requires broad-based discussion and open decision-making, but the new State Budget Act is heading in the opposite direction

129. Use of the money collected from taxpayers is one of the main levers in addition to laws and other rules that the governors of the state can use to steer social development. By approving the state budget the Riigikogu grants the Government of the Republic permission to spend the money collected from people for the achievement of certain goals, such as mitigation of unemployment, improving access to medical care and supporting the competitiveness of the economy.

130. In the state budget the plans of the state's leaders are expressed in monetary terms. The budget is used to finance the advancement of life in Estonia in the manner in which the Riigikogu and the Government of the Republic envision it to develop.

131. However, establishing and deciding on society's development trends cannot be the privilege and obligation of the government alone. Matching the state's development needs to financial options and choosing how much taxpayers' money to spend and on what calls for broad-based discussion involving taxpayers as well. This also means that the Riigikogu must be able to assess the cost proposals of the government, understand the budget draft and have the ability to steer the state's development through budgeting.

132. As described in previous chapters, the Estonian public sector will be unable to provide the same amounts of services in the long term despite the good condition of public finance. We need to find an honest answer to the question as to what benefits the public sector should offer, whom they should be offered to and in what amounts.

Reviewing and agreeing on the services provided by the state requires broad public consensus

133. Agreeing on an extensive review of the services and benefits provided by the state and affordable financing should not only take place at the level of government or, even more narrowly, the Ministry of Finance. This requires a broader social platform, and budgeting in the state should take place in a manner that allows for broad-based discussion and open decisions.

134. The National Audit Office has drawn attention to the problems in the state's budget drafting many times. The main concerns are that the state budget acts are very difficult to understand and that government explanations in budget memoranda are scarce. The National Audit Office has also found that the results of previously financed activities should be assessed more during the preparation of the state budget and also considered when new decisions are made. Reporting has also been a problem – the explanations given by the government about results achieved with taxpayers' money in the budget year, plans that were not carried out and the reasons for this are often superficial and not based on an analysis of the government's activities.

135. The Ministry of Finance has now started to amend the budgeting act and has proposed a draft of the new state budget act[2]. The main reason why the act will be amended is the obligation to assume the new financial management rules of the European Union from 2014. In order to cut back growing debt and the budget deficit, the European Union has established limits on the amounts by which public expenditure may exceed public revenue, i.e. the goal is to have balanced budgets in Member States joined with the Fiscal Compact agreement.

136. The Ministry of Finance has therefore prepared the new draft of the state budget base act to establish specific limits and rules for everyone who receives a significant proportion of the money they need for their activities from the state budget or whose activities are controlled by the state.

137. The Ministry of Finance is also making changes to budget drafting that are not demanded by the European Union. For example, there are amendments regarding the level of detail in the manner of presentation of the state budget and in the principles of strategic planning of the state's activities. The National Audit Office analysed the extent to which the new state budget (base) act contributed to maintaining the balance of the state budget, the broad-based planning of the state's development and funding the plans.

Estonia is establishing tighter budget rules for itself than demanded by the European Union

138. In March 2012 twenty-five EU Member States agreed on the financial management principles pursuant to which the budget of a country's government sector must be balanced or in surplus. These principles also specify that such a balance be kept in mind in the mid-term (i.e. 4-5 years) and that a structural budget deficit of up to 1% of GDP be permitted under certain conditions. This is an important buffer for the smooth management of public finance and performance of the state's tasks (e.g. making investments), which at the same time do not threaten the sustainability of public finance.

Structural budget position of government sector – the cyclically adjusted budget position of the government sector, which does not consider one-off or temporary transactions

139. However, the intention is to add an even stricter clause to Estonia's budgeting rules which stipulates that the state budget must be annually in structural balance or surplus. In other words, after cleaning the budget of the automatic stabilizers and of one-off transactions, the expenditure planned in the budget should not be greater than expected revenue.

140. Establishing budget rules that are tighter than demanded by the European Union may not be a bad choice, but it is still a rather principled fiscal policy decision that is worthy of open discussion. The new State Budget Act must be given broad-based support, incl. in terms of whether we want to establish an inflexible balance demand for state budget

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[2] Based on documents submitted by the Ministry of Finance at the Cabinet meeting of 7 October 2013.

drafting or whether we leave ourselves the option of being more flexible with the budget within the scope of the European Union's requirements.

The management of public finance is clearly heading towards centralisation

141. In order to keep public expenditure under control, the Ministry of Finance aims many of its proposals at centralisation in the management of the state's finances and increasing the decision-making capacity of the minister of finance. The minister of finance would like to take the budgets of public undertakings, foundations and public institutions under their direct financial control to guarantee that nobody plans their finances to be in deficit or assumes obligations that could have a negative impact on the financial indicators of the state as a whole. Restrictions on the spending of local authorities serve the same purpose.

The budget will not become easier to understand

142. In addition to the government itself, its spending is also supervised by the Riigikogu, the National Audit Office and the general public. The Riigikogu must understand the goals the government is trying to achieve, the activities it plans to carry out and the amounts of money it intends to spend doing so, which means that this information must be presented in the state budget in a clear and understandable manner. Similar requirements also concern budget implementation reports, which tell the Riigikogu what the government achieved, how much money it spent and for what purpose. In order to make good budget decisions the Riigikogu needs timely and accurate information presented understandably in the agreed format.

143. This information should primarily be contained in the State's Budget Strategy, the explanatory memorandum to the annual state budget and the consolidated annual report and management report, where the government reports on how it has used state budget funds.

144. In practice, the information given in the State Budget Strategy and the explanatory memoranda to the annual state budget is often scarce and incomparable to previous periods. The new act will not improve the situation. Requirements of the content or format of the explanatory memorandum to the annual state budget will not be established and the budget strategy will remain an internal document of the government whose content is regulated by minimal requirements and which is not submitted to the Riigikogu for discussion.

145. The manner of presentation of the state budget approved every year, i.e. who receives money, how much and for what purpose, will also become more generalised (with the classification of revenue and expenditure being less detailed than before). The budget will therefore become less understandable and the government's decision-making in the detailed determination of expenditure will increase.

146. In practice, reporting on budget implementation has become a financial spreadsheet report, rather than a document describing the performance of the government. The State Budget Implementation Report informs the Riigikogu and the general public about the amount of money the government has used over the year and how much of it has been transferred to the next year. No information about how the money was used, i.e. what was done with the money, which goals were achieved and which goals were not, is given in the state budget implementation report.

Information about the achievement of the goals set for the fiscal year by the government must be given in the management report, but no requirements of the content and manner of presentation of the report have been established. The state's management report and the state budget implementation report prepared for 2012 cannot be linked to each other, because the management report is prepared by policy areas and the budget report by administrative cost division, which means that the money spent and the government's activities cannot be linked.

The state budget implementation report is impossible to understand without specific knowledge

147. In addition to the above, the National Audit Office has for many years highlighted the problem that the manner of presentation of the state budget implementation report makes understanding the use of budget funds very difficult. The numbers presented in the budget implementation report are not comparable to the annual state budget act adopted in the Riigikogu and the changes therein are not explained in the report or in the annex to the report (see also Article 150).

148. According to International Public Sector Accounting Standard IPSAS 24 'Presentation of Budget Information in Financial Statements', the budget adopted by the parliament, the final budget and the data of actual implementation of the budget must be presented in a manner that is comparable to the adopted budget. The reasons for any significant differences in the planned budget and the actual budget must also be explained. In the opinion of the National Audit Office it is therefore important for the readers of the budget implementation report to see how the ministries and their agencies have actually used the budget approved in the Riigikogu with the act. In other words, the government must explain to the Riigikogu what it promised to do with the budget money and what it actually did.

149. The current principle of preparation of the State Budget Implementation Report guarantees that the recognition of the use of money is mathematically as accurate as possible, but the report does not explain why the planned revenue and expenditure differ from the final budget and the actual revenue and expenditure. On the one hand, it is good that a report that recognises the use of money accurately is prepared here. Unfortunately, the main purpose of the report – to show the Riigikogu and the general public how the money was used – has unfortunately been forgotten.

150. The State Budget Implementation Report does not give sufficient information for making and improving fiscal decisions. There is little information about what was done with the money over the year and what was not done, and it is easy to draw the wrong conclusions on the basis of the report without understanding the principles by which it was completed. The following examples illustrate the problems:

- The expenditure of the Ministry of the Environment planned in the budget according to the 2012 State Budget Act approved by the Riigikogu was 476 million euros. The consolidated amount of expenditure included 413 million euros allocated for support, which according to the explanatory memorandum was primarily meant for the financing of green projects designed to reduce greenhouse gas emissions and projects for the development of the living environment. In the State Budget Implementation Report, however, the final expenditure budget of the ministry is given as 278 million euros. The difference is biggest in the amount of support – the report shows that the difference between the support budget approved by the Riigikogu and the actual receipts comprised *ca* 200 million euros. The state budget implementation report fails to explain the 'disappearance' of *ca* 200 million euros from the budget i.e. what actually happened to this money (see also Table 10).

Table 10. Example of Ministry of the Environment budget implementation report (million euros)

Formation and use of 2012 budget limit of Ministry of the Environment				
Final expenditure budget for 2012 (state budget approved by Riigikogu)	Final budget (usable limit) for 2012 according to budget implementation report	Actual implementation of budget expenses for 2012	Difference between budget approved by Riigikogu and limit usable pursuant to budget implementation report	Difference between budget approved by Riigikogu and actual budget expenditure
476.1	277.5	244.5	198.6	231.6

Source: National Audit Office on the basis of data from the Ministry of Finance

- The Ministry of Finance was allocated 478.2 million euros for expenditure pursuant to the 2012 State Budget Act, but the state budget implementation report shows the final expenditure budget of the ministry as 1.07 billion euros, 906 million euros of which was used. The state budget implementation report does not explain why the budget increased by *ca* 500 million euros. The difference between the amount approved by the Riigikogu and the amount indicated as actual in the report mostly arises from the increase in the amount of support.

- The 600 million euros not spent in 2011 was transferred to the 2012 state budget and 431 million euros was transferred to 2013 at the end of 2012. This is mostly money allocated for investments and support. The report does not explain why these amounts were not spent. This is not a problem that appeared in 2012 alone: large amounts of expenditure have also been transferred to the next budgetary year in previous years. In general, the reasons for transferring expenditure are delays in investments and failure to complete foreign projects by their deadlines. It is possible that these are the same projects that have been delayed year after year, but the reasons for this are not explained. As the problem (i.e. the amount of transferred money) is difficult to identify due to the manner of presentation of the budget implementation report, there is a risk that the reasons the support was underused will not be analysed when the budgets of the coming years are planned and that budgeting will not be improved.

151. Year after year, the National Audit Office has highlighted that the manner of presentation of the State Budget Implementation Report should be improved. The Ministry of Finance has perfected the report, but as a result of this it is becoming even more technical and increasingly complicated for the Riigikogu and the general public. There are also no requirements that consider the specific features of the public sector for the management reports of ministries, which should show how the budget has been implemented and why some of the planned activities have not been carried out. The new state budget act, however, does not establish requirements for the management report of the state.

152. The National Audit Office finds that in order to guarantee clarity and transparency, it is important that the State budget Strategy, the annual state budget, the explanatory memorandum to the state budget, the consolidated annual report and the management report of the government have the agreed structure and that this is not changed without explanation. The observations and proposals of members of the Riigikogu should also be considered when these issues are regulated.

The new state budget draft does not support broad-based agreement on affordable development

153. An important question in the advancement of welfare and prosperity in Estonia is whether the state's development priorities are specified by the Riigikogu or the Government of the Republic. The initial explanations and documents of the Ministry of Finance did not provide a clear answer. Until now, the Riigikogu has been able to approve and acknowledge development plans and strategies which were either required by law or which the government has sought to introduce to the Riigikogu. The new draft act stipulates that the Riigikogu will only start discussing the sectoral development plans presented by the Government. This change will place policy-making (i.e. the establishment of societal goals) and administration (i.e. the use of money) firmly in the Government's hands.

The Government's Action Programme is the defining strategy document

154. The drafts of the implementation acts enclosed with a draft of budgeting (base) act reveal that the action programme arising from the Government's coalition agreement will be the most important document in the future development of the state. The Government's Action Programme is the most important, practical plan steering the state's development and forms the basis for performance measurement. The structure of the state budget strategy is later prepared on the basis of the action programme and the allocation of budget funds for up to four years is planned on the basis thereof. The Government has not planned any substantive roles for the Riigikogu in the strategic management of the state.

155. The National Audit Office finds that the Riigikogu should take the leading role in the determination of the state's development priorities and should establish the major goals in the advancement of life in Estonia. The Riigikogu must also ask the Government whether and how it has managed to carry out the instructions and goals given by the Riigikogu, and the Government must be obliged to report on its activities both substantively and analytically. If the strategic planning of the state's development remains the internal business of the Government to the present extent and the rules of the game are determined by the same institution, the assessment of performance and the balance of power between the legislative and executive branches will become questionable.

156. If the budget is so general that the figures do not tell anyone anything about state budget expenditure and the explanations of what the money will be spent on and the report about spending are given in bulky documents that have no agreed structure, then the system is suitable for technocratic state governance rather than one that is democratic, explanatory and in compliance with good governance practice. If the Riigikogu only plays a symbolic role in strategic and mid-term planning as a party approving whatever the Government decides to do, it means the state budget process is removed from social debate and is stagnating. Amendments to the State Budget Act seem to fortify the technocratic model and a unilateral control (balance- and maximum control-based) approach to public finance.

157. The technocratic model probably justified itself during the crisis when decisions about the use of money were made technically from the 'centre', primarily on the basis of the time-critical nature of the decisions and the bigger picture of public finance, and responsibility for striking a balance between service quality and the allocated money was left with the recipient. This model was effective in terms of the speed of decision-making and control and complies with the usual cost-controlling role of the Ministry of Finance, but it is not suitable in a situation where it is necessary to extensively review the services provided by the state. This review must engage those who use the budget funds and it should be broad-based and substantive. The Ministry of Finance has not prepared for this task. The new draft seems to reject rather than favour a multitude of ideas and finding innovative solutions in order to agree on the scope of governance we want and how we can afford it. Looking at the challenges that lie ahead of us, however, shows that every idea is worth considering. Keeping the Riigikogu and public opinion away from development planning and decision-making with regard to funding public policies is not a good idea.

The pension policy of the state – postponed decisions

Did you know that…

…the largest single amount in the state budget – 6.5 billion euros in total – will be allocated to pensions from 2014-2017?

The pension insurance deficit keeps increasing

158. Maintaining the pension system takes up a remarkable proportion of the state budget. Pension expenditure in 2013 totals 1.67 billion euros or *ca* 22% of the state budget. State pension insurance expenses thereby comprise 1.48 billion euros, while transfers to the mandatory funded pension system or second pillar amount to 177.8 billion euros.[3]

159. National pension insurance has been in deficit since 2009, because the state's pension expenses considerably exceed the tax revenue collected for this purpose. The deficit of state pension insurance in 2013 is 370 million euros. In comparison, the amount that the state will spend on the rescue sector, police and border guards in total in 2013 amounts to 196 million euros. The deficit keeps growing and will reach 474 million euros by 2017.

160. The pension insurance deficit will comprise 4.8% of the 2013 state budget and will increase to 5.2% by 2017.[4] According to forecasts, pension insurance will remain in deficit for at least another 50 years.[5]

161. The deficit will be somewhat reduced by the implementation of the second pension pillar or the mandatory funded pension, but this does not guarantee the sustainability of the system. The first pension pillar or state pension insurance will remain in deficit if no profound changes are made.

[3] 2013 State Budget Act

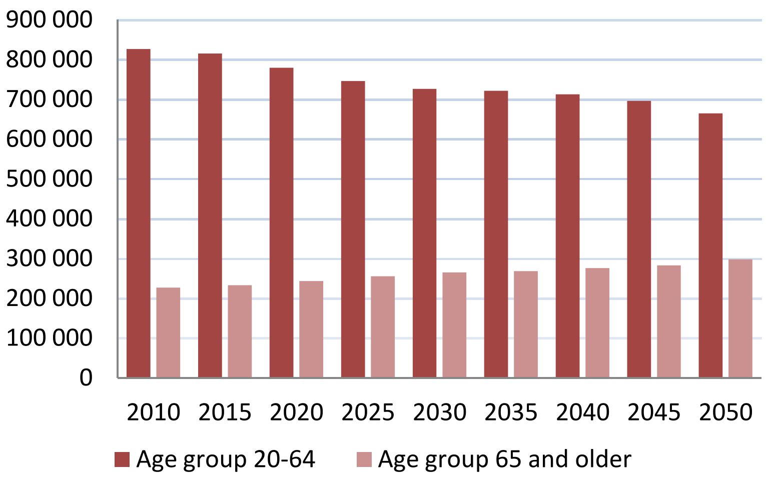
[4] State Budget Strategy 2014–2017

[5] Opportunities of Sustainable Financing of the Estonian Social Insurance System. Praxis Centre for Policy Studies, 2011

162. The state has to cover this constant deficit with money that could otherwise be used elsewhere. Teachers and doctors have gone on strike because the state cannot find the money for their pay rise. Based on the collective agreement signed after the strike, the state will spend 28.4 million euros on the pay rise of doctors in 2013; 40 million is planned for the pay rise of teachers. These expenses in total comprise just 18% of the amount that will be spent covering the pension insurance deficit from the state budget this year.

163. The demographic processes occurring in Estonia deepen the pension insurance deficit further: population aging, negative natural population growth and constant emigration of working-age people and children. The number of working-age people will decrease and the number of pensioners will increase as a result of these processes. According to forecasts, the number of people over 65 years of age will increase by 31% between 2010 and 2050, i.e. from 227,000 to *ca* 300,000. At the same time, the number of working-age people (aged 20-64) will decrease by *ca* 20%, i.e. from 827,000 to 665,000. Both indicators will follow the same path after 2050 (see also Figure 20).

Figure 20. Number of working-age and retirement-age people in 2010 and changes from 2015 to 2050



Source: Statistics Estonia

164. Since funding the pension system is largely based on taxing salaries, the revenue required for the payment of pensions will reduce as a result of the decrease in working-age people. The number of pensioners will increase at the same time, which means that the taxes paid by one working person will have to support an increasing number of pensioners. According to forecasts, there will only be 1.3 working people to support one pensioner by 2060. The relevant ratio before the recession (until 2008) was 1.7.[6]

The average retirement age is 59.6

People retire before the official retirement age

165. The fact that people retire earlier than expected is also an important factor causing the budget deficit. The state has made the decision to raise

[6] Sustainability of State Pension Insurance. Ministry of Finance, 2012

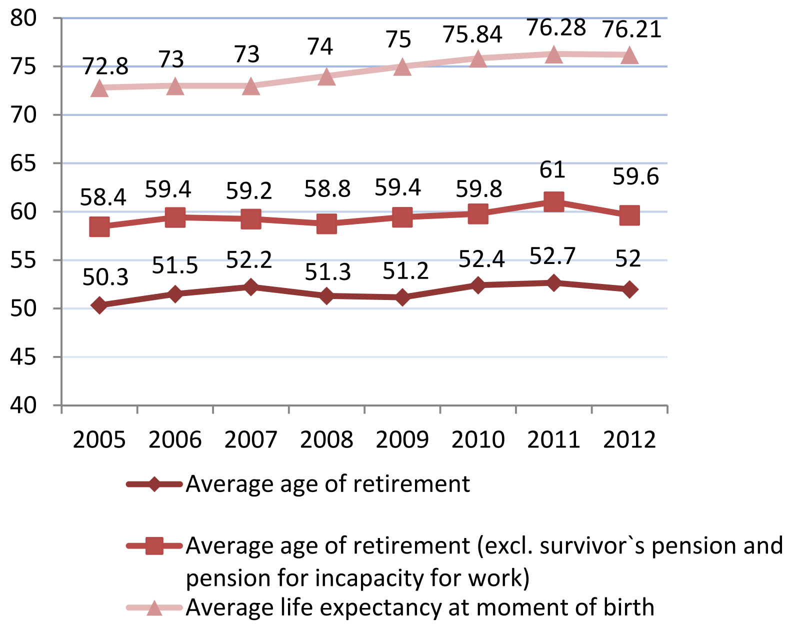
the retirement age to 65, but it is unclear how it will be guaranteed that people actually work until this age.

A survivor's pension is paid to the family members of a provider in the event of the provider's death.

A disability pension is paid to people at least 16 years of age who are declared permanently incapacitated for work, who have lost 40-100% of their capacity to work, and who have acquired the necessary period of pensionable service in Estonia by the time their incapacity for work is ascertained.

166. In 2012 the official retirement age was 63 for men and *ca* 61.5 for women, but the average age at which people retired was 59.6 years. If we also include recipients of disability and survivor's pensions[7], the average retirement age falls to 52 (see Figure 21). The average age at which people retire has not changed significantly in recent years despite the increase in average life expectancy. As a result, the state pays people pensions for more years on average.

Figure 21. Average life expectancy and age at which people retired from 2005–2012



Source: Statistics Estonia, Social Insurance Board

An old-age pension is paid to people who have acquired at least 15 years of pensionable service in Estonia. The present retirement age in Estonia is 63 for men and less for women.

167. This shows that at present many people are not leaving the labour market when they have attained the official retirement age, but are doing so considerably earlier. The calculations of the Praxis Centre for Policy Studies[8] indicate that *ca* 40% of men and 30% of women receive various types of pensions before they attain retirement age. On the one hand, the reason for this is the low competitiveness of people approaching retirement age on the labour market; and on the other, the pension schemes that enable people to retire early, such as the early retirement pension.

Disability insurance reforms must continue

168. One important reason for the low average retirement age is the high number of people who start receiving disability pensions. The average age at which people start receiving disability pensions has remained stable at around 45 years. 90% of people to whom disability pensions

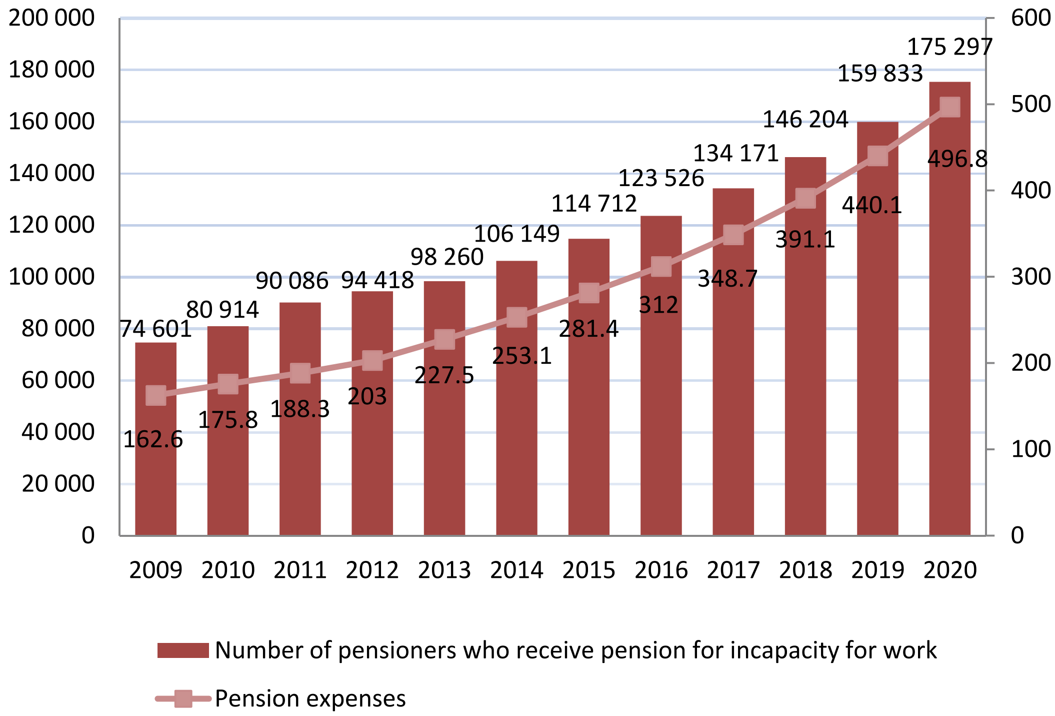
[7] The number of survivor's pension recipients as at 1 January 2013 was 6972. As their total number is relatively small, the age at which they start receiving the pension does not have a major impact on the average indicator.

[8] Opportunities of Sustainable Financing of the Estonian Social Insurance System. Praxis Centre for Policy Studies, 2011

have been granted once, remain on the pension. This means that the state pays the person a pension for 33 years on average.

169. The number of disability pensioners has increased since 2001 by 118% and reached *ca* 100,000 (see Figure 22). This comprises more than 7% of the Estonian population. It is remarkable that since 2008 there are more people who have started receiving disability pensions than people who have started receiving old-age pensions. In 2012 the state spent more than 203 million euros or 15% of total national pension insurance expenditure on disability pensions.[9]

Figure 22. Forecast of number of disability pensioners if present system continues



Source: Social Insurance Board, Ministry of Social Affairs

170. The Ministry of Social Affairs is preparing a new disability insurance system. One of the goals of this new system is to reduce the number of disability pensioners by giving them the chance to return to the labour market in a new profession as a result of rehabilitation services and training. The Ministry of Social Affairs estimates that the number of disability pensioners will decrease to 80,000 by 2020 once the new system is implemented.

171. Although the draft of the disability insurance reform was initially supposed to be completed by Q4 2012[10], no agreement has been reached on several important points that would make it possible to achieve the goals. For example, there is still no consensus regarding occupational accident insurance and no solution has been offered for the diagnosis and treatment of occupational diseases. The extent to which the provision of

[9] Data of the Social Insurance Board

[10] Memorandum of the Minister of Social Affairs of 14 March 2012 for the Cabinet session

rehabilitation services will change remains unclear[11] as are the parties whose financial burden will increase as a result of the changes or how big this increase will be. Implementation of the planned changes without these decisions is impossible.

Unemployed people and disability pensioners choose early retirement instead of going to work

172. The disability pension, however, is not the only problematic pension type that allows people to retire early and creates massive expenses in the pension system. The early retirement pension, which was being paid to *ca* 22,000 people at the end of 2012, is also such a pension.

Early retirement is permitted up to three years before the legal retirement age, but the amount of the pension is then reduced by 0.4% for every month of early retirement.

An early retirement pension is granted to a person for life and is not recalculated or renamed when the person attains retirement age.

173. The analysis carried out by the National Audit Office revealed that three quarters of the people who retired early did not have official jobs before they retired, 75% of whom were registered with the Unemployment Insurance Fund (2012), because registering as unemployed guarantees health insurance. Low levels of education and a poor command or lack of Estonian language skills is a problem for many of these people. Some people who have retired early are those who have lost their capacity for work and exchange the small disability pension for a larger early retirement pension once they attain the relevant age.

Read more

in the audit report entitled "Sustainability of the state's pension policy" that will be completed in 2013.

174. The large proportion of unemployed people and disability pensioners among those who have retired early indicates that the system for helping the unemployed and disabled carries its problems and expenses over to the pension system. As a result of this, the people who leave the labour market are those whose ability to compete is low due to problems concealed elsewhere and who should be brought back to the labour market instead of letting them retire.

Different pension schemes have no justification

175. *Ca* 25% of the entire pension insurance budget is spent on special types of pensions. The National Audit Office finds that these expenses could be partially avoided in future. On the one hand, the payment of different types of pensions is a burden to the pension insurance fund. On the other hand, the state misses out on the tax revenue it would receive if people who retired early continued working.

The sustainability of the pension system requires systematic changes

176. The pension system is considered sustainable if the expenditure and revenue of state pension insurance are balanced and pensions are adequate or guarantee the preservation of a reasonable standard of living. The current system cannot meet these conditions.

177. The state should either reduce expenditure or increase revenue in order to make the pension system more sustainable. The state's pension expenditure can be reduced by raising the retirement age, reducing the amount of pensions or terminating the payment of certain pension types from the state budget. Increasing revenue would first and foremost require increasing the tax burden.

Pension insurance would be balanced if the average old-age pension were reduced to 200 euros or social tax was increased by 10%

178. Considering the extent of the pension insurance deficit, it cannot be covered by changing just one factor in the system. This is why all parts of the pension system should be reviewed. For example, if we wanted to balance state pension insurance in 2013 we would have to reduce the

[11] The Ministry of Social Affairs promised to prepare the draft of the Rehabilitation Services Act by the last quarter of 2013.

average old-age pension from 312 euros to *ca* 200 euros. If we decided to increase taxes, the pension insurance part of social tax (currently 20%) should grow by *ca* 10%.[12]

179. Neither of these options would likely be acceptable to society. Reducing pensions would make it considerably more difficult for pensioners to manage. A tax hike of 10% would considerably increase labour taxes, which are already at the same level as the European Union average. Balancing pension insurance by 2035 means that the retirement age should also increase constantly after 2026, reaching 66 by 2035 and 69.25 by 2060.[13] This means that the state must abandon special schemes that allow people to exit the labour market before they attain retirement age.

Automatic adjustment of the system to population processes would guarantee the sustainability of pension insurance

'Automatic adjustment mechanisms' are tools for adjusting benefits, rights and/or contributions according to changes in agreed indicators.

Source: Adequate, Sustainable and Safe European Pension System. Green Paper of the European Commission. 2010, SEK(2010)830

180. Countries with aging populations need to find enduring solutions for their pension insurance systems. One-off political decisions will not necessarily guarantee the system's sustainability, stability or solidarity between generations. This means that in an ideal scenario the political choices that concern the pension system should be established for decades and be based on objective indicators.

181. Many countries (e.g. Finland, Sweden, Germany and Japan) have introduced 'automatic adjustment mechanisms' to balance the impact of population aging and economic crises on the pension system. These mechanisms make it possible to adjust the pension system according to agreed statistical indicators, thereby reducing dependence on political factors. This also helps avoid the system ending up in a near-crisis if the necessary decisions have not been made. The use of automatic adjustment mechanisms also provides more reassurance to the parties to the system, as it is known how and on what basis the system will change in future.[14]

182. Automatic adjustment mechanisms can be applied to different factors of the pension system. The most widespread types of mechanisms in other countries affect the retirement age and the amounts of pensions. For example, it is possible to tie the retirement age to life expectancy, whereby the retirement age is regularly adjusted according to life expectancy statistics. The retirement age can also be increased in accordance with changes in the ratio of working-age population to pensioners: for example, it is possible to determine how many pensioners there should be per working-age person, and then use this to calculate the retirement age every year. As the development of such indicators is gradual, the automatic adjustment mechanisms would make it possible to adjust the pension system smoothly and avoid for instance one-off sudden increases in the retirement age. In this manner, any changes would have a more even impact on different generations than one-off political decisions. In addition to the above, other countries have also adopted automatic adjustment systems that are linked to e.g. the system's financial balance and tax rate.

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[12] Opportunities of Sustainable Financing of the Estonian Social Insurance System. Praxis Centre for Policy Studies, 2011.

[13] Opportunities of Sustainable Financing of the Estonian Social Insurance System. Praxis Centre for Policy Studies, 2011, pp. 115-116.

[14] Sustainability of State Pension Insurance. Ministry of Finance, 2012.

183. In the opinion of the National Audit Office it is important to identify the automatic adjustment mechanism that is the most suitable for the demographic and economic situation in Estonia and to implement it. An agreement about the conditions of this mechanism should be made as early as possible so that it can be implemented as of 2026, when the determined increase in the retirement age will end. If automatic adjustment systems are deemed unsuitable for Estonia, the other option could be to continue increasing the retirement age after 2026 at the same pace as from 2017–2026. As a result, the retirement age would increase to 70 by 2051.

Decisions on how to make the pension system sustainable in the long term must be made in the next couple of years

184. The state has avoided making the decisions necessary to guarantee the sustainability of the pension system. The increase in the retirement age that has been agreed on will end in 2026 and there are plans to analyse further changes in 2019. This may mean that the preparation time is too short for the population and an inability to adjust the system smoothly in line with demographic changes.

185. The implementation of an automatic adjustment mechanism, which would make it possible to find long-term solutions, has not been thoroughly considered so far. Also, disability insurance has not been reformed and the justification for the payment of special types of pensions has not been reviewed. This situation pushes the achievement of a sustainable pension system into the distant future. Until then, the deficit in the state pension insurance system will remain a significant and constantly increasing burden on the state budget.

186. Achieving a sustainable pension system calls for comprehensive reforms and a long-term plan. Apart from reforming the different parts of the system, an agreement should be made as soon as possible about the time and conditions of the implementation of an automatic adjustment mechanism or about increasing the retirement age at the current pace. Without changes, pension insurance will be in deficit for decades to come, which will weaken the budgetary position and limit the state's opportunities to invest in other areas.

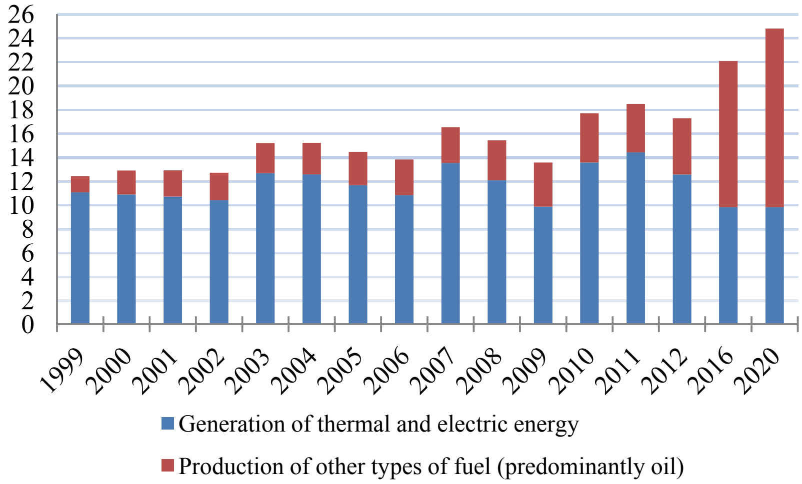
Oil shale – an opportunity to earn additional budget revenue

187. The state has primarily focused on cost-cutting in order to adapt to demographic changes and maintain a balanced budget. Considering the significant decrease in European Union support money in the future, finding additional ways of increasing state budget revenue is as important as cost-cutting. The taxation of a natural resource which is of national importance is an opportunity that has so far unused.

188. Oil shale has been mined for *ca* 100 years. Oil shale has mostly been used for electricity generation. The use of oil shale has been changing in recent years – it is now mainly a raw material for making shale oil.

189. Consumption of oil shale has increased by six million tons in the last 14 years, and in 2011 it achieved the highest level in Estonia during the country's years of independence – 18.5 million tons per year. In the coming years the consumption of oil shale will depend mainly on the plans of oil producers and the extraction volume limits established by the state. Looking at the plans of shale oil producers, the volumes of oil shale extraction could grow up to 25 million tons per year (see Figure 23).

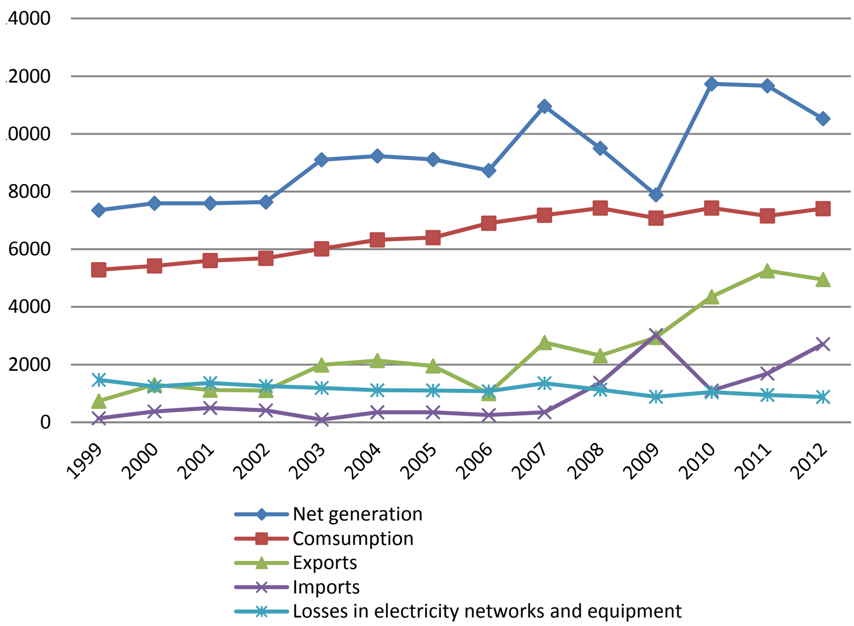
Figure 23. Oil shale consumption from 1999–2012 and forecast for 2016–2020 (million tonns)



Source: National Audit Office on the basis of data from Statistics Estonia and the Ministry of Finance

190. The reason behind the increase in oil shale consumption is not growing domestic demand, but export of electricity and oil produced from oil shale. The electricity generated in 2012 exceeded domestic consumption by 29% (see Figure 24). Electricity exports have increased *ca* seven-fold in the last 14 years.

Figure 24. Net generation, consumption, exports imports and losses (in electricity networks and equipment) of electricity from 1999–2012 (GWh)



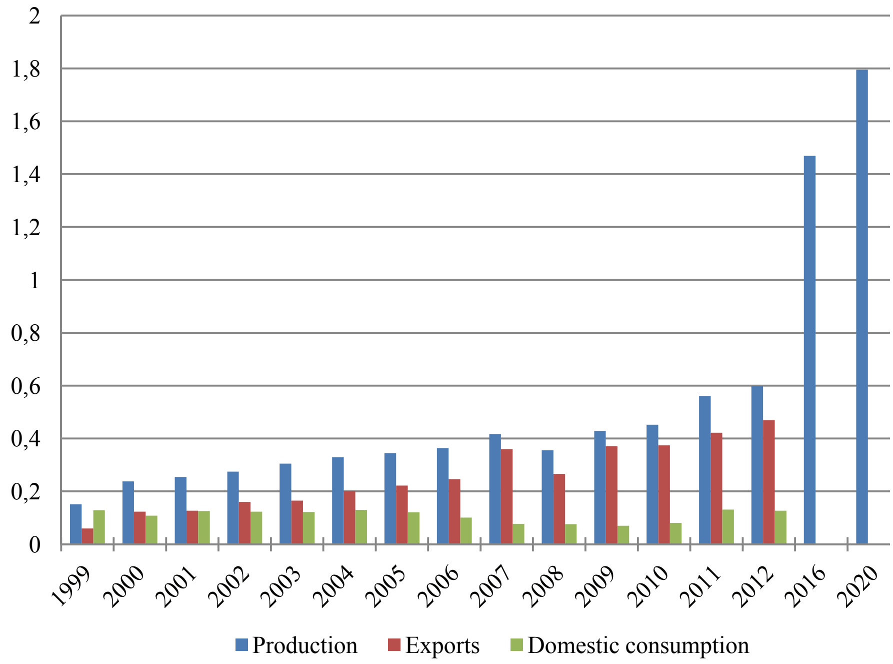
Source: Statistics Estonia

Did you know that…

…at the beginning of 2013 both Eesti Energia AS and Viru Keemia Grupp AS were planning to establish refining plants in Estonia to produce petrol and diesel from oil shale, but these plans have now been put on hold?

191. 78% of the shale oil produced in Estonia was exported in 2012. Shale oil exports have increased *ca* eight-fold in 14 years (see Figure 25). Shale oil production grew consistently from 1999–2012 due to high oil prices and guaranteed profitability for oil producers. Large profits have encouraged oil producers to make plans to multiply their production.

Figure 25. Shale oil production, exports, imports and consumption from 1999–2012 and forecast for 2016–2020 (million tons)



Source: National Audit Office on the basis of data of Statistics Estonia and forecasts of entrepreneurs

Society does not get any benefit from exporting electricity and producing oil from oil shale

192. The exporting of oil shale products is beneficial to society only if producers offset the environmental damage caused by oil shale mining and processing in Estonia and if the state receives fair revenue from the profit of the entrepreneurs engaged in the use of oil shale.

193. Estonia has not established a single tax aimed at earning revenue for the state from oil shale production. Until now the state has only considered it necessary to demand environmental charges for the extraction and processing of oil shale in order to influence entrepreneurs to use natural resources sustainably and to remedy the damage caused to the environment. The environmental charges received by the state and local authorities from the oil shale sector amount to *ca* 56 million euros per year.

194. The conclusions reached in environmental charges analyses[15] are that the environmental charges paid by the oil shale sector do not cover all of the environmental damage caused or influence entrepreneurs to use natural resources more sustainably. The National Audit Office came to the same conclusions in its audits dealing with environmental charges.

195. As the environmental charges do not cover the damage caused to the environment in full, every ton of oil shale extracted creates additional costs for the state and society more broadly. In order to eliminate the environmental damage caused, the state will have to incur costs in the

[15] Analysis of the impact of environmental charges. Stockholm Environment Institute in Tallinn, University of Tartu, Centre for Applied Social Sciences; 2013

future that are larger than the environmental charges it receives from the entrepreneurs.

196. The state has also increased its use of environmental charges to cover other state budget expenditure instead of environmental expenses. For example, *ca* 40%[16] of environmental charges were included in general public revenue in 2012.

197. The partial receipt of environmental charges in general public revenue became possible with the amendment of the Environmental Charges Act in 2010, pursuant to which only the charges defined in the amendment are assigned directly to the Environmental Investment Centre. If the charges were increased in future, the increase would result in more money being received in general public revenue.

198. The National Audit Office emphasises that the environmental charges received from the oil shale sector and their redistribution into general public revenue alone would not guarantee that the state received fair royalties for the use of oil shale. There is no revenue, because the current environmental charges do not cover actual environmental damage and the environmental impact remains extensive. The reason given earlier to justify the need to tolerate the environmental damage associated with the oil shale power industry was guaranteeing cheaper electricity for Estonian consumers, but this can no longer be a valid point in conditions where the electricity market is open and both electricity and oil are exported.

Mining companies have to pay more taxes than electricity and oil producers

Did you know that…

…in addition to taxes, the state withdraws *ca* 90 million euros per year from the state energy company Eesti Energia Group in dividends?

At the same time, Eesti Energia Group was given 150 million euros from the state budget in 2012 to increase its share capital.

199. In order to assess whether the state receives fair revenue from companies engaged in oil shale extraction and processing for the right to use a natural resource of national importance, we need to look at the tax burden of the oil shale sector as a whole instead of just the environmental charges.

200. The state receives *ca* 80–90 million euros per year from the oil shale sector as environmental charges, labour taxes and excise duties. Looking at the division of the tax burden in the oil shale value chain, we see that the tax burden on the biggest oil shale mining company (AS Eesti Energia Kaevandused) is considerably larger than that of oil and electricity production companies (see Table 11).

201. For example, the share of national taxes in the sales revenue of oil producers is five times smaller than in the sales revenue of the mining company and 1.5 times smaller than that of electricity producer Narva Elektrijaamad.

[16] The environmental charges paid to local authorities, whose purpose has not been defined, are not included here.

Table 11. Share of taxes paid by oil shale sector in sales revenue in 2011 (%)

Share of taxes	Eesti Energia Kaevandused AS (mining company)	Eesti Energia Õlitööstuse AS & VKG Oil AS (oil producers)	Eesti Energia Narva Elektrijaamad AS (electricity producer)
Share of environmental charges in sales revenue	13.1	1.3	4.5
Share of labour taxes in sales revenue	7.0	1.7	1.5
Total share of national taxes in sales revenue	20	4	6

Source: National Audit Office on the basis of the annual reports of companies

Did you know that…

…the study 'Assessment of the Socioeconomic Impact of Oil Shale Mining and Processing' by the Praxis Centre for Policy Studies indicates that the share of oil shale companies' profit in sales revenue is several times higher than the average of the Estonian mining and processing industry?

202. In 2012 AS Eesti Energia Kaevandused (mining company) paid the state 43 million euros in labour tax and environmental charges, which comprises 53% of the total labour taxes and environmental charges in the oil shale sector. Environmental charges comprised more than two-thirds of the amount paid to the state.

203. The peculiarity of the taxation of the oil shale sector is that the least profitable branch bears the biggest tax burden. The analysis prepared by the Estonian Competition Authority in 2013[17] indicates that the profitability of oil shale mining companies is 13%, the estimated profitability of electricity generation on the open market 33% and the profitability of oil production 83%.

204. The high profitability of electricity and oil production is mainly a result of the high market price of electricity and shale oil, but cheap oil shale, low environmental charges and the fact that shale oil is not taxed also play a role.

Other countries charge more for the use of natural resources

205. Unlike Estonia, other countries tax the use of natural resources at higher rates than those imposed on ordinary business. States usually demand additional royalties from entrepreneurs for the use of natural resources.

206. For example, Norway applies a resource rent to its oil industry in addition to the ordinary corporate income tax (28% of net profit), which amounts to 50% of net profit. The income tax imposed on companies that deal with oil and natural resources in Ireland is twice as high as the ordinary tax (25% instead of 12.5%). Irish oil companies also pay a tax of 5–15% depending on the profitability of the oil field and the investments made in it. In Russia oil companies pay *ca* 11 euros per ton of oil (called a royalty) plus 20% corporate income tax and 35–60% export customs duty, which depends on the oil price.

The state does not obtain the due value from oil shale production

207. The National Audit Office is of the opinion that Estonia should value its oil shale more. One option is to consider taxing the income earned from oil. For example, the state earned *ca* 12 million euros from oil production in 2012 as national taxes (environmental charges, labour taxes and excise duties) while the operating profit of oil producers amounted to *ca* 91 million euros.

[17] Analysis of Competitive Situation in Oil Shale Sector. Competition Board; 2013

Did you know that…

- …companies pay no tax on their profits in Estonia?
- …companies only pay income tax when dividends are paid out to owners?

208. Considering the plans of oil producers to produce *ca* 1.8 million tons of oil (see Figure 25), their operating profit would increase to 288 million euros. Even if the state imposed 25% income tax on oil producers based on the most modest calculations, the amount of additional revenue received in the state budget would be 72 million euros in 2020. It is important to note that while the state can withdraw income from public undertakings as dividends, it cannot do so in the case of private companies. (See also Table 12.)

Table 12. Economic indicators of oil producers in 2012

Company name	Oil production (thousand tons)	Sales revenue (million euros)	National taxes paid, incl. labour taxes and environmental charges (million euros)	Operating profit (million euros)
VKG Oil AS*	309	138	3.8	37
Eesti Energia Õlitööstuse AS	211	91	4.5	45
Kiviõli Keemiatööstuse OÜ**	65	35	3.9	9

* Based on the 2011 Annual Report of VKG Oil AS

** The economic indicators of Kiviõli Keemiatööstuse OÜ include mining activities.

Source: National Audit Office on the basis of the annual reports of the companies

209. The Government of the Republic has also discussed the receipt of fair income from oil shale mining and processing. The goal to discuss the possible establishment of oil shale royalties was set in the Government's action programme. The Ministry of Finance completed the analysis of oil shale taxation in spring 2013. Unfortunately, taxation of the income earned on the use of oil shale was precluded in the analysis, as it allegedly does not comply with the principles of the Estonian tax system. No agreement was reached about tax amendments at the Government session and it was decided to put the topic on hold until 2016.

210. Postponing a decision regarding the taxation of oil shale until 2016 raises the question as to whether the completion of the National Development Plan of the Energy Sector and the National Development Plan for the Utilisation of Oil Shale by 2015 is expedient.

211. The National Audit Office is of the opinion that agreements on issues concerning oil shale and associated royalties and taxation should be agreed before 2015, because it is impossible to set clear, achievable goals or determine activities in the development plans of the energy sector until taxation issues are resolved. Oil shale processors who are planning to invest large amounts in oil production also need clarity.

Public undertakings – there is no owner's vision

Public undertakings comprise more than one-fifth of public sector assets

212. As at April 2013 the state of Estonia was the sole owner of 27 commercial undertakings and one of the owners of another 11 commercial undertakings. As at the end of 2012 the value of assets owned by public undertakings amounted to 5 million euros or around a quarter (23%) of total public sector assets.

Read more

in the audit report of the National Audit Office entitled 'Organisation of Management of Public Undertakings'

213. Public undertakings invested 750 million euros in 2011, which is more than the amount invested by the government sector (678 millions). However, the dividends taken from commercial undertakings are an important source of revenue for the State Treasury. Since public undertakings comprise a large share of the state's assets and economic activities, their health has a strong impact on the economy and development of the entire state.

214. The law permits the state to participate in enterprise for three reasons: 1) to offer people goods and services that the private sector is not ready or able to offer to a sufficient extent, but which must be guaranteed to citizens; 2) to keep strategically important infrastructure under the state's control; and 3) to earn revenue for the state. In order to perform these functions successfully and use taxpayers' money in the best possible manner, it is necessary for the state to manage its undertakings economically, efficiently and effectively.

215. The National Audit Office evaluated the state's activities in the management of commercial undertakings in an audit report entitled 'Organisation of Management of Public Undertakings', which was published in autumn 2013. The National Audit Office audited nine public undertakings and the ministries that manage their shareholdings.[18]

The state does not often steer the activities of its undertakings

Often no goals are established for the activities of commercial undertakings

216. It is obvious that a commercial undertaking operates on the basis of a strategy approved by the owner and that the Supervisory Board as the representative of the owner evaluates how successful the execution of the strategy has been.

217. However, the audit revealed that owners often set no goals for the activities of public undertakings. Evaluation of the management of public undertakings showed that almost half of the audited undertakings did not have a strategy approved by the Supervisory Board. At the beginning of 2013, four of the nine audited public undertakings did not have a valid, comprehensive strategy approved by the undertaking's Supervisory Board – including the state's biggest undertaking, Eesti Energia (see also Table 13).

Even if goals are set, their achievement is not always checked

218. Even if an undertaking has such a strategy, the Supervisory Board does not always bother to regularly assess its implementation or the achievement of the goals set for the undertaking by the state. The Supervisory Board of just one of the nine audited companies had assessed the implementation of the strategy comprehensively every year, confirming this with a resolution (see Table 13).

[18] Eesti Energia AS, Elering AS, AS Eesti Raudtee, AS Estonian Air, AS Tallinna Sadam, Lennuliiklusteeninduse AS, AS Eesti Loto, AS Andmevara, AS Eesti Kaardikeskus, Ministry of Economic Affairs and Communications, Ministry of Finance, Ministry of the Interior and Ministry of the Environment.

Table 13. Strategies of audited commercial undertakings and assessment of their implementation

	AS Andme-vara	Eesti Energia AS	AS Eesti Kaardi-keskus	AS Eesti Loto	AS Eesti Raudtee	Elering AS	AS Estonian Air*	Lennuliiklus-teeninduse AS	AS Tallinna Sadam
The undertaking had a valid strategy approved by the Supervisory Board as at the start of 2013.	+	–	–	–	+	+	–	+	+
The Supervisory Board of undertaking assesses of the achievement of the goals set with the strategy every year and confirms this with a resolution.	–	–	–	–	–	+	–	–	–

* AS Estonian Air approved a strategy at the end of January 2013.

Source: National Audit Office on the basis of the data of commercial undertakings

219. In other undertakings the Supervisory Board did not assess the implementation of the strategy every year in the audited period and the implementation of the strategy of one undertaking had not been assessed at all during the audited period. The Supervisory Boards usually reviewed the separate economic action plans of the undertakings (budget, investment plan and activity-specific overviews).

220. The lack of a strategy means that the undertaking and the state have not agreed on what the state expects from the undertaking, i.e. the state basically has no say in steering the development of the undertaking.

Despite the lack of a strategy, the state has still given undertakings hundreds of millions of euros by increasing their share capital

221. The lack of a strategy, however, has not prevented the undertakings from investing or the state from giving them hundreds of millions of euros. The total amount of investments made by all public undertakings in the last two years is *ca* 2.7 billion euros, which exceeds the amount of investments made from the state budget. The state gave the audited undertakings *ca* 227 million euros from the state budget from 2006–2012. In the case of undertakings that have no strategy, it is unclear what goals and information were used by the Management Board and Supervisory Board as the basis on which investment decisions were made and on which the owner invested money in the undertaking.

222. The explanatory memoranda to the state budget also do not explain why the state needs to give taxpayers' money to undertakings and which undertakings it will be given to. For example, 150 million euros was given to Eesti Energia AS in 2012, but the explanatory memorandum to the State Budget Act contained no mention of the company to which the money was paid or which activities it was to be used for. The Riigikogu approved the state budget act with the following explanation: "The planned financing transactions of the Ministry of Economic Affairs and Communications in 2012 include 171,391,165 euros for subscription of shares in companies."

223. This means that the Riigikogu did not determine the purpose for which or the undertakings to which *ca* 200 million euros was allocated. The National Audit Office has already pointed out to the Government of the Republic in the past that no substantive explanations are given to the Riigikogu or the general public about the undertakings that need additional money or the reasons why they need it. In its response, the Ministry of Finance stated that the criticism of the National Audit Office could not be taken seriously and that the lack of information in the explanatory memorandum to the state budget was not a problem because the state budget is thoroughly discussed and prepared in the Riigikogu and the members of the Riigikogu can always ask if there is anything they wish to clarify.

224. Public undertakings plan to invest another *ca* 3 billion euros over the next three years. Many investments made by public undertakings are directly or indirectly covered by the taxpayer and the investment decisions of several undertakings are recognised on the invoices submitted to consumers for services provided. The most important thing in terms of such amounts is the presumption that the owner has thoroughly considered the investments made by the undertakings and that they are based on the undertaking's strategy, which everyone can understand.

Owner's supervision is weak – the state does not stand up for its interests

The Supervisory Boards of undertakings fail to perform their duties

225. The lack of a strategy approved by the Supervisory Board or the failure to assess the performance of a strategy is the Supervisory Board's responsibility and negligence, because it is their duty to identify the owner's interests, demand that the Management Board prepare a strategy that meets these interests and approve the strategy with a resolution if it is suitable.

226. The interviews conducted in the course of the audit also revealed that officials, Management Board members and the chairmen of Supervisory Boards feel that the ability of Supervisory Boards to have a say in setting the goals of undertakings and then assessing them is often poor. The reasons suggested are the practice by which Supervisory Boards are formed and the lack of transparency in the appointment of members, which means that the people on the Supervisory Boards do not have the necessary skills and knowledge.

227. The Management Boards of undertakings pointed out that the Supervisory Board or the owner are often not equal partners to the Management Board, as they are unable to control the activities of the Management Board or give competent opinions in the case of investment or strategy decisions.

228. Officials from both the Ministry of Economic Affairs and Communications and the Ministry of Finance are critical of the current practice of the composition of Supervisory Boards and their abilities. They have reported to the OECD for many years that the appointment of Supervisory Board members is problematic and non-transparent. They do admit that the suitability and procedure for the appointment of Supervisory Board members could be better regulated by law, but they still feel that their initiative alone is not enough to change the situation and that there is no political desire to change things.

It is also unclear in practice what the owner expects from Supervisory Board members and what the responsibility of Supervisory Board members is

229. However, it is also somewhat unclear in practice what the owner actually expects from Supervisory Board members in the management of the undertaking and how a member of the Supervisory Board should be held responsible if the undertaking's performance deteriorates significantly as a result of the member's incompetence or negligence. The regulation of the duties of Supervisory Board members at the level of law is very general and the audit revealed that they have not been agreed with the minister in writing. The Management Board and Supervisory Board members of the audited undertakings and officials also have different views of the role of Supervisory Boards. This means that those engaged in the management of undertakings have a different understanding of what owner's supervision should entail and this is why exercising equally efficient supervision over the undertakings is difficult.

It is unclear why the state needs one or another undertaking

The state does not have a clear policy for owning undertakings

230. The problems in setting goals for undertakings and in owner's supervision largely stem from the owner's failure to explain to itself why it needs to keep these undertakings. Ministers as the managers of the holdings are obliged to report to the Government of the Republic every year and explain why owning each and every undertaking remains necessary, but the reasons they give are superficial, laconic and repeated without changes year to year.

231. The first thing that purposeful and expedient management of public undertakings requires is for the state to understand why it needs the undertaking in the first place. It is necessary to think through the public duties that the undertaking performs, how its activities relate to the strategic interests of the state, whether and how much income the undertaking has to earn or whether earning income is the sole reason for which it was established. It must also be analysed whether the undertaking has to belong fully or partly to the state in order to perform the public duty or whether the service could be outsourced from the private sector. The need for a public undertaking may also change over time. However, the (continuing) need to own a public undertaking has not been thought through in this manner or justified to the general public.

232. The result is that the parties engaged in the management of the undertaking have a different view of why the undertaking has to be kept (fully) in state ownership. The audit revealed that the Management Board and Supervisory Board members of undertakings are not convinced or do not agree that it is necessary for the state to own the undertaking they manage. The Management Board and Supervisory Board members of eight of the nine audited undertakings felt that the undertaking did not necessarily have to belong to the state, or their positions on the matter were different. Several comparisons with other countries were given where an undertaking that provides a similar service or represents a similar sector functions successfully in private ownership. It was often admitted that the state has no participation policy or that it is unclear, and the reasons why the state should be involved in one or another undertaking have not been specified.

Steering the activities of public undertakings and owner's supervision have not improved in the last five years

233. The National Audit Office has audited the activities of the state in steering the undertakings and guaranteeing owner's supervision in the past. In 2007 the National Audit Office published a report entitled "Owner's Supervision in Public Undertakings and Foundations" where the observations and conclusions we made were largely similar to those in the new audit published in 2013.

234. In an audit carried out six years ago the National Audit Office found that the reason the state is involved in commercial undertakings and what the goals are that it seeks to achieve as the owner – i.e. how participation in undertakings is related to public interests and the state's strategic goals – have not been determined or clarified. At the time it was also admitted that the state as the owner of commercial undertakings has failed to clearly specify the supervision duties or requirements of Supervisory Boards. Supervisory Boards are exercising supervision unevenly, i.e. it is not systematic. There are still no solutions to these problems.

The Minister of Economic Affairs and Communications sees a need to change the organisation of and manner in which public undertakings are managed, but the Minister of Finance does not

235. The Minister of Economic Affairs and Communications, who manages the biggest public undertakings, agreed with the conclusions made by the National Audit Office in the audit entitled 'Organisation of Management of Public Undertakings' published in 2013 and found that its recommendations were largely appropriate. The minister highlighted the activities that had already been initiated in his area of government to improve the management of public undertakings and emphasised that it is necessary to word the principles of having holdings in public undertakings; to set specific expectations and goals for the operations of undertakings; and to perfect the process of forming the Supervisory Boards of undertakings.

236. The Minister of Finance as the minister who coordinated the management of public undertakings did find that the expedient management of holdings could be further improved, but only agreed with one of the recommendations made by the National Audit Office. The minister essentially agreed with the National Audit Office that all undertakings must have a strategy and budget, and promised to analyse whether the State Assets Act should be updated to guarantee that they are prepared. This basically means that the minister does not think that changing the organisation of the management of public undertakings is necessary.

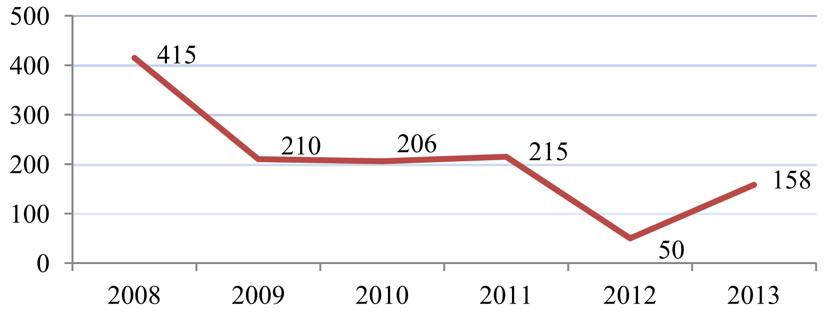
Investments – lessons from EU money

237. Estonia's opportunities to invest increased sharply when funding from the European Union started. In 2009, when the State Treasury was hit with a sudden decrease in tax revenue, it was possible for the Government to maintain the investment volume with the help of European Union funding. Whilst 558 million euros was invested from the state budget before the recession and EU support comprised 25% of this amount, the share of EU money in investments had grown to 60% by 2009.

The state is using less of its own revenue for investments than in 2009

238. The importance of European Union funds in covering the investment expenses of Estonia has not diminished. The amount of investments has almost doubled compared to the period of the recession, reaching *ca* 1 billion euros in 2011, but the state is using even less of its own revenue for investments than it did during the recession (see Figure 26).

Figure 26. Investments of governing areas from state's own revenue 2008–2013 (million euros)

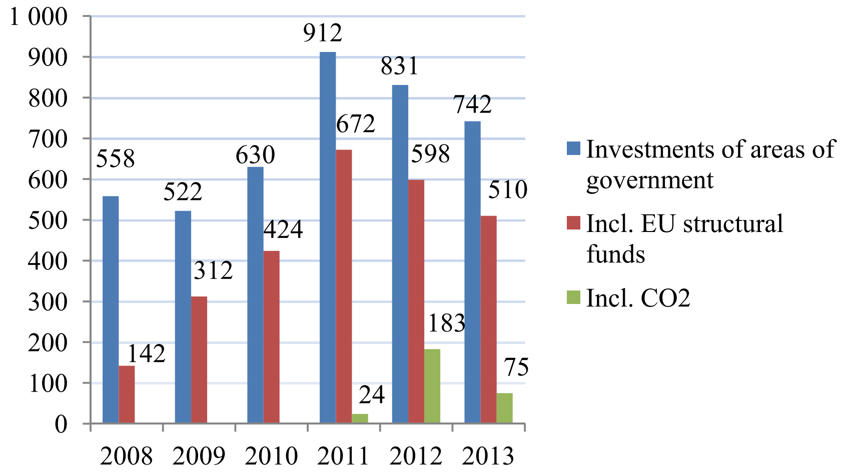


* Only includes state's own revenue; does not include European Union funding, revenue from sale of unused national emission quotas (CO_2), other foreign aid or investments made by Riigi Kinnisvara AS

Source: Ministry of Finance

239. From 2008-2013 the investments from the state budget amounted up to 4.2 billion euros, *ca* 3 billion euros or 70% of which was covered with European Union financing/funding and revenue from the sales of unused national emission quotas. Over the years, 60-94% of investment expenses have been covered from foreign support and money earned from sales of unused national emission quotas (CO_2) (see Figure 27).

Figure 27. Investments of governing areas in state budget (million euros)



Source: Ministry of Finance

240. Investments have started decreasing gradually because the support granted in the EU budget period of 2007–2013 is running out – 742 million euros in 2013 will drop to 322 million euros in 2015. The volume of investments will start growing again thereafter, as Estonia will start using the support of the new budget period of the European Union. The final amount that will be received from Europe is not yet certain, but the approximate amount that European taxpayers will support Estonia in the period of 2014–2020 is 5.9 billion euros.

241. Although the entire amount of support will not be invested and the amount that will be made available is not yet known, it is likely that most of the state's investments will be made with the support of the EU in the next seven years. It is therefore extremely important that the lessons from the previous period are taken into account when investments for the next support period are planned.

Investments that can be made with EU money are favoured

242. Making investments is part of developing the state. The kind of school network, roads or hospital network the state creates has a direct impact on the lives of the people living here and determines their satisfaction with their state. The investments made by the state must support society's development; they must be selected on the basis of the comprehensive development vision of the state and for the implementation of this vision.

243. Sectoral development plans currently hold a central place in the system for the management of the development of Estonia, as they are the documents in which the Government of the Republic sets specific goals for the advancement of certain areas, the activities required for their achievement and the financing plans. They also include the indicators used to evaluate the achievement of goals. The first development plans were developed in the early 1990s, but the preparation of such plans gained momentum after the Government of the Republic approved the state's strategic planning system at the end of 2005.

244. The majority of current development plans were approved by the Riigikogu or Government of the Republic from 2005–2007. One reason for this is that the development plan system had just been created and the ministries hoped to obtain more money from the state budget with the help of the plans. Another reason is that the distribution of the 3.3 billion euros in support allocated by the European Union to Estonia started in the period 2005–2007, and many development plans had to be prepared to obtain this money.

245. However, this led to a situation where some of the state's development plans did not focus on the comprehensive development of an area, but on problems that could be resolved with the help of the European Union structural funds. The importance of EU funds in covering the expenses of the state, especially investments, increased even further during the recession and the years that followed. This is why the focus on money received from the European Union has continued to increase in the state's action plans and investment plans since 2009.

Many actual development needs are given no attention

246. The downside of planning the state's development on the basis of EU money is that the development needs of areas that are not considered priorities by the union may be left unresolved. Estonia's development needs, however, are broader and more diverse that the priorities of the EU. The state should therefore realise that foreign support should not replace the investments made by the state itself, but help advance the state's development.

247. For example, the biggest problem in museums is the preservation and depositing of exhibits, i.e. depositories should be top of the investment list. However, EU money cannot be used for this purpose. Road construction and renovation is in a similar situation. EU money has been used to repair and build main roads, but this money cannot be used for repairs to the state's connecting and side roads or local roads, although the need for such repairs is obvious.

248. In a situation where the main focus is on the quick use of EU money, the decisions that need to be made for the sake of the comprehensive development of an area are left in the background. For example, the audit 'Management of Education Investments' revealed that the state still does not have a vision of what the necessary and manageable education network should be like and which principles should be followed in its creation. In the case of vocational educational institutions, for example, the state has emphasised the principle of guaranteeing uniform regional access (with a vocational educational institution in every county), but this has not been done in the case of the state's general education schools (schools for special needs students and upper secondary schools). This has led to a situation where investment money is given to all educational institutions without giving any thought as to whether they will all still be necessary a few years from now.

Future maintenance costs are often forgotten in the rush to invest

249. The vagueness of the state's development and investment vision means that the use of investment funds has often been directed by the owners of investment objects for whom the preservation of a local school or other institution is important without any consideration of changes in population. Also, people are often in such a rush to invest that they forgot to consider whether sustainable management of the investment object is even possible.

250. The same problems characterise the decisions that need to be made about the future EU financing period. The European Commission demands that the use of money by Member States in the new period be considerably more focused than in the previous one, i.e. the priorities chosen for financing must be clearer (and there should be fewer of them). This is somewhat problematic in terms of the development needs of Estonia. For example, Estonia needs to streamline its hospital and school network and invest in primary health care centres, which is why these areas have been chosen as priorities when the spending of EU money is being planned. There is no doubt that these investments are necessary, but unfortunately they do not comply with the starting points of the European Commission's financing choices. The European Commission itself has also pointed this out. Should a situation arise where EU money cannot be used for investments in these areas, Estonia will have to find money from the state budget or abandon the investments altogether. The latter would seriously affect the quality and accessibility of important public services.

Administrative incapacity hinders the use of investment money

Estonia prefers larger investment objects

251. Although the European Union generally does not set a minimum threshold for infrastructure objects to be financed (with the exception of road infrastructure projects), Estonia has chosen to invest mostly in large projects. Examples of this are large road construction projects, but also the desire to finance the construction of the Estonian Academy of Art and the Estonian National Museum with foreign support. On the one hand, this choice is based on the understanding that the smaller the number of projects, the easier it is to manage their implementation. On the other hand, the wish to spend as much EU money as possible as quickly as possible has also driven people to favour large projects.

252. The stories of the new buildings of the Estonian Academy of Art and the Estonian National Museum also demonstrate that using the money as quickly as possible is the main goal instead of using it in a purposeful manner. EU money could not be used for either of these projects (and in the case of the museum this was already suspected when the application was lodged) and the investments now have to be made from the state budget or, in the case of the Academy of Art, in the next financing period. The Road Administration has also confirmed that too much money has been spent by admitting in hindsight that some of the traffic intersections that were built are too big.

Public procurement reviews prevent the use of EU money

253. Achievement of the state's goal – to use the money at the desired speed – has also been obstructed by requests for public procurement reviews. The construction of the Aruvalla-Kose road perfectly illustrates the impact of such reviews. The first construction procurement took place in 2008 and the road was supposed to be completed in 2011. Requests for reviews and the need to organise a new procurement have since delayed construction of the road for two years; it will now hopefully be completed in November 2013. Table 14 indicates that tenderers requested reviews of 272 procurement procedures (i.e. every 33rd procurement) in 2012. The results of requests for review accepted for processing indicate, however, that only 44% of all requests have been satisfied. 39% of the requests were not justified.

Table 14. Procurements referred to review committee*

	2010	2011	2012
Total requests for review submitted by tenderers	285	259	272
Number of rejected requests	68	68	72
Number of satisfied requests among all accepted for processing	107	96	90
Share of satisfied requests among requests accepted for processing, %	48	50	44
Share of requests not satisfied among requests accepted for processing, %	37	38	39

* The table does not include the resolution of requests for review by agreement, the abandoning of requests for review by the requester, the declaring of requests as unjustified by the contracting authority and the termination of review proceedings with a resolution of the review committee once the Ministry of Finance has made a decision or issued a precept.

Source: Ministry of Finance

254. The review of breaches of the use of structural funds published by the Ministry of Finance[19] reveals that the total number of breaches ascertained during the programme period and the number of suspected breaches in the period 2008–2012 was 305, the majority of which (*ca* 47%) were breaches of procurement rules. Support applicants often need help and advice in the organisation of a public procurement and the state has not offered enough of this so far. The large number of contested public procurements and breaches shows that the state could consider the creation of a competent public procurement centre which would be in charge of organising procurements, or it should pay more attention to procurement consultations and training.

[19] Breaches in the Use of Structural Funds of the 2007–2013 Programme Period. January 2007 to March 2013. Ministry of Finance; 2013. See http://www.fin.ee/toetustega-seotud-rikkumised.

255. Considering the increasing number of unsatisfied requests for review and the fact that the people who submit challenges withdraw 12% of them, the state should carry out an in-depth analysis of how many unsatisfied or withdrawn complaints are submitted for malicious purposes. In order to reduce the number of malicious requests for review, the state should increase the liability of tenderers and demand additional guarantees whenever necessary in order to compensate damage that may be caused.

256. All in all, the National Audit Office finds that foreign support is an extremely important resource for the state that supports its development, but that the state's own capacity and a complete development vision must not be forgotten when it is used. EU money should not simply be seen as a replacement for the state's own money when investments are made. Foreign support may be an engine for development in some areas, but the state should not base its plans solely on opportunities to use EU money, but rather on its own needs, and it should steer the money in such a manner that the benefits derived from it in future are as great as possible.

Local authorities – the state has not sought to deal with intrinsic problems

257. Estonia must solve a number of significant problems in the provision of public services. In a 2011 report of the OECD they are phrased as follows: consolidation of public services at the central level and discrepancies between financial capability and obligations at the local level.

258. Possible solutions include adapting the requirements for the provision of services with the needs of people, tying the local level to regional development and regional policy, and matching the quantity of services to the capacity of the local authority and increasing the scale.[20]

New regional development strategy 2020

259. Regional development is steered with the 'Regional Development Strategy 2005–2015'. The Ministry of the Interior has admitted that the situation in development at the local and regional level is problematic. The development of the state is not regionally balanced due to the uneven development capacity of local authorities and small investment capability. Alongside the other new European Union Member States, Estonia is considered a country where large regional development differences have not provided an impetus to increase the importance of regional development.[21]

260. In 2012 the Minister of Regional Affairs started preparing the new 'Estonian Regional Development Strategy 2020'. The proposal for its preparation was approved by the Government of the Republic in June 2012 and the strategy was supposed to be completed by May 2013.

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[20] Public Governance Reviews. Estonia. Towards a Single Government Approach. Assessment and Recommendations. OECD, 2011, p. 6. See http://www.valitsus.ee/UserFiles/valitsus/et/riigikantselei/uldinfo/dokumendiregister/Uuringud/OECD%20hindamisdokument_eesti%20keeles.pdf

[21] Analysis of the Starting Situation of the Estonian Regional Development Strategy 2020, articles 56–57

261. The overall goal of the strategy is to guarantee the balanced, efficient and sustainable regional development of Estonia by ensuring that the specific advantages of regions are used in the interests of the region itself, as well as the state as a whole. The new strategy must form the basis for designing the measures of regional development in the next budget period of the European Union.

262. Although the source document of the new strategy describes the fact that the everyday activity space of people is no longer limited to the territory of just one local authority as an obstacle to regional development and regional balance, the need to change the organisation of local authorities has not been approached in the strategy.

263. The National Audit Office is of the opinion that clarity in the organisation of the local level should be the precondition that makes the implementation of the regional development strategy possible. These are basic choices: should the capability of local authorities improve on its own without any interference, or will the state show initiative and start managing the process?

Seven new municipalities will be formed from 18 local authorities in 2013

New municipality	LAs merging into new municipality
Audru municipality	Lavassaare municipality, Audru municipality
Hiiu municipality	Kärdla town, Kõrgessaare municipality
Kose municipality	Kose municipality, Kõue municipality
Lääne-Nigula municipality	Risti municipality, Taebla municipality, Oru municipality
Lüganuse municipality	Püssi town, Maidla municipality, Lüganuse municipality
Põlva municipality	Põlva town, Põlva municipality
Viljandi municipality	Pärsti municipality, Paistu municipality, Saarepeedi municipality, Viiratsi municipality

The voluntary merger of local governments will not solve problems

264. The current 226 local authorities will become 215 by way of a voluntary merger after the local council elections in 2013. New local authorities will be created in six counties and they will be larger than the existing ones with their 3,000 to *ca* 10,000 residents – but this will not solve the problems of local authorities in the long run. There are several merging local authorities that are not interested in discussions about the future of local authorities and who only care about spending the merger support, which amounts to less than half a million euros.[22]

265. Although the voluntary merger of several local authorities is positive, such bottom-up changes that are entirely voluntary mean that the state is merely an onlooker and the intrinsic problems of local authorities will not be resolved. What we need above all is clarity in the goals of state governance: what the ratio of centralisation and decentralisation is; and whether anything needs to be rearranged in state governance on a broader scale.

The Minister of Regional Affairs has initiated local government organisation reform

266. The Minister of Regional Affairs initiated local government organisation reform in autumn 2012. Initiation of the reform was not related to the preparation of the regional development strategy. First of all, the Minister of Regional Affairs sought to determine which of the six proposed local government organisation models was preferred by the stakeholders. He involved local authorities, local authority associations, county governments, constitutional institutions, political parties and experts for this purpose. The proposed models covered versions from the present model of small municipalities to a two-tier local authority, a local authority based on a county local authority association and a local authority that merges around a county, parish or county centre.

267. When he proposed the six models, the Minister of Regional Affairs described the goal of the local government organisation reform as the

[22] Rein Raudvere. Merger Support was Received, but No Peace. *Maaleht*, 2 May 2013

creation of local authorities where the number of residents and resources are as equal as possible. The new local authorities should be able to deal with the development of the business environment, democratically guarantee the organisation of all issues of local life and provide people with services of similar content and quality everywhere in Estonia.

The number of local authorities should decrease *ca* four-fold by 2017 as a result of Estonia's pull centres

268. Discussions of the proposed models took place from October to December 2012. The model that won the most support is the model of an Estonia of pull centres. According to this model Estonia would have 30-50 local authorities with at least 5,000 to 10,000 residents. Local authorities would thereby merge largely on a voluntary basis and with the pull centre selected by the local authority.

269. Local authorities have time to agree on merging until June 2014. After this, the Government of the Republic will name a pull centre for all local authorities that have not found partners with whom to merge. The mergers would be prepared from January 2015 to April 2017. By October 2017, councils would already be elected within the borders of the merged local authorities.

270. This intent for the development of a local government organisation reform act was submitted for approval in 2013. The Ministry of Justice, the Ministry of Culture, the Ministry of the Environment and the Association of Municipalities of Estonia did not approve the intent for the development of the act. The reason why the Association of Municipalities of Estonia refused to approve the intent is that no answer was given to the main question, i.e. what the essential functions of local authorities are. County governors informed the Minister of Regional Affairs of the selected pull centres in August. The list of 14 counties consists of 52 pull centres plus those in Harju County. The draft framework act with which the pull centres and the local authority merger process will be decided will be completed by the end of the year.

Local authority reform requires a complete view

271. The National Audit Office finds that the initial desire of the Minister of Regional Affairs to find the most preferred local government model from a selection that is based on the number of local authorities left after the reform entails a risk that the focus may shift to the size of local authorities, with the division of functions between state and local authorities left in the background. Although problems with the capacity of local authorities have been known for years – not all local authorities are able to perform the functions assigned to them, some only perform them in part or fail to provide public services at a good level, and fragmented local government organisation makes planning the development of larger units impossible – the topics concerning the functions of local authorities were initially left out of the reform plan.

The equalisation of local authorities should not obstruct the development of more successful ones

272. The National Audit Office is also of the opinion that setting the creation of local authorities whose population and resources are as equal as possible as the goal of the reform means that the specific problems of larger local authorities (such as Tallinn and Tartu and the larger municipalities nearest to them) have been completely overlooked. These are the local authorities with more people and resources than others, which gives them the kind of potential that differs completely from that of the other local authorities in Estonia, but also create problems that do not exist elsewhere.

273. Equalisation alone cannot be the goal of the planned local government organisation reform, as it would curb the development of more capable local authorities. Finding solutions to the problems of larger and more capable local authorities (e.g. guaranteeing access to services in a situation where the population of Tallinn and the nearest local authorities is growing rapidly, and the elimination of obstacles to cooperation) should also be attempted when the reform is planned. The present legal framework has not favoured the joint performance of functions – the law provides no working mechanisms for joint performance or delegation of functions, the establishment of joint agencies etc.

274. If the reform is a success and local authorities merge with pull centres, there will be local authorities in Estonia where people will be living in very sparsely populated and large areas of land. It would therefore be sensible to consider whether it is justified to expect all local authorities to perform the same functions after their number has been reduced.

Sectoral reform will not solve the underlying problems of local governments

Delaying reform will lead to a situation where each area plans its own reform

275. The differences between local authorities themselves as well as the impact of each change on local government organisation in general must be considered when reforms are planned. Unfortunately, the plans made in administrative organisation in the last year are characterised by the opposite: for example, dissatisfaction with the quality of the education provided by smaller local authorities and the need to streamline the school network have caused a situation where 'back door' reform is being carried out. It can be said that the Ministry of Education and Research is carrying out functional local government reform with the establishment of state-owned upper secondary schools and taking steps to make the use of the teachers' payroll stricter than before.

276. The desire to separate basic schools and upper secondary schools as levels of education with different goals and the attempt to have local authorities reach reasonable agreements on streamlining the school network are justified – small local authorities are unable to maintain upper secondary schools due to a decreasing number of students.

277. Although the need to decide it the state should maintain an upper secondary school is urgent, this decision has still not been taken after several years. This has caused confusion among local authorities, as it is unclear where the state intends to establish its upper secondary schools and what will happen to the existing municipal upper secondary schools.

Did you know that…

…the Riigikogu is discussing the Draft Basic Schools and Upper Secondary Schools Act and Associated Other Acts Amendment Act 340 SE, which aims to turn currently flexible education allowances into targeted allocations from the state budget?

278. Secondly, the Ministry of Education and Research wishes to regulate the teachers' payroll allocated to local authorities in great detail without giving any consideration to the present model, where the provision of education is mainly on the shoulders of local authorities, and the resulting expectation of local authorities to be able to use the money flexibly. Such one-off decisions do not consider the deeper reasons for the problems of local authorities and do not offer complete solutions. Decisions about the organisation of education should be tied to a review of how the other functions of the state and local authorities have been divided and the general streamlining of the financing system.

The state has not sought to deal with the intrinsic issues of local authorities

279. All in all, the National Audit Office emphasises that it is unreasonable to expect local authorities whose population numbers differ from one another more than 4200 times and whose revenues differ more than 4500 times to be able to cope with the same functions and to do so equally well. Changes in local government organisation are unavoidable. The state has not sought to deal with the intrinsic problems of local authorities for years and has failed to make decisions that cannot be made by anyone else. An Estonia of pull centres may be a good plan to change local government organisation, not because it received more support than the other five models proposed by the Minister of Regional Affairs, but in the event that it is given content that resolves the intrinsic problems associated with the tasks and financing of local authorities.

Did you know that…

…on 16 March 2010 the Supreme Court en banc made ruling 3-4-8-09, which declared that failure to issue the following kinds of legislative acts contravenes the Constitution?

- acts that stipulate which functions assigned to local authorities by law are self-governing and which are national
- acts which distinguish the money granted to local government units for the resolution and organisation of local issues from money meant for the performance of national functions and which stipulate that the national obligations assigned to local government units are financed from the state budget

280. The role of a local authority pursuant to the Constitution of Estonia is to balance governmental authority. The state must find a way to decentralise public authority and to create strong local authorities in the interests of democracy. Local authorities cannot simply be regarded as service providers or instruments in the performance of the state's functions. The content of decentralisation is that decisions which are important to the community are made as close to the people as possible. Such a local authority can only function if the state ensures the necessary premises i.e guarantees – the main one of which is the right of local authorities to find the most suitable decisions for its people when issues of local life are being resolved. The chance to make decisions must be in balance with the money that their performance requires. The ruling made by the Supreme Court also states that local authorities must have adequate sources of income; the option to design their revenue within certain limits and to decide on the use of the money themselves; and that the state is obliged to create such a financing system and guarantee that the system makes it possible to assess the adequacy of funding in single cases. The ruling made by the Supreme Court states that the money allocated for the performance of self-governing and national functions should therefore be clearly distinguished.

The division of self-governing and national functions remains vague

281. The National Audit Office is of the opinion that not all of the functions performed by local authorities have been clearly classified as self-governing or national. For example, the Draft Law Enforcement Act Implementation Act indicates potential confusion in the division of functions, as its explanatory memorandum contains an admission that the implementation of law enforcement may give rise to the question as to whether 'state supervision' only means supervision of the performance of national functions or whether it also covers supervision of the performance of the functions of local authorities.

282. Although supervision competencies in certain areas must be defined in the laws governing the relevant area, the National Audit Office advises the Riigikogu Committee to initiate a process in draft proceedings whereby the laws associated with supervision are reviewed from the aspect of the determination of functions. The process should then be continued and other areas should be reviewed in the same manner.

283. The National Audit Office is of the opinion that in many areas of activity of local authorities it is possible to highlight the functions that constitute the performance of national functions, such as payment of subsistence support, supervision of the safety of building work, maintenance of national databases and processing of misdemeanours. The National Audit Office also made a suggestion to the Ministry of Finance in the course of the development of the new Draft State Budget Act that covering the expenses of the national functions of local authorities and holding negotiations between the representatives of local authorities and the Government of the Republic about these functions should be separately highlighted in the draft act.

The local authority financing system requires fundamental changes

A study carried out in 2000 revealed a significant shortage of revenue in financing local authorities

284. In addition to distinguishing between functions, it must also be possible to obtain reassurance that the financing provided for self-governing functions is sufficient for their performance. Unfortunately, the government has no analyses to present as confirmation of the sufficiency of money. The need for money in the different areas of activity of local authorities was surveyed several years ago when the Ministry of the Interior and the Danish Ministry of the Interior carried out a study in 2000.

285. The study reached the conclusion that there is a significant shortage of revenue in financing the mandatory functions of local authorities and that accumulating all possible revenue would have little impact on the situation. The reasons for the shortage highlighted in the study are the fact that the mandatory functions of local authorities have not been clearly defined, service standards are missing in many areas and the need for unavoidable investments is large.

Personal income tax plays a remarkable role in the local authority financing system

286. The principles of the local authority financing system have made local authorities compete for people, especially working people, whose registered place of residence is in the local authority.

287. The dependence of revenue on attracting residents to the local authority puts many local authorities in a less favourable position than others, as they are unable to influence their revenue due to their demographic situation or location. The gap between the poorer and richer local authorities is reduced with the payment of support from the state budget equalisation fund.

288. For example, the 74 million euros in the 2013 state budget equalisation fund is divided as follows: 44% to local authorities located in southern Estonia which have 25% of the country’s population; 29% to local authorities in north-eastern Estonia with 12% of the population; and 1% to local authorities in northern Estonia with 42% of the population. However, the important role of personal income tax means that the revenue of local authorities depends on regional wage differences, which are larger.

Local taxes are not important sources of revenue for local authorities

289. The option to influence its revenue with the establishment of local taxes is one of the guarantees of local authorities. A municipality, town or city can only establish taxes permitted by law. The Local Taxes Act of 1994 currently allows local authorities to establish just six types of taxes or charges: advertisement tax; road and street closure tax; motor vehicle tax; animal tax; entertainment tax; and parking fees.

290. Types of local taxes have been significantly reduced over the years – head tax, local income tax and, since 2012, sales tax and boat tax have been abolished. Neither existing nor previous types of tax have turned local taxes into an important source of revenue for local authorities.

291. Advertisement tax is the local tax most widely imposed by local authorities. The advertisement tax collected in 51 municipalities and towns/cities in 2012 totalled 3 million euros. Only a very small number of local authorities implement other local taxes. In 2012, 24 municipalities and towns/cities collected road and street closure tax; eight collected money from parking fees; and one local authority collected animal tax. The revenue generated by these taxes and charges is small and the administration costs of some tax may make establishing the tax pointless.

292. The existing local tax types do not now allow municipalities, towns or cities to react flexibly to the need to finance important development activities. An example here is the establishment of a local tax for a short period of time in order to establish an object that is important to the community or to build roads and communications which would make entrepreneurs interested in investing in the local authority and thereby create new jobs. However, local authorities as promoters of the development of business currently remain in the background.

293. Although the functions of local authorities do not include supporting business and creating jobs, the motivation of local authorities to work on the promotion of business could be increased if the companies located in the local authority's territory contributed some of the tax money they currently pay to the state (in addition to the personal income tax received by the local authority) to the local authority's revenue.

294. This means that when it comes to the local authority financing system, the things that need to be thought through are the establishment of certain types of (local) taxes, the division of the tax revenue of the state and local authorities and the purpose of the support paid by the state to local authorities from the state budget and the stringency of its use.

Local authorities have no land to offer entrepreneurs

295. Another problem in local authorities that wish to voluntarily develop entrepreneurship is that entrepreneurs often want the local government to provide them with land that is suitable for development, and to do so quickly. Usually, local authorities do not have this kind of land and obtaining it is not easy. For example, the Government of the Republic has rejected the requests of local authorities to have unreformed land placed in municipal ownership, stating that promoting entrepreneurship is not a function of local authorities.

296. Although ownership reforms are about to end, the share of municipal land is insignificant. 17,000 land units with a total area of *ca* 36,000 hectares have been placed in municipal ownership free of charge during the land reform, which comprises *ca* 2.8% of the total number of land units but just 0.9% of the total area of registered land. Only slightly more than 3% of commercial and production land has been transferred to local authorities.

297. The Land Board is of the opinion that the area of municipal land should increase mainly on account of land under local roads, green areas and parks that has not yet been formalised. The final deadline for submitting applications for the transfer of land to municipal ownership set for local authorities is 30 June 2016.

298. Although the State Assets Act permits the granting of land to local authorities for free or for less than its ordinary value for the purpose of developing the business environment, this has not added much momentum to the advancement of entrepreneurship. This option has been available since 2010, but the Government of the Republic has still not adopted the procedure required by law pursuant to which commercial, production, transport and social land can be transferred for the purpose of developing the business environment of a local authority.

Democracy issues in local authorities are related to political culture and awareness

The state's role in steering local life is growing

299. Democracy problems in local authorities are related to general political culture, awareness and often also the small size of local authorities. Informal relationships have a major impact on decisions in small communities. According to the anti-corruption strategy, corruption at the political level and at the level of officials is a problem in the public sector. In local authorities the most dangerous of these – political corruption – concerns legislative drafting, influencing of political decisions and the use of public resources in the interests of political parties and election campaigns. Entrepreneurs, developers and people looking for kindergarten or school places have complained about corruption in administration.

300. The non-transparency of the activities of local authorities and the weakness of internal control favours corruption. This leads to the risk that private interests will be preferred to public ones, as the background of decisions or conditions of transactions often remain disguised from the general public.

Read more

in the National Audit Office's audit report 'Prevention of Corruption in the Transactions of Municipalities and Cities', completed in 2012;

in the National Audit Office's audit report 'Prevention of Corruption in the Organisation of Work in Rural Municipalities and Cities', completed in 2009.

301. The risk of private interests winning out over public ones is illustrated by the fact that in early 2012 the number of council and government members of Estonian local authorities totalled 4,100, 75% of whom were at the same time also shareholders or Management Board/Supervisory Board members of a private legal entity. Most council and government members are associated with undertakings that are independent and operate in private interests. The total number of such undertakings across all local authorities is 6,002. According to the Commercial Register, Piirissaare municipality is the only local authority in Estonia that has no undertakings that are related to council or government members but are instead independent of the local authority. In the remaining local authorities the number of such undertakings is usually *ca* 30, but there are some that have more than 100 such undertakings.

302. A study commissioned by the Ministry of Finance indicates that the values of local authority officials are lower than those of state officials. Although the majority of local authority officials marked honesty, trustworthiness and lawfulness as very important values, the number of those who hesitated was still higher than average.

303. The National Audit Office is of the opinion that local authorities should deal with corruption awareness and ethical issues more systematically. The managers of agencies should primarily be kept in mind here. To date there has been no competent and coordinating agency that consistently trains or advises local authorities.

304. The National Audit Office finds that the creation of an organisation of work that prevents corruption has taken a back seat among the priorities of local authority leaders. For example, local authorities do not always have an overview of all of the undertakings of officials. This has resulted in repeated breaches of the Anti-corruption Act. Most of these breaches are cases where a local government official entered into transactions with private companies related to the official themselves or to their relatives. The sum of such transactions amounted to tens of thousands of euros in some local governments. Another obligation that has been breached is that officials must abstain from making decisions if they concern the interests of companies related to the official or persons close to them, i.e. if the decision may lead to a conflict of interest.

305. The National Audit Office emphasises the need to considerably reduce these risks by making information about settlements between local authorities and the undertakings that depend on them and operate in private interests accessible to the general public.

There remains a lot to do in the development of internal controls in local authorities

306. However, counting solely on public controls is not an option. Local authorities themselves must improve the efficiency of their internal controls, make the work of audit committees more meaningful and review their internal control systems. The latter, alongside the organisation of the work of the internal auditor, has been guaranteed by the council since 2013.

307. Although the need for an internal auditor in every local authority was noted in the previous Anti-corruption Strategy for 2008–2012, such official is only found in a few local authorities and their number have not increased in recent years. Unfortunately, most local authorities still fail to see the benefits that a professional internal audit would bring them.

308. When a municipality, town or city decides to implement an internal audit, the work of the internal auditor must be organised pursuant to the Auditors Activities Act and the internal auditor must pass a professional qualification exam. Unfortunately, it has become evident that those engaged in internal controls in local authorities are prepared to take the professional qualification exam but are held back by the exam's high price, problems accessing training and a lack of support from their employers. The National Audit Office foresaw these difficulties and the associated risks and therefore advised the Ministry of Finance in the course of the development of the Act to give local authorities more support for the development of internal audits. The risk that local authorities will stop all internal audit activities when they see the requirements set for internal audits has unfortunately materialised: in order to dodge the performance of qualification requirements, one council changed the name of its internal auditor to 'internal controller'.

Strong and democratic local authorities will not emerge without local authority reform

309. In order to summarise the problems associated with local authorities, we must note that another year has passed without any steered or controlled development. This is a vicious circle: people move to places where they can find work and earn more money, and the places they leave behind become steadily weaker. The state is the only one who can and should make principal changes to manage this process, but sticks its head in the sand and does everything it can to avoid dealing with local government problems.

310. The National Audit Office is of the opinion that Estonian people need strong and democratic local authorities that can help people and act as partners to the state government. These cannot emerge in the conditions on which the organisation of local government is currently based. Changes in local government organisation must cover the functions, financing and capability of local authorities. Time will tell whether the idea of local government reform that emerged in 2012 will grow into extensive reform that will be successfully carried out and whether the state has the wisdom to carry out other essential reforms in a way that means the right hand knows what the left hand is doing.

Figure 28. Actual population density in Estonia

The areas where population density is up to four people per square kilometre are marked in red on this map. The total number of people living in the area marked in red is 18 404, which is 1.4% of the total population of Estonia. The map was prepared on the basis of the census carried out by Statistics Estonia in 2011.

The map was prepared and the data of the census were processed by doctoral candidate of geoinformatics Erki Saluveer from the University of Tartu, who also specialises in research into the spatial mobility of the population and the development of urban regions.

National Audit Office of Estonia
Narva mnt 11a
15013 Tallinn
Phone: +372 640 0700
Fax: +372 661 6012
E-mail: riigikontroll@riigikontroll.ee

www.riigikontroll.ee
www.facebook.com/riigikontroll
www.twitter.com/riigikontroll

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If you have any questions, do not hesitate to contact us:
E-mail: press@riigikontroll.ee or riigikontroll@riigikontroll.ee
Phone: +3726400704, +3726400777
Fax: +372 6616012