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Budgeting in Estonia

by
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Since independence, Estonia has been at the forefront of institutional reform in the area of financial management. Budget formulation is divided into two distinct stages: strategic planning and preparation of the annual budget that is submitted to Parliament. This article describes key characteristics of budgeting in Estonia, including the budget formulation process in both stages, parliamentary approval, the organisation of budget execution, and procedures for accounting and auditing.

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Preface

This review of the budget procedure of Estonia was carried out as part of the work programme of the OECD Working Party of Senior Budget Officials and the network of Senior Budget Officials of Central, Eastern and South-Eastern European Countries. The latter network was established in 2004 at the initiative of the OECD Working Party of Senior Budget Officials and reports to it. Budget reviews serve as a basis for the examination of the budget procedure during the annual meetings of the Working Party or the network and enable the participants to discuss the budget procedure of the country under examination in depth.

A mission consisting of Dr. Dirk-Jan Kraan (head, OECD Secretariat), Dr. Joachim Wehner (London School of Economics) and Ms. Kirsten Richter (German Technical Cooperation) visited Tallinn from 21 to 25 January 2008 to carry out the review. During its visit, the mission met with Mr. Ivar Sikk, Deputy Secretary General for State Budget and Public Governance, Mr. Siim Sikkut, Deputy Head of the State Budget Department, Ms. Kadri Maasik, Head of the Budget Unit of the State Budget Department, Ms. Ülle Mathiesen, Head of the State Treasury Department, Ms. Juta Maar, Deputy Head of the State Treasury Department, Ms. Kaie Karniol, Head of the Public Governance Policy Department, and other officials of the Ministry of Finance of Estonia; Ms. Kaie Koskaru, Head of the Finance and Property Management Division, and other officials of the Ministry of Justice of Estonia; Mr. Juhani Lemmik, Director of Audit, and other officials of the National Audit Office of Estonia; Mr. Jürgen Ligi, Chair of the Finance Committee of Parliament; Ms. Tiina Licht, Advisor and Head of the Secretariat of the Finance Committee of the Parliament of Estonia and other officials of the Secretariat; Mr. Jüri Voigemast, Director of Bureau of the Association of Estonian Cities and other officials of the Association and of the Association of Municipalities of Estonia; and Mr. Klas Klaas, Advisor of the Strategy Office of the State Chancellery of Estonia.

OECD budget reviews are meant to serve as a basis for peer review among budget officials. This is only possible if they are based on clear information and good understanding of the procedures and practices of the country under review. The mission is grateful to the Estonian officials for the efforts they made to provide the mission with information and to explain Estonian procedures which are sometimes difficult to grasp on the basis of written documents only. The mission feels that it has acquired a good insight into the Estonian budget process and the reform plans that are being developed.

As usual, this review describes the budget process and offers some suggestions about reforms in the light of international best practice. At the request of the Estonian authorities, this review contains in addition some comments on the reform plans that are being developed at the moment, particularly in the "Concept Paper" prepared by the Ministry of Finance.

The mission would like to thank Mr. Siim Sikkut and Ms. Kadri Maasik and their collaborators for the excellent organisation of the meetings, their unsparing help with the collection of information and documents, and their hospitality during the mission's stay in Tallinn.

The views expressed in this review are those of the OECD Secretariat and should not be attributed to any organisation or individual consulted for this review.

1. Introduction

1.1. General characteristics

Estonia, which regained independence in 1991, is a parliamentary republic with a unicameral Parliament. The governance institutions of the country are laid down in the Constitution and in legislation. The Government of the Republic Act regulates the governance of the central government sector of Estonia. There are two levels of government: the state and the municipalities. County authorities exist, but they are state agencies.

Economic growth in Estonia has been remarkable. Since the independence of Estonia at the beginning of the 1990s, the 12 countries that joined the EU in 2004 and 2007 have grown more or less at the same pace, which has generally been more than twice as high as that of the 15 older EU countries. Furthermore, since the beginning of the 21st century, the Baltic countries have clearly outperformed the other accession countries and, among the Baltic countries, Estonia stands at the top with around 9% annual real growth over the last three years, marginally ahead of Latvia (Republic of Estonia, 2007a, 2007b). In other words, Estonia had the fastest-growing economy among all 27 countries of the EU. Nevertheless, GDP per capita is still at a level of 42% of the EU average in 2006 (30% in Latvia and Lithuania). If adjusted for purchasing power parity, GDP per capita in 2006 was 68% of the EU average in 2006. Even if growth remains at more than 3% ahead of the EU average in the coming decade, convergence with the EU level of prosperity would require at least two decades (given that the price level will also converge to the EU average level).

Estonia is a small European country. In surface area it is comparable to Belgium, the Czech Republic, the Netherlands, the Slovak Republic or Switzerland, but it has a population of only 1 340 600. It is comparable to the Nordic countries in terms of population density (number of people per square kilometre). Furthermore, the population is decreasing, though at a decelerating rate. In the period 2000-03, the population decreased by over 5 000 persons per year (0.37% of the population per year) but in the period 2005-06 by less than 3 000 persons per year (0.22% of the population). The fertility rate is at 1.5 children per woman, *i.e.* roughly the European average but not enough to maintain a constant population; that would require a fertility rate of 2.1 children per woman[1] (Republic of Estonia, 2007a).

The average rate of employment of people aged 15-64 in Estonia was 64% in 2005 and increased to 67.7% in 2006 and 69.1% in 2007. That rate is above the EU average and slightly higher than in other Baltic countries. The unemployment rate of people aged 15-74 fell to 7.9% in 2005, to 5.9% in 2006, and to 4.7% in 2007. That rate is some percentage points lower than the EU average unemployment rate and the rate in the other Baltic countries. These good results are mainly due to increases in demand for labour and active labour market policies, conducted through the Labour Market Board. The groups in Estonia that are at risk for unemployment are young people (aged 15-24), people with a disability, persons released from prison, the elderly (aged 55 to the retirement age of 63) and the long-term unemployed (more than 12 months). The good results of recent years have mainly been achieved by integration in the labour market of the elderly and the long-term unemployed, especially of non-Estonian origin. In spite of these results, the unemployment of people of non-Estonian origin (particularly Russian-speaking) has remained relatively high (at 9.3%).

The main problems for the people in this group are the lack of Estonian language skills and their high proportion among the population of north-eastern Estonia (around 80%) where many large industrial enterprises have been closed or are struggling to survive. On the other hand, new industries and the service sector have recently grown up in this part of the country, which has contributed to the good results (Republic of Estonia, 2007a).

In view of the labour market conditions mentioned above, Estonia has made good progress in attaining the Lisbon targets of the European Union. According to these targets, overall employment for the population aged 15-64 must reach 70% in 2010, the employment rate of women in this age group must reach 60% and the employment rate of the elderly (aged 55-64) must reach 50%. Estonia has already reached the latter two targets and is well on the way to reaching the first target (Republic of Estonia, 2007a).

Estonia scores well on freedom of investment, protection of property rights, the development of the financial sector, and a low level of taxation, which have all contributed to its rapid economic growth. Real growth has mainly been based on domestic consumption (15.1% in 2006, 8.9% in 2007) and gross fixed capital formation (22.4% in 2006, 7.8% in 2007). The grants of the EU structural funds contributed only moderately to gross capital formation because of the small share of government investment in total investment. As in previous years, net exports contributed negatively in 2006 and 2007 because imports exceeded exports. As a consequence of large imports of consumer goods triggered by increasing domestic consumption, the trade balance deteriorated from –13.7% of GDP in 2005 to –17.7% of GDP in 2006 and to –17% of GDP in 2007. As a consequence of these developments, the current account deficit rose from 10% of GDP in 2005 to 15.5% of GDP in 2006 and to 17.4% of GDP in 2007 (in 2007 partly due to income balance deterioration: –4.6% of GDP in 2006 to –6.8% of GDP in 2007). The increasing deficit in the trade balance as a consequence of increasing imports was partly compensated by an increasing income surplus caused by income repatriation by Estonian residents abroad. The manufacturing sector and the services sector were the fastest growing sectors (increases in 2006 of 11.9% and 11.1% respectively, and in 2007 of 7.5% and 6.6% respectively). Within the services sector, the financial services stand out (23.3% in 2006 and 23.5% in 2007). (IMF, 2007a, partly updated by the most recent estimates of the Estonian Ministry of Finance).

Real wages in Estonia are rising at a fast pace. In 2005, they rose by 6.4%, while nominal wages rose by 10.8% (IMF, 2007a); in 2006, real wages rose by 11.6%, while nominal wages rose by 16.5% (Republic of Estonia, 2007b); in 2007, real wages rose by 13% while nominal wages rose by 20.4%. The increase of labour productivity (value added per work hour) has lagged behind the wage increase over the last couple of years, partly as a consequence of the increase in employment. Although this tendency seemed to diminish in recent years, in 2006 and 2007 it became more salient again.

Inflation remains relatively high in Estonia. From 2005 to 2006, the Consumer Price Index (CPI) rose from 4.1% in 2005, to 4.4% in 2006 (Republic of Estonia, 2007a). In 2007 it moved into the 5-7% range (6.6% on average; IMF, 2007a). In 2008, it is estimated to reach 8.6%. Rises in energy, food and housing prices are important determinants. Furthermore, Estonia maintains a fixed exchange rate of its currency, the Estonian kroon (EEK), to the euro through a Currency Board Arrangement (CBA). This implies that the authorities do not possess effective instruments of monetary policy (particularly interest policy) in order to bring down inflation. Estonia meets all the Maastricht criteria for euro adoption by comfortable margins, except inflation, which is well above the Maastricht threshold of around 3%.[2] The increasing role of core inflation[3] suggests that it will be difficult to reach the threshold in the next few years. The government decided to advance planned rate increases in several excise taxes to early 2008 in order to ensure that their impact on inflation would not be felt in the years when it now aims to reach the threshold, namely 2010-11. This signal was supported by statements reaffirming that euro adoption is a government priority and identifying 2011 as the first theoretically possible entry date. Table 1 illustrates the growth performance of the Estonian economy in comparison to the older EU countries (EU15) and the EU accession countries (EU12).

Table 1. **Real growth of gross domestic product (GDP)**

In per cent, year on year

	2002	2003	2004	2005	2006	2007	2008
EU15	1.1	1.2	2.3	1.6	2.8	2.7[a]	2.5[a]
EU10/12	4.1	4.3	5.3	5.8	6.2	5.5[a]	5.0[a]
Estonia	8.0	7.2	8.3	10.2	11.2	7.1[a]	3.7[a]

a) Forecasts.

Sources: EU15 2002-08 and EU10/12 2002-06: Eurostat; *EU10/12 forecasts:* OECD calculations; *Estonia:* estimates Estonian Ministry of Finance.

The expenditures of general government have fallen over the period 2000-06 by 3.5 percentage points from 36.5% of GDP in 2000 to 33% of GDP in 2006. Over the period 2000-05, the average expenditures of general government of EU countries have increased by 1.1 percentage points from 45.9% of GDP in 2000 to 47% in 2005. General government expenditures in Estonia are more than 10 percentage points lower than average in the EU. Around 50% of government expenditure (around 17% of GDP) concerns final consumption expenditure on publicly provided goods and services, about evenly divided over collective consumption (defence, public order and safety, basic research, etc.) and individual consumption (health services, education, etc.). Around 30% of government expenditure (around 10% of GDP) concerns social benefits (in cash and in kind), the largest part of which is spent on pensions, child and family benefits, and unemployment benefits. Around 3% of general government expenditure (around 1% of GDP) concerns subsidies. Interest payments are very small (less than 0.5% of expenditure, less than 0.2% of GDP). The remaining part of expenditures includes gross capital formation and transfers.

In order to slow down inflation and qualify for euro adoption as soon as possible, the government of Estonia is pursuing a conservative fiscal policy. For this purpose, the government presented a substantial general government surplus in the budget for 2007 and the budget for 2008. Furthermore, the government intends to keep the general government budget position in balance or surplus over the medium term. All revenue exceeding forecasts is intended to be saved. In addition, the government feels that, considering the present status of the economy and the outlook for the coming years, domestic demand and consumption need to be limited, if necessary by limiting consumption in the public sector. In spite of these intentions, the budget for 2007 included a substantial increase in current expenditures (12% in real terms), including large public sector wage increases. Additional wage increases were authorised by a large supplementary budget for 2007 (EEK 2.7 billion). As to the medium term (2009-11), the government aims to restrain total expenditure (slightly reduce it as a share of GDP) and to maintain a surplus (set at 0.5% in the "State Budget Strategy 2008-2011").[4]

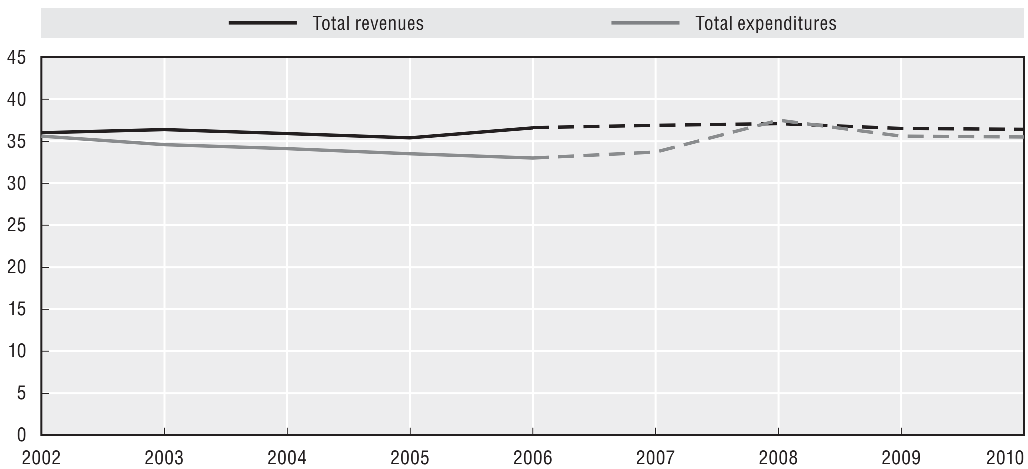
Through 2000-06, the tax burden was relatively stable, with the highest level reached in 2002 at 31.1% of GDP. By far the most important taxes are the social tax (32.4% of total general government tax revenue in 2007), the value-added tax (28.6% of total general government tax revenue in 2007) and the personal income tax, levied at a flat rate of 22% in 2007 (18.7% of total general government tax revenue in 2007). Excise duties contribute substantially as well (10.5% of total general government tax revenue in 2007). The corporate tax, also levied at a flat rate of 22% in 2007, contributes relatively little (5.2% of total general government tax revenue in 2007).

In recent years, the structure of the tax system has been changed through a gradual shift from direct taxation (income tax, corporate tax) to indirect taxation (value-added tax, excise duties). The share of non-tax revenue was stable over the years 2000-06 at around 14% of total general government revenue (around 5% of GDP). In 2007, it was slightly larger at 15.4% of total general government revenue, mainly as a consequence of increased inflow of EU grants. The government intends to cut income tax rates by a further 4 percentage points (to 18% in 2011). The income tax threshold will be raised by 50% in 2011. Also, a reform of the corporate tax, required by 2009 to conform to EU regulations, will reduce tax revenue (especially in the transition year 2009). The Estonian authorities have stated, however, that fiscal discipline is the first priority and that off-setting measures will be taken if necessary to respect the balance or surplus target for the budget position (IMF, 2007a).

Figure 1 shows the development of general government expenditures and revenues in Estonia.

Figure 1. **Expenditures and revenues of general government**

In per cent of GDP



Source: Latest estimates of the Ministry of Finance, Tallinn.

From 2000 to 2005, the budget as submitted by the government was usually in balance (zero deficit).[5] In 2006, a small surplus of 0.1% of GDP was presented, in 2007 a more substantial one of 0.7%. Furthermore, according to the "State Budget Strategy 2008-2011", the planned surplus is to be maintained at 0.5% of GDP over the period 2008-11. Due to strong and larger-than-expected growth, Estonia has in fact always had a general government surplus since 2002. In the period 2003-05, the windfalls amounted to slightly more than 2% of GDP, in 2006 to almost 4%, and in 2007 to slightly more than 0.5% (Republic of Estonia, 2007a).

The surplus of general government was mostly due to windfall tax and non-tax revenues of the central government. In the past, the local government sector has usually been in deficit. However, as from 2006, local governments have improved their fiscal position, mostly due to high windfall revenues from the tax-sharing arrangement for income tax, to revenues from sales of assets and to lower-than-expected costs. The revenues of the local government sector increased from 2003 to 2006 by 49%. Moreover, the city of Tallinn, which strongly affects the fiscal results of local governments, has managed to reduce its budget deficit. The social security sector consists of the Health Insurance Fund and the Unemployment Insurance Fund. The Health Insurance Fund is mostly financed by the earmarked social tax (13% out of the social tax rate of 33%). This fund has so far been in surplus, but, in view of demographic developments, the pressure on the fund will increase in the medium and long term. The Unemployment Insurance Fund is financed by the unemployment insurance premiums and has, since its establishment in 2002, realised a surplus (in the first year, necessitated by the need to build up a reserve; more recently, because of the favourable conditions of the labour market). The state pension insurance (mainly old age and disability pensions) is managed by the central government (not by a separate social insurance fund), but financed by the social tax (20% out of the social tax rate of 33%). The pension insurance scheme is in deficit. In recent years, large transfers were made from the general tax fund to the Health Insurance Fund and the state pension insurance reserve. Table 2 shows the development of the balance of general government and its components.

Table 2. **General government balance and its components**

In per cent of GDP

	2002	2003	2004	2005	2006	2007[a]	2008[a]	2009[a]	2010[a]
General government balance	0.4	1.8	1.6	1.8	3.4	2.8	0.0	1.0	1.0
Central government balance	0.3	1.6	1.6	1.6	2.8	2.5	–0.4	1.1	1.1
Local government balance	–0.6	–0.3	0.4	–0.3	0.0	–0.3	–0.2	–0.3	–0.3
Social security balance	0.7	0.5	0.3	0.5	0.6	0.6	0.6	0.2	0.2

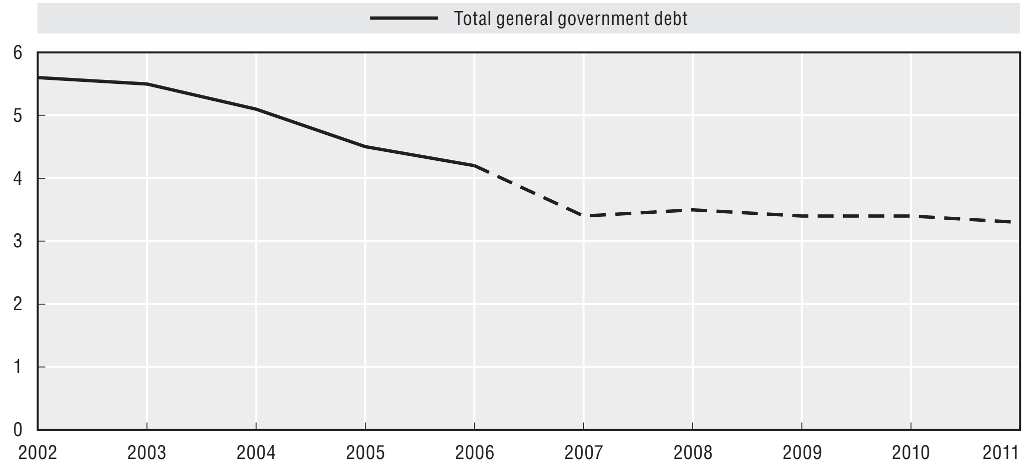
a) Forecasts.
Source: Latest estimates of the Ministry of Finance, Tallinn.

Budgetary policy in Estonia has always aimed at a balanced general government sector over the medium term, and since 2007 at a surplus. As a consequence, the level of public debt is very low. At the end of 2007, public debt in Estonia amounted to 3.4% of GDP (Republic of Estonia, 2007b). In the past few years, public debt has mainly decreased as a consequence of the surplus of the central government. Local government debt grew from the beginning of the 21st century until 2006, mainly as a consequence of local government deficits (Republic of Estonia, 2007a). In 2007, local public debt accounted for 69% of total public debt.

In Estonia, the public debt does not provide an entirely accurate picture of the financial position of the government. Due to the circumstances in the financial markets, the repayment of public debt has not always been the most profitable way of investing financial resources. Instead, reserves have been built up, especially in the central government and the social security funds. At the end of 2007, the financial reserves of the central government were nearly eight times as large as the central government debt: around 8.9% of GDP (Republic of Estonia, 2007a).

Figure 2 shows the development of public debt in Estonia.

Figure 2. **Public debt**
In per cent of GDP



Source: Latest estimates of the Ministry of Finance, Tallinn.

1.2. Institutional policy in the recent past

Since independence, Estonia has been at the forefront of institutional reform in the area of financial management. It has developed modern and efficient budgetary institutions. In order to place the present situation and the recommendations of this report in proper perspective, this section will briefly review the most important evaluations and reforms of the past.

After independence, the State Budget Act of Estonia (the organic budget law) was passed in 1993. Since the act had many shortcomings concerning the coverage of the general government sector, the time schedule of budget preparation, financial reporting requirements and auditing procedures, among other things, the State Budget Act was thoroughly revised in 1999. This revision amounted in fact to the passing of a new State Budget Act. The revision introduced modern budget procedures based on the principles of transparency, budgetary discipline, effective parliamentary scrutiny and comprehensive external audit. The revised State Budget Act prescribed a strict timetable, ensuring the timely approval of the annual budget law before the start of the fiscal year. It also created the Stabilisation Reserve Fund with a view to macroeconomic stabilisation and control of economic risks arising from emergency situations.

In 2001, the IMF published its first "Report on the Observance of Standards and Codes (ROSC), Fiscal Transparency Module" on the Estonian budget procedure. The report noted that "Estonia had achieved most of the requirements of fiscal transparency and, with planned improvements, should move to full observance of the Code" (namely, the IMF Code of Good Practices on Fiscal Transparency). The report recommended a further revision of the State Budget Act to clarify the concept of general government in the Estonian context in the light of international accounting standards. In addition, the report suggested improvements in financial reporting concerning the government balance sheet and debt, the establishment of guidelines for debt and investment management policies, the clarification of the status of macroeconomic forecasts, and the improvement of the accuracy of multi-year estimates.

In 2003, the State Budget Act was again revised. The strategic planning procedure for the medium term as well as the medium-term expenditure framework were introduced. Follow-up was given to the various recommendations of the IMF report of 2001. Among other things, the general government was clearly defined and the extra-budgetary funds as well as some foreign-financed capital expenditures (mostly EU projects) were included in the definition. Furthermore, the carry-over rules were changed, resulting in a marked reduction in end-of-year spending rushes ("December fever"). In an additional amendment of 2004, the general procedures of internal audit were incorporated in the State Budget Act.

In 2004, the National Audit Office Act was passed. This law amounted to a modernisation of the external audit function in Estonia. The law treats the composition, tasks, competences and procedures of the National Audit Office. But some provisions concerning specific roles of the National Audit Office in the budget process have remained in the State Budget Act.

In November 2007, the IMF prepared its second "Report on the Observance of Standards and Codes (ROSC), Fiscal Transparency Module" on the Estonian budget procedure. The report noted that, since the 2001 report, the improvements required by IMF standards on fiscal transparency had largely been achieved. The report expressed some concern about the routine recourse to supplementary budgets in the last few years. Furthermore, the report recommended the adjustment of the overly tolerant carry-over regime introduced in 2003. It also recommended ring-fencing the contingency reserve so that Parliament would be prevented from using it as a financing source for budget amendments. Other measures advocated in the report were to: include a statement on potential fiscal risk flowing from uncertainty about macroeconomic assumptions and contingent liabilities in the budget documentation; strengthen the procedures of performance measurement and evaluation (including a more programme-oriented budget classification); include a statement on long-term sustainability in the budget documentation; strengthen portfolio management arrangements in view of the rapidly rising financial reserves; guarantee statutory independence to the Statistical Office of Estonia; and provide for external scrutiny of the macroeconomic assumptions going into the budget.

In a recently released Concept Paper, the Ministry of Finance, in co-operation with the line ministries, the State Chancellery and the National Audit Office, proposes a new important reform of the budget process. The paper covers all stages of the public financial management (PFM) cycle. The paper is based on two main observations of the present situation:

- PFM does not in fact function as one complete cycle or system as it should.
- As a result of the above, PFM is inefficient: a lot of administrative resources are used in the process, but not to the best possible result (such as duplication of activities, too much emphasis on planning, and too little on analysis).

In order to remedy the situation, the Concept Paper proposes six important institutional changes which would affect all stages of the budget process, namely: strengthening the performance base of planning; introducing accrual-based budgeting; turning reporting into a management instrument and linking it closely with planning; making the medium-term planning framework more stable; developing accountability mechanisms and strengthening internal control; and developing internal audit. These proposals will be discussed in the following sections.

2. Budget formulation

2.1. Planning and budgeting

A prominent feature of the Estonian budget formulation process is that it is divided into two distinct stages. The first stage focuses on deciding multi-year strategies. It formally starts in January when the Ministry of Finance sends guidelines, based on a government decree, for preparing Organisational Development Plans, and runs until May when the Cabinet adopts the State Budget Strategy. The second stage of the formulation process focuses on the preparation of the annual budget that is submitted to Parliament, and lasts from May to the end of December. This section first looks at the role of the coalition agreement as a key document that guides the annual budget process. The discussion then turns to the macroeconomic forecasting function, strategic planning, and the annual budget.

2.2. The coalition agreement

Since the 1990s, Estonia has been governed by coalitions of various political parties. Following elections, the prospective governing partners negotiate a coalition agreement. The current agreement covers the years 2007 to 2011. These agreements create expectations for the budget – for instance with regard to social benefits, new policy initiatives and tax policy. Coalition agreements are important for capturing overall budget policy priorities, and provide broad guidance for spending plans over the electoral cycle.

Budgeting in Estonia is not guided by a numerical fiscal rule. However, the most recent coalition agreement promises to "continue pursuing a strict budgetary policy with a budget surplus and reduction of the government debt". While this agreement has no legally binding status, it is a public document, and the breach of such fundamental promises would be politically damaging to the governing parties. Even without explicit commitment in previous coalition agreements, a balanced budget has been considered the norm in Estonia since the 1990s, and some budget officials mention that in fact it has become a "dogma". The Estonian authorities are aware that setting a target for the nominal balance may lead to pro-cyclical effects. However, they feel that so far this policy has been right for Estonia because the structural changes in the economy have been extensive and have not allowed for evaluating the economic cycle or the cyclical position of the budget with sufficient reliability (Republic of Estonia, 2007b). For the future, the Ministry of Finance is contemplating the introduction of an expenditure rule, possibly in conjunction with a balanced budget rule to provide an anchor for the medium term, but no concrete decisions have yet been taken to pursue this idea.

The Prime Minister ensures that ministerial spending plans are broadly consistent with the commitments in the coalition agreement. During February to early March, the Prime Minister holds a series of bilateral meetings with each minister to discuss draft Organisational Development Plans prior to their submission to the Ministry of Finance (see below). The focus of these discussions is on ensuring the consistency of policy initiatives and related budget submissions with the government's work plan, as well as on key problem areas. It should be noted that coalition politics means that Cabinet ministers are relatively independent. For example, in practice the coalition partners can change their respective ministers. Nonetheless, the Prime Minister plays a general oversight role with regard to major fiscal policy issues, in addition to the Minister of Finance.

2.3. Macroeconomic forecasting

Macroeconomic forecasts are provided by the Economic Analysis Department of the Ministry of Finance. The department employs 14 people and consists of a public finance unit and a macroeconomic unit. Historically, the department has provided forecasts twice a year to inform the budget formulation process, *i.e.* in spring and summer. The spring forecast contributes to the formulation of the State Budget Strategy and is published in March or April. The summer forecast informs the drafting of the annual budget and is published in August. These forecasts are made publicly available on the website of the Ministry of Finance. More recently, the department has also provided additional forecasts for the European Union's convergence programme for the European Commission, in November. All budget-related forecasts cover a five-year period (n + 4). The department also prepares selected long-term forecasts. For instance, the convergence programme requires scenario analysis for pensions.

The macroeconomic unit forecasts a comprehensive list of economic variables. There is no macroeconomic model for forecasting purposes, since the available data time series are too short and due to the frequency of fundamental structural changes since the 1990s. The unit has plans to develop a new model in the future. The public finance unit produces forecasts of revenues, the budget balance and debt for the central and general government. It also assesses the sensitivity of general tax revenue and the budgetary balance of the general government to changes in economic growth assumptions. Revenue forecasts are made on the basis of existing policy as well as anticipated legislative changes. Forecasting of expenditures is the responsibility of the State Budget Department, which in turn relies on forecasts provided by spending ministries – for instance, with regard to entitlement spending. Analyses of tax changes are conducted as a rule and discussed with the Tax Policy Department, and the effect of crucial structural expenditure changes may also be considered.

The forecasts are compared with previous forecasts and data produced by other institutions, including the Bank of Estonia, commercial banks, and the Estonian Institute of Economic Research which is owned by the Chamber of Commerce. Accurate forecasting is difficult in the current economic environment. For instance, the 2006 summer forecast underestimated private consumption and a loan boom that led to the expansion of revenues from value-added tax. Moreover, tax collection improved beyond expectations.

Officials do not recall incidents of political interference with forecasting activities. Although not an independent agency, the Economic Analysis Department reports directly to the Secretary General of the Ministry of Finance. This creates a degree of independence from the State Budget Department. Still, the analytic work of the Economic Analysis Department has not always been without controversy. In the run-up to elections in March 2007, it carried out an analysis of the budgetary impact of the election programmes of six political parties. The results were not favourable for some parties. Although intended for internal consumption, parts of the conclusion were leaked to the press.

2.4. Strategic planning

The budget formulation process commences one year prior to the beginning of the relevant fiscal year which coincides with the calendar year (see Table 3). This process is driven by the State Budget Department, which reports to the Deputy Secretary General of State Budget and Governance Policy (see Figure 3). The State Budget Department has about 35 staff.

Table 3. **Timetable for budget formulation**

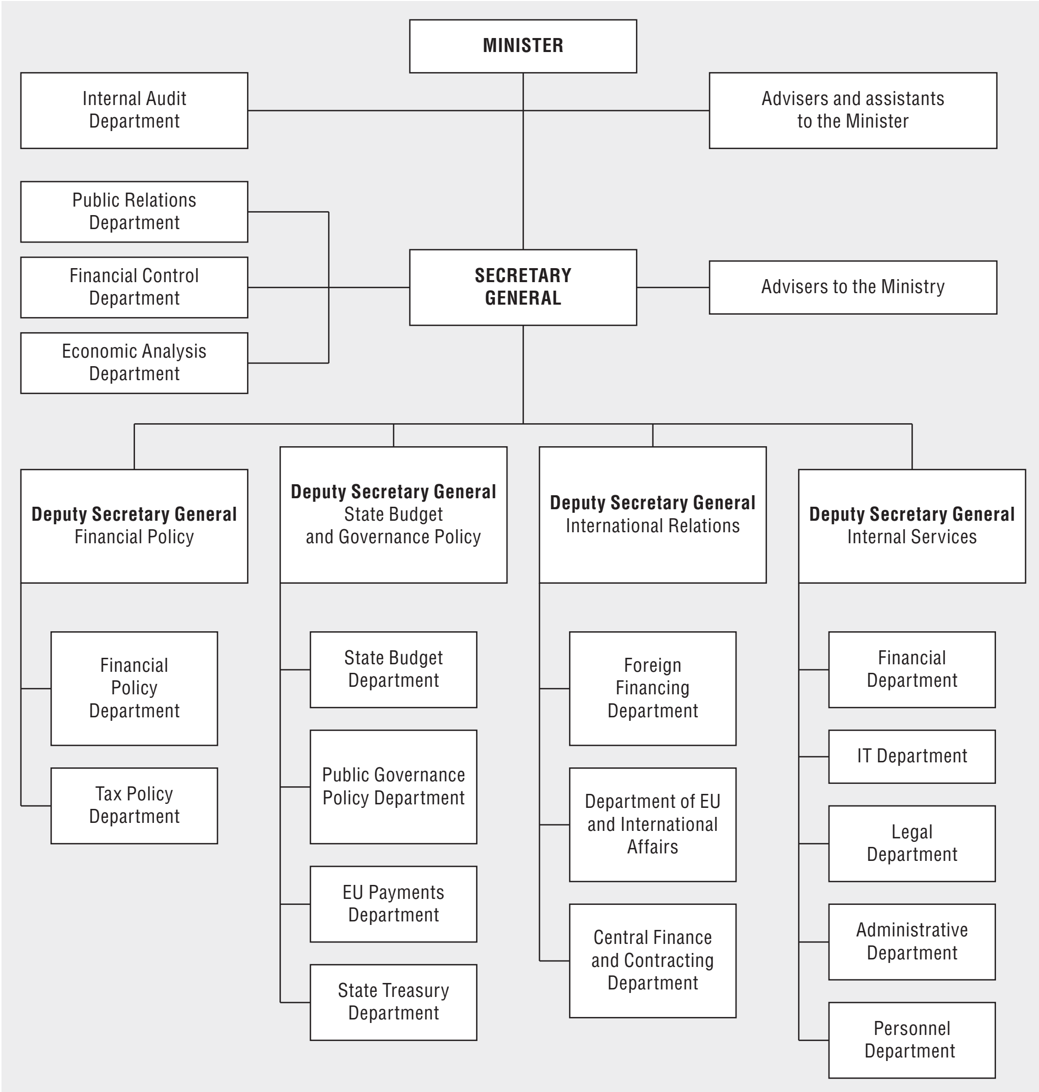
	Activity
January	The Ministry of Finance issues the budget circular to line ministries with a timetable.
March	Line ministries submit a four-year Organisational Development Plan together with a financial plan to the Ministry of Finance.
March/April	The Economic Analysis Department of the Ministry of Finance publishes the spring macroeconomic forecast.
April	The Ministry of Finance negotiates with line ministries and prepares the draft State Budget Strategy for discussion in the Cabinet.
May	The State Budget Strategy is approved by the Cabinet and published. The Ministry of Finance issues the budget decree with official annual budget envelopes for line ministries.
June	Line ministries submit next year's budget bids and Organisational Operational Plans to the Ministry of Finance.
August	Budget negotiations between the Ministry of Finance and line ministries.
August	The Economic Analysis Department of the Ministry of Finance publishes the summer macroeconomic forecast. Finalisation of the budget estimates and memorandum.
September	The Cabinet approves the draft budget.
By 1 October	Budget presented to Parliament and budget memorandum published.
December	Parliament adopts the budget.

The 2003 revision of the State Budget Act introduced a strategic planning process that culminates in the adoption of the State Budget Strategy. In January, the State Budget Department issues a budget circular to spending ministries that provides a timetable for the preparation of the strategy document. By March, each line ministry submits an Organisational Development Plan with an attached financial plan. These draw on the previous year's State Budget Strategy, with typically about 5% variation in the figures in non-election years and more in election years. The financial plans cover four years and are based on the previous year's State Budget Strategy (t + 1, t + 2, t + 3 plus an additional out-year). The costs of any new initiatives or changes to funding for existing initiatives are identified separately within the financial plans.

Each ministry prepares an Organisational Development Plan that is divided into programmes and sub-programmes. So far, there has been no uniform treatment of spending on horizontal functions, *i.e.* the expenditures necessary for running the core ministry and central support services. Some ministries have created a separate programme for such activities, while others use a rule to split this spending across substantive programmes. The Ministry of Finance envisages that overhead costs will be divided between programmes in accordance with specific principles to be determined in each governing area. Programmes in the Organisational Development Plans do not cut across ministries, but they can cut across government agencies which are subordinate to ministries and employ about 90% of civil servants (see Section 4 below). Some agencies match sub-programmes identified in the Organisational Development Plan of a ministry.

During April, the Ministry of Finance consolidates the various Organisational Development Plans into the State Budget Strategy. This process includes negotiations between the Ministry of Finance and spending ministries about their plans. In theory, the Ministry of Finance could renegotiate every line, but in practice the focus is on some especially salient issues – for instance, when delivery falls short of expected results – as well as on the additional funding requested above the level of last year's strategy document. The negotiations primarily take place first between officials of the State Budget Department and the relevant spending ministry. The negotiations also entail an exchange between the relevant minister and the Minister of Finance to discuss the more controversial issues. Any unresolved issues have to be resolved at Cabinet level.

Figure 3. **The organisation of the Ministry of Finance**



Source: Ministry of Finance of the Republic of Estonia, Tallinn, *www.fin.ee*.

The Cabinet is involved in the preparation of the State Budget Strategy on several occasions. There are two types of meetings, *i.e.* Government Sessions where official decisions are taken and the agenda, minutes and decisions are public, and the less formal Cabinet meetings which are held regularly on Thursday afternoons. The draft State Budget Strategy is discussed in the latter forum prior to its consideration and approval in an official Government Session in May. Nonetheless, the State Chancellery has the view that a document containing ceilings for the total and the sectors should be discussed and decided after the summer rather than before, when too many issues are still in the open. According to this view, the ceilings should subsequently be maintained and not be subject to renegotiation during budget preparation. In this way, duplication of decision making could be avoided. Once approved, the strategy is published on the website of the Ministry of Finance which also provides a citizen's summary on line and in print. At present, Parliament does not approve or formally discuss this document.

In the process of compiling the 2008-11 strategy document, the Ministry of Finance reclassified a number of programmes of the Organisational Development Plans to cross-cut ministerial boundaries. For example, the goal of "family and population policy" brings together sub-goals from the development plans of five different institutions, *i.e.* the Ministry of Social Affairs, the Ministry of Population Affairs, the State Chancellery, the Ministry of Culture, and the Ministry of Economic Affairs and Communications. As a result, the classifications of the Organisational Development Plans and the State Budget Strategy are different, although the responsible spending ministry and the relevant amounts are clearly identified in a financial table provided for each policy area. The State Budget Strategy is structured by policy area and provides a "goal", "sub-goals" and "key activities" together with "results expected" by the end of the four-year period. An example is provided in Box 1.

Box 1. **The structure of the State Budget Strategy (one example)**

Family and population policy

Goal: To achieve a growth of the population of Estonia through an increase in the birth rate and life expectancy and improvement of living standards.

Sub-goal 1: To provide children with better development opportunities and protection of health.

Key activity 1: Extension of the period of payment of parental benefits until the child is 18 months old. To implement this activity, additional funds to the amount of EEK 1.77 billion will be allocated from the budget of the Ministry of Social Affairs through 2008-11.

Result expected 1: The difference between the poverty rate of children and the poverty rate of the population will fall from 3.6% (2006) to 3.2%.

Source: Republic of Estonia (2007), "State Budget Strategy 2008-2011", Ministry of Finance, Tallinn, *www.fin.ee*.

Some OECD countries use multi-year budgeting frameworks to fix sectoral ceilings for the medium term (see Box 2). In Estonia, the four-year framework provided by the State Budget Strategy does not establish fixed sectoral envelopes. In fact, the out-year figures in the strategy provide only a rough basis for the annual budget process. One official even remarked that ministers often do not know what was in last year's strategy when negotiating the new strategy document.

In the Concept Paper of 2007, the Ministry of Finance proposes the use of a strategy for a fixed four-year term linked to the electoral period. The Concept Paper further envisages that Parliament formally discuss and adopt the strategy together with the first budget of a newly elected Government in September of the relevant year. Under this proposal, the Organisational Development Plans would be transformed into instruments of zero-based spending review, equally on a four-year basis. The resulting State Budget Strategy could still be reconsidered between elections by way of a mid-term review, but only under limited circumstances (for instance, a major change in economic conditions or in the composition of the coalition) and without adjusting the list of programmes. The Concept Paper also proposes that the strategy be prepared and adopted in real prices, so that changes in inflation can be accommodated.

Box 2. **Multi-annual fiscal frameworks and estimates**

A multi-annual fiscal framework is prescriptive (it prescribes targets or ceilings for the total and the sectors), whereas multi-annual estimates are descriptive (they describe the future consequences of current laws and policies at the line-item level). Deciding the fiscal framework is the first step in the annual budget process. The subsequent steps involve the adjustment of policies in order to fit the corresponding budgetary and multi-annual estimates into the targets or ceilings. The decision on the fiscal framework can be seen as a top-down process, and establishing budgetary and multi-annual estimates as a bottom-up process. In fact, the reconciliation of prescriptive targets or ceilings with descriptive line-item estimates is central to a programme-based budget process. Fiscal frameworks can be flexible or fixed. A flexible framework can be adjusted from year to year in the light of macroeconomic circumstances, both for the total and the sectors. A fixed framework works with a ceiling for the total that cannot be adjusted from year to year (although reallocation between sectors within the fixed total is usually possible). Fixed frameworks can be periodical or rolling. A periodical framework remains in force until it expires, after which new ceilings are decided. A rolling framework is extended every year with one out-year. Some countries that use fixed frameworks have rolling ones (Sweden); others use periodical ones (the Netherlands, the United Kingdom).

The implementation of these plans would lend more weight to the strategy document by transforming it into a government programme accompanied by a fiscal framework. However, some officials point out that it may be too early to move to a system with fixed four-year allocations, since it has proven difficult to forecast spending and revenues over even shorter periods. On the other hand, budget officials in a major line ministry think that the strategic planning process in its current form puts a heavy strain on resources, at the expense of analytic work, and voiced support for the idea that the strategy should only be prepared for a four-year period. A solution for Estonia could be to consider the framework as "flexible" in the sense that it can be updated from year to year at the beginning of the annual budget process, say in the early autumn as proposed by the State Chancellery (see above). It would then be important to maintain the framework as decided in the previous year as much as possible, but nevertheless allow updates in the light of new economic developments or new political priorities. The annual process of updating the fiscal framework could be part of the annual budget process and be clearly divided from the strategic planning process which would become a quadri-annual exercise coupled to the Cabinet's formation. After some years of experience with a flexible framework and after it has become clear that the framework can mostly be maintained from year to year, the step towards a fixed framework can then be considered.

2.5. The annual budget

Following Cabinet approval of the State Budget Strategy in May, the Ministry of Finance issues the budget decree with indicative ceilings (targets) for each spending ministry. On this basis, the ministries prepare an Organisational Operational Plan and related budget bid. The Organisational Operational Plan is essentially the first-year section of the Organisational Development Plan, updated on the basis of agreed figures of the State Budget Strategy. The Organisational Operational Plans and the budget bids are submitted to the Ministry of Finance in June, and a second round of negotiations is carried out until

August, again at both the civil servant and bilateral ministerial level. The original budget bids are not routinely made available, but could be requested on the basis of freedom of information legislation.

During September, the Prime Minister and the Cabinet again become involved. It normally takes two Cabinet meetings to work through a range of still unresolved issues, usually related to wages and investments, as well as unexpected developments. Occasionally, a few controversial decisions are left for the parliamentary process. Importantly, the nature of coalition politics in Estonia is such that the Prime Minister and the Minister of Finance do not necessarily develop a common line ahead of Cabinet meetings. When controversial issues have to be taken to Cabinet level, the Prime Minister normally has the last word, but this depends on political dynamics. The Cabinet approves the draft budget in September.

The idea is that the Organisational Operational Plan and the budget bid should complement one another. However, the link is tenuous, since the Organisational Operational Plans are classified on a programme basis (along the lines of the Organisational Development Plans) whereas the budget is not, and as a result only the ministerial totals match. The Ministry of Finance and the budget departments of line ministries understand how the appropriations and programme structure match, but a detailed reconciliation is not made public. Furthermore, the budget law contains only appropriations for the budget year, whereas the figures in the Organisational Operational Plans, which are published as part of the explanatory notes with the budget, contain multi-annual estimates as well. How the reconciliation in the out-years works is therefore even less transparent. In some line ministries, it appears that the operational plan drives the preparation of the budget bid, but this may not be the case for all entities. Overall, the link between the programme-based figures of the operational plans and the appropriations is difficult to understand for Parliament as well as the broader public. According to budget officials, one justification for preparing and including these plans in the budget documentation is that Parliament thus far has not been involved in the programme-based negotiations and that it would be necessary to open dialogue with parliamentarians about the relevance and improvement of programme information.

In contrast to the Organisational Operational Plan, the appropriations structure of the budget law is by organisational and economic classification. There are 18 governing areas: 11 ministries, a minister without portfolio (the Minister of Regional Affairs), the State Chancellery, and five constitutional institutions (the Parliament, the National Audit Office, the Office of the President, the Legal Chancellor, and the Supreme Court). For each governing area, the appropriations contain a single capital account for the entire governing area. For current expenditures, the appropriations are broken down by organisation. A typical line ministry will have several executive agencies operating under it, as defined in the Government of the Republic Act. In total there are 103 agencies, including ministries.[6] For both the core ministry as well as each other government agency, the appropriations distinguish transfers (subdivided by type and by recipient), administrative expenditures (with only occasional disaggregation), and other expenditures. All in all there are 925 line items (in 2008), including 810 for expenditures, 90 for revenues and 25 for financing transactions. The draft budget law is accompanied by a budget memorandum that contains three parts: the summer macroeconomic forecast prepared by the Economic Analysis Department; the final versions of the Organisational Operational Plans; and a written explanation by line item.

The Concept Paper proposes aligning annual budgets with the State Budget Strategy and envisages appropriations on a programme basis. While the objectives and targets in the State Budget Strategy focus on outcomes in a four-year perspective, the budget would complement these with annual objectives and targets at output level. The reclassification of the budget on a programme basis would be an important step forward. It would make the budget more transparent for parliamentarians and the general public (much fewer line items), more result-oriented and better suited to fulfil its priority-setting role. It is also a good idea to focus the line items on programmes or activity areas and to use outputs as cost indicators (at least as far as outputs are actually used to finance the services[7]). Over the past decade, various OECD countries[8] have reclassified their budgets according to programmatic areas, and this reform has generally been successful. This reform does not necessarily require splitting up the costs of core ministries (policy making and central support units). OECD countries that have opted for a programme classification have generally kept administrative expenditures (costs of core ministries and administrative agencies) apart from programme expenditures in order to avoid that programme money would be used for staff remuneration and office facilities. For Estonia this reform would imply that the Organisational Operational Plans, with specification of the outputs to be realised in the budget year, would become better integrated in the budget. A programmatic budget would also become better aligned with a four-year State Budget Strategy. It should be kept in mind, though, that the latter would probably become a more political document if it were developed into a medium-term government programme as envisaged in the Concept Paper. Political documents cannot easily be moulded into rigid structures based on the needs of the budget process. A rigid alignment of the budget classification to the State Budget Strategy should therefore not be seen as a high priority. More important is that the programme classification of the budget is logically aligned to the policy structures and the legislation in place. It is also important that the programme structure of the budget remains aligned with the organisational structure of government because overlapping responsibilities of organisational units concerning line items are a sure recipe for trouble.[9] It is advisable to consult closely with Parliament on this reform in particular.

The Concept Paper also proposes that each minister defend his/her own budget and financial report in Parliament whereas, currently, the Minister of Finance presents and defends the budget and the financial report. This is an important change that puts more emphasis on the responsibility of the line ministers for sectoral policies and programmes. From this perspective, it is also important that the responsibility of line ministers for medium-term planning is emphasised. Currently, medium-term sectoral planning operates through the Organisational Development Plans that are connected to the State Budget Strategy. If this document could become a quadri-annual document of a more political nature, then there would be more room for an independent sectoral planning process, tailored to the specific needs of the programme areas. In OECD countries, medium-term sectoral planning usually proceeds by programme area (not by ministry) and in a frequency adapted to the programme area. In the area of defence spending, a seven-year planning cycle could be appropriate; in law enforcement or education, a five-year cycle could be appropriate. In this connection, the proposal for policy evaluation mentioned in the Concept Paper is also relevant. According to this proposal, programmes would be evaluated regularly. For that purpose, the government would annually approve an evaluation plan including a list of five to ten programmes to be evaluated. In various OECD countries, sectoral evaluation is to some degree regulated from the centre of government. For instance, the Netherlands and the United Kingdom have decrees that specify minimum requirements (independence of evaluators, publication of the reports, involvement of external experts, etc.). However, these regulations do not make the minister of finance or the cabinet responsible for programme evaluation. Although it is very useful that programme evaluation is encouraged from the centre of government and that an ambitious evaluation culture is fostered, it should be kept in mind that the sectoral minister is responsible for sectoral policy and that the incentives for sectoral planning and evaluation ought to lie ultimately with her/him.[10]

Budget officials recall that the 2005-08 State Budget Strategy, prepared in 2004, was used for the first time to impose firm ceilings at the beginning of the budget preparation process. However, in subsequent years the ceilings of the State Budget Strategy were not always rigorously enforced. Budget bids now routinely contain items not mentioned in the strategy and proposals for new spending. One reason is that strong revenue performance has generated demands for extra spending, and some line ministry officials bluntly admit that the process in its current form allows them to resubmit previously unsuccessful proposals. Also, if the summer macroeconomic forecast is substantially more positive than the spring forecast, as has been the case in recent years, the government might decide to bring forward spending initially envisaged for later years. Other adjustments may be due to inflation or salary adjustments for the public sector that were made too late to feed into the strategy document. Officials are aware that the absence of firm ceilings has allowed line ministries to "get used to good times" and to expect additional funding to be made available during the finalisation of the annual budget. This absence has undermined budgetary discipline during the preparation process. If the decision about the fiscal framework is shifted to a later date as envisaged by the State Chancellery, all these arguments against the enforcement of ceilings during budget preparation lose their relevance. Budget discipline in Estonia could probably be improved by strengthening the top-down pressure of a decision on the general government total and the sectoral totals at a moment that is not too early in the annual budget cycle, say at the end of August.[11]

The coverage of the budget is generally comprehensive. There are two extra-budgetary funds, *i.e.* the Health Insurance Fund and the Unemployment Insurance Fund. Both funds are mostly financed by earmarked taxes (the social tax and the unemployment insurance tax). The funds are each ruled by a Board that is exempt from ministerial responsibility.[12] However, both funds are included in general government balance calculations in the explanatory note to the draft budget and the State Budget Strategy as well as in the final accounts.

At present, there are no official definitions of tax expenditures and tax baselines. The Ministry of Finance takes the view that currently there is limited use of tax expenditures in Estonia. The current intention is to start presenting any relevant information in the budget documentation from 2008 onward.

The Concept Paper of the Ministry of Finance also envisages budgeting on an accrual basis, in line with present accounting practices. According to the current plan, appropriations would have two parts for each governing area, *i.e.* a budget for revenues and expenses as well as a budget for the purchase of fixed assets. For each governing area, Parliament would set limits for net-of-revenues expenses for each objective under a programme, and for the purchase of fixed assets. Borrowing would only be allowed for the purchase of fixed assets. There would be limited scope for adjusting these limits and for carry-overs. The proposed use of accrual budgeting resembles closely the practices in Australia, New Zealand and the United Kingdom. Other OECD countries have not moved to full accruals or have explicitly decided to stay with cash/obligations budgets (the Netherlands) or cash/obligations with some accrual elements (United States).[13] Accrual-based budgeting gives a more accurate picture of the (proposed) costs and benefits of government services in the budget year. Cash is easier to understand for parliamentarians and the general public, less susceptible to inherently arbitrary accounting conventions (capital charges, depreciation methods, valuation methods of assets in kind), less costly to administer and (according to some) more equitable in intergenerational terms (because the full cost of investments are attributed to the generation that ordered them[14]). Modified accruals, which puts current expenditures on a commitment basis but which keeps front-loading investment expenditure to the delivery year, could be an alternative solution.

2.6. Conclusion

The budget formulation process has been modernised substantially in recent years. Estonia has developed a strategic planning process based on a medium-term framework and incorporating performance information. While these developments represent important steps forward, there is scope to rationalise the formulation process and to consolidate the progress that has been made with these reforms. Moreover, budget management currently benefits from the growing economy, but attention has to be paid to ensuring adequate safeguards for the system to withstand macroeconomic shocks. Notably, the following might be considered.

Reducing overlap and redundancy: The strategic planning and annual budget processes overlap substantially and are repetitive. In their current form, they create two sets of budget negotiations per year. This is an onerous process that strains analytic capacity in line ministries in particular. Instead, in line with the ideas in the Concept Paper of the Estonian Ministry of Finance, the State Budget Strategy could be reformed as a quadri-annual government programme, put up at the beginning of the Cabinet period with a focus on (political) outcomes to be achieved. Equally in line with the Concept Paper, the Organisational Development Plans could be transformed into instruments of zero-based spending review, also on a four-year basis.

Consistent classification: As envisaged in the Concept Paper, the move towards programme budgeting ought to be completed. Notably, the appropriations should be switched to a programme basis as soon as possible so that the Organisational Operational Plans, with specification of outputs to be realised in the budget year, become better integrated with the budget. Probably a programmatic budget would also become more aligned with a four-year State Budget Strategy. It should be kept in mind, though, that the latter would probably become a more political document if it were to be used as a medium-term government programme as envisaged in the Concept Paper. A rigid alignment of the budget classification to the State Budget Strategy is therefore probably not realistic and should not be seen as a high priority. More important is that the programme classification is logically aligned to the policy structures and the legislation in place. It is advisable to consult closely with Parliament on this reform in particular.

Strengthening sectoral planning and evaluation: The Concept Paper proposes that each minister defend his/her own budget and financial report in Parliament whereas, currently, the Minister of Finance presents and defends the budget and the financial report. This is an important change that puts more emphasis on the responsibility of the line ministers for sectoral policies and programmes. From this perspective, it is also important that the responsibility of line ministers for medium-term planning is emphasised. If the State Budget Strategy could become a quadri-annual document of a more political nature, then there would be more room for an independent sectoral planning process, tailored to the specific needs of the programme areas. In OECD countries, medium-term sectoral planning usually proceeds by programme area (not by ministry) and in a frequency adapted to the programme area. The Concept Paper also proposes regular evaluation of programmes. In various OECD countries, sectoral evaluation is to some degree regulated from the centre of government. Although it is very useful that programme evaluation is encouraged from the centre of government and that an ambitious evaluation culture is fostered, it should be kept in mind that the sectoral minister is responsible for sectoral policy and that the incentives for sectoral planning and evaluation ought to lie ultimately with her/him.

Safeguarding fiscal discipline during budget preparation: The targets for the budgetary totals of line ministries in the State Budget Strategy as well as those in the budget decree are currently soft. While the detrimental effects of this practice may not be obvious now, the real test of the current arrangements will occur if the economic situation worsens. It is important that steps are taken now to protect the system by reinforcing the top-down steering of the annual budget cycle. Notably, the Ministry of Finance should impose binding expenditure ceilings (not indicative limits or soft targets) during budget formulation. The best moment to decide these ceilings is at the end of August (after the budget requests and the summer macroeconomic forecast). Subsequently they should be rigorously enforced.

A meaningful multi-year approach: Options should be explored for making medium-term planning more meaningful. These options could take the form of a four-year fixed fiscal framework that is developed once at the beginning of each electoral period, as proposed by the Ministry of Finance. However, this is a demanding system. Instead, a flexible framework, to be updated from year to year, would be an important step forward. The framework should be kept as stable as possible from year to year. If Estonia succeeds in keeping the framework stable during a number of years, the step to a fixed framework can be envisaged. Multi-year estimates should be integrated into the annual budget, which would help to ensure consistency with the fiscal framework.

Accrual budgeting: According to the Concept Paper, Estonia contemplates moving to full accrual budgeting. In OECD countries, there is no consensus about the pros and cons of this reform. Modified accruals, which puts current expenditures on a commitment basis but which keeps front-loading investment expenditure to the delivery year, is used by many countries and could be an alternative solution.

3. Parliamentary approval

Box 3. **The Estonian Parliament**

Estonia has a unicameral Parliament, the *Riigikogu*, with 101 seats. Members are elected by popular vote under a system of proportional representation to serve four-year terms. Apart from its role in law making, Parliament elects the President, approves the candidate for Prime Minister designated by the President (or in certain circumstances nominates the candidate for Prime Minister), and appoints some high-ranking officials, including the President of the Supreme Court and the Chair of the Bank of Estonia. Parliament appoints from among its members a Chair (or Speaker) and two Deputy Chairs who form the Board of the *Riigikogu* and direct its work in accordance with the *Riigikogu* Rules of Procedure Act and the *Riigikogu* Administration Act.

In the parliamentary elections of March 2007, six political parties gained seats in Parliament: the Estonian Reform Party (31 seats), the Estonian Centre Party (29), the Union of Pro Patria and Res Publica (19), the Social Democratic Party (10), the Estonian Greens (6), and the People's Union of Estonia (6). Members of Parliament have the right to form factions, which must consist of not less than five members elected from the same list of candidates. Members can join only one faction. Factions are registered with the Board of the *Riigikogu* and facilitate political co-ordination. Factions, like individual members as well as parliamentary committees, have the right to initiate draft legislation.

Source: Parliament of Estonia, Tallinn, *www.riigikogu.ee*.

3.1. *Legal framework*

The fundamental rules for the parliamentary approval process are set out in Chapter 8 of the Constitution. According to Article 115, Parliament must adopt a budget for all state income and expenditures on an annual basis. The government must present a draft budget to Parliament no later than three months before the commencement of the budget year, *i.e.* by 1 October. On the basis of a proposal by the government, Parliament may also adopt a supplementary budget during the budget year.

Article 116 of the Constitution restricts the amendment powers of Parliament. Proposed amendments to the budget that "require a decrease in income, an increase of expenditures, or a redistribution of expenditures, as prescribed in the draft national budget, must be accompanied by the necessary financial calculations, prepared by the initiators, which indicate the sources of income to cover the proposed expenditures". Moreover, Parliament cannot eliminate or reduce mandatory spending, *i.e.* expenditures in the budget which are prescribed by other laws. Article 20(2) of the State Budget Act further adds the restriction that Parliament may not cancel nor decrease expenditures from foreign contracts it has ratified.

The budget adopted by Parliament enters into force at the beginning of the budget year. If approval is delayed beyond the beginning of the budget year, the government can spend each month up to one-twelfth of the expenditures of the previous budget year (Article 118). Article 22 of the State Budget Act further stipulates that interim spending must be limited to expenditures foreseen in the previous year's budget as well as in the draft budget of the fiscal year already begun, and may not exceed the amount of the smaller of those two totals. Moreover, expenditures not foreseen in the previous budget year but required by other laws, *i.e.* mandatory spending, can be undertaken with approval by the government. If Parliament has not adopted the budget within two months after the beginning of the budget year, the Constitution obliges the President of the Republic to declare early parliamentary elections (Article 119).

3.2. The Finance Committee

The Finance Committee is one of the 11 standing committees of the *Riigikogu*. Its membership includes representatives from all political factions, and the chair is from a government party. The committee was established in 1992. Until 1994, it was called the Budget and Tax Committee. The new name reflects the fact that its mandate is broader than taxation and spending issues and also covers insurance and banking.

The committee discusses the draft budget law as well as draft laws relating to taxation, insurance and banking issues, and resolves related problems and issues at the legislative level. The greater part of the draft laws referred to the Finance Committee deal with amendments to acts relating to the financial and tax systems. Amongst the most important budget-related acts and resolutions passed by the committee are the annual budget laws, supplementary budget laws and budget amendment laws. It also passes a resolution on the approval of the report on the implementation of the state budget, which is adopted every year. The Committee is further responsible for changes to the State Budget Act (the organic budget law) which establishes the procedure for drafting, adopting and implementing the annual budget law, as well as for issues relating to intergovernmental fiscal relations.

There is no specialised parliamentary research service to assist Parliament with scrutinising the budget. However, the Finance Committee has some analytical support. Three analysts are attached to the committee, although one of these positions is currently vacant. The committee can also hire a consultant, but only for administrative support. It is generally difficult to attract appropriately qualified staff. For example, the current vacancy is the result of difficulties in attracting a legal expert.

Since 2004, there is also a parliamentary State Budget Control Select Committee to ensure more ongoing engagement with the findings produced by the National Audit Office of Estonia. This committee is discussed in more detail in Section 5 below.

3.3. Parliamentary process

In practice, Parliament receives the draft budget law at the end of September, ahead of the first reading debate. This allows time for members to get acquainted with its contents. The draft budget law is discussed in the Finance Committee in October-December. The committee considers the draft law within a few weeks before each of the three readings in the plenary.

At the first reading, which takes place in October, the Minister of Finance makes a report on general principles of the draft budget and gives an overview of the conditions of the Estonian economy and the main objectives of the government. After the end of the first reading, members, standing committees and factions may submit motions to amend the budget. All members can put forward amendments at this stage. The Finance Committee conducts a number of hearings, starting with a selection of ministers, the Bank of Estonia and private sector banks. Sectoral committees consider the relevant parts of the budget and hold hearings with the respective ministers. Proposals can be forwarded to the Finance Committee for deliberation. These hearings are not public. The Finance Committee considers all the motions to amend the draft budget law.

The second reading consists of a detailed deliberation on the provisions of the draft budget law. The government also gives its opinion on parliamentary amendment motions. In 2003, the *Riigikogu* Rules of Procedure Act added a procedural restriction. According to its Article 120, motions to amend the budget that are put forward after the suspension of the second reading cannot be put to a vote if they lack the support of the government and the Finance Committee. Hence the second reading of the budget is the last chance for individual parliamentarians to propose amendments. In practice, a substantial number of proposals are discussed during the second reading. Predictably, opposition proposals are typically voted down, whilst proposals with Government support are adopted.

At the third reading of the draft budget law, only committees and factions may submit motions to amend the budget. After the second reading, the Finance Committee usually discusses some dozens of amendments but only some of these are supported by the Government and approved by the Finance Committee. By convention, amendment proposals that are debated during the third reading are usually presented and voted on as a package. In particular, the third reading can sometimes be interrupted and may spread over several days. The budget has always been approved in December.

The budgetary impact of amendments is limited and amounts to usually around 0.2% of total expenditures. Successful amendments often involve constituency issues, notably regional investments. Given the high level of aggregation of investment expenditures in the appropriations, implementation of parliamentary proposals for reallocation between projects relies on a tacit agreement that in practice has never been violated during budget execution. To comply with the legal limits on amendments, increases in line items have been covered in recent years by shifting funds from the contingency reserve (the Reserve Fund of the Government of the Republic, see Section 4.3 below). Up to two-thirds of the amount for this reserve in the draft budget law is used by Parliament to finance increases on input line items elsewhere in the budget. In 2008, the contingency fund amounted to 0.14% of approved spending. In recent years, the Ministry of Finance has deliberately inflated the size of this reserve in the draft budget to ensure the availability of a little extra funding for the Parliament's priorities in order to smooth the passage of the budget.

Parliamentary engagement with budget issues is primarily focused on the budget laws. There is currently no established procedure for discussing the State Budget Strategy. Parliament did not discuss the 2008 strategy, although in previous years the Minister of Finance had introduced it to the Finance Committee. If the State Budget Strategy were to evolve into a statement of medium-term government policy at the beginning of a Cabinet period, as proposed in the Concept Paper, it could be discussed in plenary session in the presence of the entire Cabinet and be formally approved by Parliament. This could enhance the political relevance of the State Budget Strategy and the impact of Parliament on medium-term budgetary planning as well as strategic policy issues.

3.4. Conclusion

The role of the Estonian Parliament in the budget process is limited. The process as defined in the Constitution and the State Budget Act gives members three months to scrutinise the government proposal, which complies with the minimum recommended in the OECD best practices (OECD, 2002). A Finance Committee is in place, with a co-ordinating role in the budget process. The formal powers of Parliament to amend the budget are limited but leave space for engagement with spending priorities. Thus, the legal and institutional basics of the approval process are sound. However, there are also some issues that Parliament may want to consider.

Facilitating programmatic scrutiny: Parliamentary scrutiny remains focused on the input line items of the budget rather than on the priorities among and within programmes. This disconnects Parliament from the strategic debate that precedes the presentation of the budget. In order for Parliament to strengthen its role as the ultimate power of the purse, it is important that the appropriations are moved to a programme basis. The Ministry of Finance should consult closely with Parliament and the Finance Committee in particular, to ensure cross-partisan support for this reform and to address any concerns about its impact on parliamentary oversight.

Strategic engagement: There is currently no process to facilitate parliamentary engagement with the State Budget Strategy. This undermines the status of the strategy document and also weakens parliamentary oversight. Options should be considered that would enable greater parliamentary involvement. If the State Budget Strategy were to evolve into a statement of medium-term government policy at the beginning of a Cabinet period, as proposed in the Concept Paper, it could be discussed in plenary session in the presence of the entire Cabinet and be formally approved by Parliament. This would enhance the political relevance of the State Budget Strategy and the impact of Parliament on medium-term budgetary planning as well as strategic policy issues.

4. Budget execution

4.1. The organisation of budget execution

After the budget law has been approved by Parliament, it enters into force at the beginning of the fiscal year. If the budget law has not been passed by the beginning of the fiscal year, the State Budget Act provides that per month expenditures can be made up to one-twelfth of total expenditures of the previous budget year, until the state budget is passed.

After parliamentary approval, the Minister of Finance proposes and the government decides a list of spending limits that breaks down the separate line items of the budget into more detailed items. In particular, the departmental lump sum for capital investment is broken down by project, and administrative expenditures of agencies (see Section 2.5 above) are broken down into wages, other operational expenditure and other expenditures. The State Budget Department introduces the approved limits into the IT system ("e-Treasury") through which the payments are made.

As soon as the limits have been fed into the IT system, budget holders (responsible for one or more line items of the budget) can start spending. From this point onwards the execution of the budget takes place in a rather decentralised manner. The ministries are responsible for executing the budget allocated to their governing area according to the law. The State Treasury Department in the Ministry of Finance is responsible for the execution and recording of the payments. There is no requirement for central registration of commitments at the State Treasury Department except for those exceeding EUR 50 000. Contracts exceeding this limit are published in a central register. The Treasury can inspect these contracts and check whether procurement procedures have been applied correctly. Other commitments are not subject to Treasury approval. Budget holders record and monitor commitments through their own financial units. Before payment orders are submitted to the Treasury, they are first signed by the responsible official, then passed to the financial unit and finally approved by the secretary general of the ministry or the head of the agency (depending on internal decentralisation). The Treasury does not check the payments on any other aspect than compliance with the spending limit. The budget holders are responsible for the internal financial control of their commitments and payments.

The State Treasury Department operates a Single Treasury Account system (STA) involving three main accounts in three commercial banks (not in the Bank of Estonia). The Treasury system comprises about 700 budget holders (including 103 central government agencies and 227 municipalities; the rest are mostly municipal agencies, hospitals and schools) which hold approximately 2 000 sub-accounts in the STA. Each budget holder has an expenditure account as well as revenue accounts, if necessary, in terms of different revenue types. About 80% of transactions are carried out within the same bank and 20% of transactions between banks. All municipalities have a treasury account (in order to receive grants) from which they transfer cash to their own accounts outside of the STA.

Formerly, the Treasury had a decentralised structure. In 1997, the Treasury had 120 branches. With computerisation and the development of e-Treasury, the decentralised structure became obsolete, and by 2003 the last branches were closed. Today the State Treasury is a department of the Ministry of Finance and has a staff of 35. Through e-Treasury, budget holders can communicate with the Treasury, make payments and reservations, and submit and receive statements and reports.

4.2. Budget flexibility and reallocation

In general, the government or a minister cannot change the line items of the budget in any other way than through supplementary budget laws or amendments of the budget law.

Supplementary budget laws are allowed by Article 43 of the State Budget Act and are required for all changes that affect the level of total expenditure. On the proposal of the government, a draft supplementary budget law must be submitted to Parliament no later than three months before the end of the budget year in the case of an increase of total expenditure and no later than two months before the end in the case of a decrease of total expenditure. The draft supplementary budget has the same classification as the annual budget and is submitted to Parliament together with an explanatory note. In recent years, supplementary budgets have been adopted annually and have always involved an increase in total expenditures. The main reason for these supplementary budgets was higher-than-expected revenues. Supplementary budgets have mainly been used to bring forward spending on priority expenditures that were planned for later years. In past years, supplementary budgets were usually submitted rather late in the year and were discussed in Parliament together with the annual budget of the following year. As a consequence of late submission, the additional funds appropriated through the supplementary budget mostly had to be carried over to the following year. This course of affairs raises the question of why the supplementary budgets were not integrated with the upcoming budgets in the first place. Possibly the political wish to decouple the spending package contained in the supplementary budget from the upcoming budget and to present a tight budget for the upcoming year played a role in these policy choices. If Estonia were to move in the direction of a stable multi-annual framework, supplementary budgets should no longer be used for the conduct of regular budgetary policy, but only for real emergencies or regularisation of overspending on mandatory programmes.

In contrast to supplementary budget laws, amendments do not involve a change in total expenditure but only a reallocation. In order to initiate an amendment, the government must submit a draft budget amendment law to Parliament no later than two months before the end of the budget year. Amendments require the specification of compensation for any increase of a line item. In recent years, amendments to budget laws have been made within the supplementary budget laws.

Apart from measures requiring parliamentary approval, the government can make reallocations between spending limits as specified after the adoption of the budget law (see Section 4.1 above). This type of reallocation can take place up to four times a year.

As an exception to the general rule, mandatory expenditures (for instance, on social security benefits) can be made in excess of the approved appropriations. This may occur, for example, if the number of beneficiaries changes unexpectedly. Overspending on these appropriations can be regularised after the fact through budget amendment laws or supplementary budget laws but may also be approved through the consolidated annual financial report (see Section 5.1 below). The line items that can be overspent are identified and specified separately in the budget law.

Unused appropriations are automatically cancelled at the end of the fiscal year. However, since the revision of the State Budget Act of 2003, 3% of current expenditures can be carried over to the following year. Capital expenditures can be carried over without limit. These restrictions on carrying over resources do not solve the problem of "December fever" and may create new problems.[15] The 3% rule just shifts a small amount of resources from one year to the next and will not do anything about the December fever. The tolerant rule on carrying over capital expenditure might alleviate the problem of December fever, but may create an ever increasing pool of unused funds which may pose risks for fiscal policy objectives and macroeconomic stability. Experience in OECD countries suggests that the best designed carry-over rules are those that require negotiation with the Ministry of Finance in cases where spending before the end of the year would involve risks. The Minister of Finance can then decide to allow the carry-over and compensate the shifted resources in the next fiscal year from unused funds in that year, possibly in other ministries. In this way, the Minister of Finance can take the responsibility for ensuring that pools of unused funds do not swell over the years. Additional flexibility is provided by the reserve funds.

4.3. Reserve funds

According to the State Budget Act, unforeseen expenditure needs that arise during the execution of the budget can be covered by a contingency reserve called the Reserve Fund of the Government of the Republic. Allocations from the Reserve Fund are to be made by the government for a specific purpose and are subject to a government decree on the use of the fund. The Ministry of Finance is responsible for the administration of the Reserve Fund and reports on the assets, proceeds and use of the fund twice a year. The size of the Reserve Fund is determined by the budget law and has increased recently, partly due to the government's policy of accomodating Parliament's practice of reallocating the fund's resources to other line items (see Section 3.3 above).

The Stabilisation Reserve Fund (SRF) was established in the late 1990s with the purpose of maintaining economic stability (to reduce economic risk and to prevent or alleviate socio-economic crises) and to provide for resources in emergency situations or war (to increase military preparedness and to carry out mobilisation).[16] The SRF can be financed through budgetary surpluses, sales of state assets, profits from the Bank of Estonia and accrual of interest (revenues from administration of the SRF). Initially the main source of financing came from privatisation activities. At the end of 2007, the value of the assets in the SRF amounted to EEK 6.4 billion. Allocations from the Stabilisation Reserve Fund are to be made by Parliament on the proposal of the government. However, up to 3% of the capital of the SRF as well as the proceeds from investments can also be used in normal circumstances. Authorisation for the use of these funds is provided by the annual budget law. The Ministry of Finance is responsible for the administration of the SRF and reports on the assets, the proceeds and the use of the fund on a quarterly basis. The investment portfolio of the SRF reflects a conservative investment strategy. So far, the SRF has been used only once for guaranteeing deposits in two bankruptcy cases of private banks. The SRF seems to function increasingly as the main saving vehicle of the Estonian government, where budget surpluses are invested now that public debt is almost entirely paid off.

The main purpose of the Cash Reserve Fund is to facilitate liquidity management. The size of the Cash Reserve Fund is determined by the annual budget law. The Minister of Finance has the right to use the Cash Reserve Fund for smoothing the execution of cash payments, liquidity management, covering claims from contingent liabilities, and in order to bridge financing. The government decides on the use of the Cash Reserve Fund or can authorise the Minister of Finance to do so.

4.4. Cash and debt management

Previously, budget holders prepared monthly and annual cash plans and submitted them to the Treasury. However, since the quality of the estimates was generally rather poor, budget holders are no longer required to submit such plans. They now only have to submit weekly cash plans by Thursday for the week to come. Currently, every budget holder must prepare a weekly cash plan for every account it holds in the Single Treasury Account. Based on its own data about past expenditure patterns, the Treasury prepares monthly and annual cash plans. Municipalities do not have to submit cash-flow projections.

Liquidity management is facilitated by the Cash Reserve Fund (see above) which facilitates the smoothing of liquidity surpluses and shortfalls during budget execution. In practice, the deviations between actual and forecast cash flows amount to about 1-2% of daily payments. If a budget user requires more cash than was projected, additional cash can be provided by the Treasury, subject to availability, upon request. So far no sanctions (*e.g.* charging internal interest) have been imposed on budget holders for poor quality of forecasts leading to excess or shortage of cash, although the Ministry of Finance has been contemplating such action. EU grants pose a source of uncertainty, as cash flows have been rather unpredictable.

Payment orders are submitted electronically through the e-Treasury. The system automatically checks whether the payments are within the limits and automatically blocks payment orders that are not. Payments are executed and recorded on a cash basis by the Treasury as well as in the internal accounting system of the budget holders.

The State Treasury Department is also responsible for debt management. One person is responsible for everyday liquidity management, and three portfolio managers are responsible for portfolio investments (reserves). When the annual budget law is prepared, annual cash-flow projections are made and borrowing needs are identified. The budget law defines an annual borrowing limit which is specified for short-term and long-term borrowing. Decisions on long-term borrowing must be approved by the government, whereas short-term borrowing can be decided by the Minister of Finance.

4.5. *Service delivery*

The public sector can be divided into general government and public enterprises. In Estonia, general government consists of the three sub-sectors central government, local government and social security funds.

The central government is divided into agencies. The Government of the Republic Act defines the following three types of agencies:

- Government agencies (103 agencies): ministries, the State Chancellery, county governments, executive agencies, inspectorates and their regional offices, and other government agencies. Government agencies have public executive authority. They are financed from the state budget.
- State agencies administered by the government agencies: They provide services to government agencies or perform other state functions in cultural, educational, social or other areas. State agencies do not have public executive authority. They are financed from the state budget.
- The Defence Forces of Estonia.

Estonia has a single-tier local government system.[17] The organisation of local government is based on the Local Government Organisation Act, while the local budget procedures are based on the Municipality and City Budgets Act. The local government sector consists of 227 municipalities: 34 towns and 193 rural units.[18] The size of municipalities varies from about 400 000 inhabitants in Tallinn to less than 100 in Ruhnu. Towns and rural municipalities are equal in their legal status. As over two-thirds of the municipalities have a population of under 3 000 inhabitants, many of them have found it advantageous to co-operate in providing services and carrying out administrative functions.

The main tasks assigned by law to local government include: organisation of social services, education (pre-school child care institutions, primary and secondary schools), cultural activities, primary health care, housing, local public transport, environmental protection at the local level, maintenance of local roads and streets, and provision of local public services and amenities. The number of functions delegated to local governments by the central government has increased over the last few years. Expenses incurred in the performance of functions assigned by the central government by law must be covered from the budget of the central government. Box 4 provides an overview of local government finance.

Budgetary planning in local government is hampered to a certain extent by the volatility of local revenue. The volatility is mainly due to uncertainty with respect to long-term investment grants from the state and to uncertainty with regard to the proceeds from the income tax-sharing arrangement (mostly larger-than-expected proceeds in recent years) and to a lesser extent to changes in the formula of the distribution of the equalisation grant. The latter is discussed annually with the associations of municipalities but has been mostly stable, and its outcomes predictable, since its introduction in 2003. In order to further stabilise the formula and protect it from lobbying by groups of municipalities with similar interests, it is important to fix the formula in substantive legislation as is the case in many OECD countries.

Box 4. **Local government finance**

Expenditures

Currently, local governments account for about one-quarter of general government spending. A large part of local government expenditure (around 40%) relates to education.

Revenues

The revenues of local governments stem from five sources: tax sharing (48%), local taxes (12%), the non-earmarked equalisation grant (7%), earmarked grants (23%) and non-tax revenues (10%).

The primary source of revenue is the local share of the income tax. The local share is fixed in the Income Tax Law. It fell from 100% in 1991-93 to 52% in 1995 and then remained stable at 56% from 1999 to 2003. When the tax rate was decreased in 2004, the local share was made dependent on the tax base rather than the tax proceeds in order to protect local revenue (the share is now 11.9% of taxable income). Tax shares are distributed according to residency. Equalisation is pursued via the equalisation grant.

The most important local tax is the land tax regulated by the 1993 Land Tax Act (2.9% of local revenue). In addition, there are eight other local taxes listed in the 1994 Local Taxes Act (sales tax, boat tax, advertisement tax, road and street closure tax, motor vehicle tax, animal tax, entertainment tax, parking charge). The ceiling for the land tax rate is fixed in the Land Tax Act. For all other local taxes, there is no legal rate ceiling.

The equalisation grants from central to local government are calculated annually on the basis of a formula which takes into account the local needs and the tax capacity of each local government. Local needs are proxied by the total population, number of children, number of school-age children, size of the labour force, number of elderly, number of disabled persons, and estimated costs of roads and streets. Tax capacity is proxied by the tax bases of the personal income tax, land tax, and natural resources fee. The formula for the distribution of the equalisation grant is authorised in the annual budget law. Since 2003, the formula has been adjusted from year to year on the basis of agreements made in the annual budget negotiations with local governments.

Earmarked grants include the general education grant and investment grants, among others. They are provided by sectoral ministries and are part of the budget of those ministries. A new formula for the distribution of the general education grant was implemented in 2008; it takes into account not only the total number of students in a local unit but also other factors such as class, stage, school, municipality and curriculum. Local governments will have full discretion over the use of the general education grant (provided it is spent for the purpose of the grant).

Non-tax own revenues include natural resource fees, user fees, and income from economic activities and exploitation or alienation of property.

Fiscal rules

Municipal borrowing is limited by provisions of the Rural Municipality and City Budgets Act. The law stipulates a ceiling for the stock of municipal debt at 60% of total annual own revenue (including revenue sharing and the equalisation grant but excluding earmarked grants) and a ceiling for debt service payments at 20% of current revenues (excluding earmarked grants). If local governments exceed the debt ceiling, the central government may reduce their share of the equalisation fund, but in practice there has been a reluctance to impose sanctions. The municipal debt regulation stipulates that long-term borrowing is only allowed for investment projects which are included in the local development plan.

The fiscal rule on local government (see Box 4), to the effect that municipal debt may not exceed 60% of annual own revenue (excluding grants), is being circumvented by the establishment of foundations and public-private partnerships (PPPs). Loans are taken up by these private partners and not accounted for as municipal debt. The real risk attribution is not always entirely transparent. The total value of municipal liabilities in relation to PPPs has been estimated to be around EEK 7.3 billion in 2006 (around a third of municipal own revenue). PPPs are duly reported in detail by municipalities in their annual financial reports, and lists of PPPs are placed on municipal websites (IMF, 2007b). The Estonian authorities have plans to reform the sub-national fiscal rule in order to reduce municipal deficits and to avoid circumvention. The general principle, also supported by the associations of municipalities, would be balanced budgets in the medium term, but with some flexibility from year to year. This would include investment expenditure. This is a sound principle that avoids national supervision of investment projects and borrowing that exists in many countries with golden rules (zero balance on current accounts). However, it does not eliminate the necessity for supervising the establishment of foundations and PPPs and for supervising guarantees. These forms of supervision need strengthening in Estonia.

The social security sector consists of two extra-budgetary funds: the Health Insurance Fund and the Unemployment Insurance Fund (see the relevant paragraph in Section 1.1). The funds are under the authority of independent boards but well integrated in the regular budget procedure (see Section 2.5).

The government holds ownership in 36 public enterprises, mainly in the energy and transportation sectors (*e.g.* railways, aviation, airports, seaports, etc.). In the 1990s, the government implemented an extensive privatisation programme. By 2000, the major privatisation activities had been completed. At the moment, there are no plans for further privatisation, except for a few road construction and maintenance enterprises that are being established as spin-offs of state agencies. The government recently re-purchased the railway due to problems with infrastructure development and maintenance.

4.6. Public procurement

Public procurement is regulated in the Estonian Public Procurement Act (PPA) which was passed in 2007 and replaced the old Procurement Act of 2001. The PPA complies with EU legislation. The present procurement institutions are designed with a view to optimal effectiveness and efficiency. With the adoption of the new Act, the Estonian public procurement system has been modernised and brought in line with international standards.

The Public Procurement Office (with a staff of 22) is an independent government agency under the Minstry of Finance. Its main task is to supervise public procurements. Furthermore, the Public Procurement Office advises contracting parties regarding the application of the PPA, disseminates information and evaluates the procurement performance of contracting authorities.

In addition to the Public Procurement Office, there is a Public Procurement Unit as part of the Public Governance Policy Department of the Ministry of Finance. The unit's main tasks are to draft legislation, to contribute to EU procurement policy development and to keep the Public Procurement Register. The register is a database of all procurements. All contracting authorities are required to submit their notices to the register and are responsible for the accuracy of information. The Public Procurement Unit advises contracting parties on issues within its mandate, co-operates with the Public Procurement Office on the drafting of legislation, and consults with the Public Procurement Office on issues relating to the interpretation of the PPA.

The Public Procurement Act established an independent Appeal Committee (four members) which has taken over the role of appeal authority from the Public Procurement Office. The members of the committee are appointed by the government. The decisions of the Appeal Committee can be challenged in the Administrative Court, which is a judicial body.

In 2006, 210 appeals were submitted compared to only 143 in 2007. This decrease can partly be explained by changes in law. Under the old law, the cost of submitting a complaint was rather low (EEK 100) and consequently the Public Procurement Office, which was then in charge of appeals, had to deal with numerous small complaints. Under the PPA, the fee for complaints has increased to EEK 10 000 (for contracts below the international threshold) and EEK 20 000 (for contracts above the international threshold).

The Public Procurement Act defines the thresholds and procedures. International thresholds are determined by EU directives and are renewed every two years:

- For goods and services:
  - ❖ if the contracting authority is a state authority: EUR 133 000;
  - ❖ if the contracting authority operates in the utility sector: EUR 412 000;
  - ❖ in other cases: EUR 206 000.
- For works: EUR 5 150 000.

National thresholds (starting in 2008) are defined by the Public Procurement Act:

- For goods and services: EUR 40 000.
- For works: EUR 250 000.

Under the PPA, for contracts below the national threshold (EUR 40 000) there are no obligatory procurement procedures but only notification requirements.[19] If a contract exceeds the national threshold, the tender has to be published in the Public Procurement Register, and the national procurement procedure as described in the PPA is applicable. If a contract exceeds the international threshold, the EU procurement procedure is applicable. This procedure is very similar to the national procedure, except that the deadline for submitting bids is longer.

In 2006, the total number of public procurement procedures was 8 874 and the total value of procurements was EEK 22 billion.[20]

4.7. Human resource management

Human resource arrangements are different for government agencies and the Defence Forces on the one hand and state agencies on the other. The Public Service Act determines the employment conditions (recruitment, remuneration, promotion and assessment) for the civil service, which includes the personnel of government agencies as well as municipal agencies. Employment conditions for state agencies are determined by the general labour law. Table 4 provides an overview.

Estonia has developed comprehensive policies and legislation for human resource management, which are in line with international standards.

Table 4. **Government personnel**

As at 1 January 2008

	Positions	Filled positions
Civil service (central government)		
Ministries	3 235	2 874
Boards and inspectorates	19 372	15 384
Other government agencies	4 507	3 596
Counties	908	822
Constitutional institutions	488	440
Defence Forces (as at 31 December 2006)	n.a.	2 987
Civil service (local government)		
Local government agencies	6 685	6 322
Labour law		
State agencies	60 874	57 635

The salary of civil servants consists of:

- basic salary (salary according to grade);
- additional remuneration provided by law (for years of service, academic degree, proficiency in foreign languages, processing state secrets);
- additional remuneration for performance of supplementary functions, and/or more effective performance.

In addition, civil servants receive some further benefits such as compensation of study loans.

The basic salary for civil servants is determined by a uniform set of scales for salary grades from 7 to 35. The gross salary corresponding to the grades and steps of the scales and the conditions for performance-related remuneration are established annually by a government decree.

The salary of the employees of state agencies is regulated by the Salary Act, which is applicable to every employment contract, as well as by a government decree applicable to government employees specifically. The salary scales are the same as those for the civil service.

4.8. Conclusion

Estonia has developed a modern electronic Treasury system, which functions efficiently and does not duplicate internal controls for which the budget holders bear responsibility.

In recent years, supplementary budgets have been submitted rather late in the fiscal year in order to authorise new spending packages against the background of higher-than-expected revenues. Possibly the goal of decoupling the spending package contained in the supplementary budget from the upcoming budget and presenting a tight budget for the upcoming year played a role in these policy choices. If Estonia were to move in the direction of a stable multi-annual framework, supplementary budgets should not be used for the conduct of regular budgetary policy, but only for real emergencies or regularisation of overspending on mandatory programmes.

According to the State Budget Act, 3% of current expenditures can be carried over to the following year. Capital expenditures can be carried over without limit. These restrictions on carrying over resources do not solve the problem of "December fever" and may create new problems. Experience in OECD countries suggests that the best designed carry-over rules are those that require negotiation with the Ministry of Finance in cases where spending before the end of the year would involve risks. The Minister of Finance can then decide to allow the carry-over and compensate the shifted resources in the next fiscal year from unused funds in that year, possibly in other ministries. In this way, the Minister of Finance can take the responsibility for ensuring that pools of unused funds do not swell over the years.

The Stabilisation Reserve Fund seems to function increasingly as the main saving vehicle of the Estonian government, where budget surpluses are invested now that public debt is almost entirely paid off.

The Ministry of Finance runs a modern and efficient system of cash and short-term debt management where idle cash reserves are kept to a minimum. The administration of the Single Treasury Account is outsourced to three commercial banks under a very efficient arrangement.

Estonia pays much attention to the governance structure of its public sector and the most effective and efficient institutional set-up for public service delivery. In recent years, there has been substantial decentralisation of service delivery tasks to the municipalities.

Financing arrangements for local governments have been put on a modern footing, but local revenue remains somewhat volatile, which hampers budgetary planning at the local level. The Estonian authorities should fix the distribution formula of the equalisation grant in substantive legislation.

The Estonian authorities have plans to reform the sub-national fiscal rule in order to reduce municipal deficits and to avoid circumvention. The general principle, also supported by the associations of municipalities, would be balanced budgets in the medium term, but with some flexibility from year to year. This would include investment expenditure. This is a sound principle that avoids national supervision of investment projects and borrowing that exists in many countries with golden rules (zero balance on current accounts). However, it does not eliminate the necessity for supervising the establishment of foundations and PPPs and for supervising guarantees. These forms of supervision need strengthening in Estonia.

With the adoption of the new Public Procurement Act, Estonia has modernised its public procurement system. The present procurement institutions are designed with a view to optimal effectiveness and efficiency. The Public Procurement Act is in line with international standards.

Estonia has developed comprehensive policies and legislation for human resource development, which are in line with international standards.

5. Accounting and auditing

5.1. Accounting

Accounts are kept by 1 500 accounting units attached to ministries and their agencies, municipalities and their agencies, foundations belonging to the general government sector, and public enterprises. Accounting data are reported to the Financial Control Department of the Ministry of Finance which is responsible for publication and dissemination of financial statements.

Since 2004, a system of IPSAS-based accrual accounting has been in use throughout the general government sector (International Public Sector Accounting Standards). The system provides data on assets, liabilities, commitments and payments, and provides a sufficient basis for internal audit. Smaller municipalities sometimes experience difficulties with the timely reporting of the relevant data.

In 2005, a one-off revaluation exercise took place in order to determine the value of in-kind assets of all agencies in general government. Valuation methods as well as amortisation rates for different types of in-kind assets are prescribed in the General Rules for State Accounting.[21]

The Ministry of Finance publishes quarterly financial statements which provide fairly detailed data on the financial accounts of general government four months after the reporting period. Furthermore, the Ministry of Finance publishes a consolidated annual financial report for general government that includes the budget execution report of central government. The annual report must be submitted to the National Audit Office before 30 June. Both the quarterly reports and the annual reports are based on the data from the accounting units and reconciled with data from the Treasury payment system. The reports are published on the website of the Ministry of Finance.

In 2008, the Ministry of Finance introduced monthly financial reporting. For that purpose, accounting units will report monthly accounting data to the Financial Control Department of the Ministry of Finance. The monthly reports will have at least the same level of detail as the present quarterly reports. In addition, they will contain accounting data by programmes and sub-programmes of the operational plans (so in fact anticipating a programmatic reclassification, see Section 2.5 above). From the perspective of a results-oriented budget process, it is important that the monthly reports also report on outputs as cost indicators, at least insofar as outputs are actually used to finance the services (see Section 2.5 above). The Ministry of Finance is also planning to introduce a mid-year report at the same level of detail as the present annual report.

In addition to the financial statements of the Financial Control Department, the Ministry of Finance publishes monthly cash-flow reports from the Treasury in a press release on the Internet. These reports follow the line-item classification of the budget, so that they provide a good insight of budget execution cash data. Daily data on cash transactions can also be accessed on the website of the ministry.

Financial reporting in Estonia is accurate and timely and in accordance with international standards. Particularly, the financial reporting practices score very high on transparency, as all important data are released on the website of the Ministry of Finance after only a short delay.

5.2. Internal audit

Internal audit procedures were introduced in Estonia in the year 2000. At present, all ministries and agencies of the central government have internal audit units, staffed by between 1 and 6 persons depending on the size and complexity of the agency and its financial administration. The background of internal auditors is often in law or in economics. Until now, there has been no certification system for internal auditors in Estonia.

The Ministry of Finance co-ordinates the work of internal audit units through its Internal Audit Department. This department is responsible for the internal auditing of grants from the EU structural funds, the development of internal audit methodology, and the training of internal audit staff. In addition, it produces an annual report on the development of the internal audit function and evaluations of internal audit performance throughout the central government. These reports are not published.

Audit units are independent from the financial and accounting units of the agencies. Audit units report directly to ministers or heads of agencies. They used to work according to guidelines developed by the Ministry of Finance but now they follow IPSAS standards. Internal audit reports are submitted to the National Audit Office. They are not published, which is in accordance with international practice and may contribute to the critical quality of their content. Internal audit units do provide public declarations of reliability on the accounts of the ministry or agency. These declarations may include critical comments on internal control procedures or on specific expenditures, and may include recommendations. Officials of the Internal Audit Department estimate that 70% of the recommendations of internal audit units are followed up.

Until now, internal audits have mostly been financial (compliance) audits. The Ministry of Finance intends to start internal performance audits in 2009. A training programme concerning performance auditing is being set up for internal auditors. Internal auditors are responsible to their ministers and agency heads but the Internal Audit Department can offer suggestions for audits. Recent suggestions have included procurements, grants to municipalities, and non-tax revenues of agencies.

The Concept Paper proposes that internal audit units should no longer be required to issue a declaration of reliability. Indeed, this task does not fit well into the mandate of internal auditors which is to advise the minister or agency head about risks and options for improvement. The Concept Paper proposal is sensible. In many OECD countries, internal audit units are not required to issue such statements. Checking reliability remains a task of the external auditor.

Furthermore, the Concept Paper proposes to develop further the legislation concerning internal audit, which at present does not adequately cover the role of internal audit. Among other things, the Cabinet would annually decide about priorities for internal audits, and the Minister of Finance – in addition to the line minister – would be given the authority to order internal audits in all programmes of the central government. In addition, the Cabinet would receive from the Minister of Finance an annual overview of internal audit findings, with a special focus on those that deal with various governing areas (horizontal issues). These are all excellent ideas and would, upon realisation, make Estonia a vanguard country in the EU in the area of internal audit.

5.3. External audit

External audit in Estonia is based on the National Audit Act 2004. The National Audit Office (NAO), headed by the Auditor-General, is in charge of external audit. According to the Constitution (Article 132), the NAO is an independent state body. The National Audit Act created a comprehensive and modern procedure for external audit.

On the recommendation of the President of the Republic, the Auditor-General is appointed by Parliament for a period of five years. The Auditor-General can be reappointed without limit and can only be removed from office by Parliament on the grounds of sustained incompetence or criminal activities. The NAO has a staff of 107 (including support staff), of which there are 60 auditors (as at 31 December 2007). Most auditors hold academic degrees in economics, law or public administration. They all have extensive experience in the public sector. Many auditors are licensed, but not all. About 25 auditors work on financial audits and 35 on performance audits. For specific tasks, the NAO may hire licensed auditors from the private sector. The staff turnover in the NAO is 14% each year, which is about normal. The detailed list of staff members with the office's structure is available on the NAO website, *www.riigikontroll.ee*.

The NAO is a constitutional body and, like all other constitutional bodies, submits its budget bids to the Ministry of Finance. But the National Audit Act provides special protection against downward adjustments in its budget. The salaries of NAO employees and performance bonuses, as well as experts' remuneration, are determined by the Auditor-General within the limits of the NAO budget.

According to the National Audit Act, the task of the NAO is to inform Parliament and the public on whether the government is using resources in accordance with the rules prescribed by law, whether the results have been achieved, and whether operational and reliable procedures have been created for their achievement. The NAO evaluates whether the state is operating economically, efficiently and effectively.

The NAO conducts both financial audits (compliance) and performance audits. In the last few years, the National Audit Office has produced 50 to 60 special audit reports in addition to the annual report. Of the special reports, 25 to 30 were performance audits.

The NAO covers the entire public sector, including legal persons in public law and their subsidiaries, non-profit institutions controlled by the state, companies in private law (largely) owned by the state or by a legal person in public law, and other legal persons performing administrative duties according to public law. At the local level, the NAO conducts only financial audits, particularly audits on the use of state property, grants from the state budget, or funds used for the performance of state functions, while other audits of local governments, including performance audits, remain the responsibility of the municipal councils. In practice, the National Audit Office has conducted from 10 to 15 audits on municipal financial management, usually on horizontal themes such as the remuneration of teachers, but in some cases on an individual municipality. Public enterprises are required to commission their own external audit reports with certified accountants, but these reports are subject to review by the NAO.

Apart from the annual report, the NAO decides on its own programme of work and is autonomous in the selection of the special audits it will pursue. The Finance Committee of Parliament can make suggestions for special audits (see Section 3.2 above).

The work of the NAO is based on international auditing standards, including those of the International Organization of Supreme Audit Institutions (INTOSAI). In practice, the work and activities of the NAO are not subject to interference by the government or by any other external authority. The NAO is free to decide on its audit approach and to report without restriction or interference. It has good access to all the records, persons, assets, premises and data, including information classified by the State Secret Act, that are required for the effective performance of its mandate and it has powers to enforce its rights. Critical assessments in audit reports are generally accompanied by recommendations to correct misleading or erroneous information in financial accounts or to improve inefficient or ineffective practices or policies. All audits are submitted to the government for comment before the final report is approved by the Auditor-General and published. Special audits can be published at any time of the year.

The National Audit Act requires the NAO to produce a consolidated annual audit report of the state. For that purpose, a draft consolidated annual financial report of the state is submitted by the Ministry of Finance to the NAO not later than 30 June. The annual NAO report audits the consolidated annual financial report of the state and gives an overview of the audit activities of the preceding year. Included is a statement on the use and preservation of state assets. A draft consolidated annual audit report is submitted to the government for comment. The final annual audit report is appended to the consolidated annual report of the state and submitted to Parliament not later than 31 August of the year following the fiscal year.

According to the National Audit Act (Article 51), the NAO is required to disclose each audit report except where the report contains information concerning a state or business secret or information subject to banking secrecy or if disclosure thereof is contrary to legislation in any other manner. In such a case, the NAO is required to disclose all parts of the report which can be disclosed. The NAO submits its reports, including the consolidated annual audit report, to Parliament and makes them publicly available through the NAO website.

The NAO also audits the annual reports of the constitutional institutions (except itself): the Chancellery of the Parliament, the Office of the President, the Chancellery of the Legal Chancellor, and the Supreme Court (Article 45 of the State Budget Act). The NAO audits the annual reports of constitutional institutions not later than 31 May of the year following the fiscal year.

The audit reports of the NAO are considered by the parliamentary State Budget Control Select Committee (see Section 3.2), but can also be considered by other parliamentary committees. The State Budget Control Select Committee consists of six members, three from parties of the government coalition and three from opposition parties. The Committee is chaired by a member of the opposition. Since the committee is a "special committee", its members also sit on other standing committees. The Committee meets every week in a session of up to two hours. The Committee holds about 15 public hearings on audit reports every year. Auditors from the NAO are usually invited to make presentations during the hearings. Government officials (either ministers or senior civil servants) are invited to about a third of the hearings. The Committee may submit written questions to the government, which should be answered within a month. The proceedings of the Committee are reported by a rapporteur to the speaker of Parliament. The proceedings may include promises of Cabinet members or government officials to make corrections in accounts or to adjust practices or policies. There is no other follow up on audit reports on the part of Parliament.

The NAO may follow up on its earlier audits by: *i)* sending letters to remind the authorities of earlier recommendations or to comment on the way earlier recommendations are implemented; *ii)* starting a follow-up audit on the same subject; and/or *iii)* reporting in the consolidated annual audit report. The latter report contains a chapter on the implementation of earlier recommendations. According to the annual consolidated audit report of 2006, approximately 25% of the NAO recommendations of that year were implemented fully or partly.

NAO officials stated that, in general, the quality of the government accounts is appropriate. The performance audits are generally more critical than the financial audits. The reason is that the performance management practices in the ministries are still being developed and are not yet fully effective. The NAO has also uncovered deficiencies in the transparency of budget procedures, mainly due to the discrepancy between the expenditure classification of the State Budget Strategy and the annual budget law. The NAO is generally satisfied with the response of the government to its recommendations, although a long time is often needed before corrective action is implemented. More energetic follow-up on the part of the government and closer supervision by the State Budget Control Select Committee on timely action would be welcomed by the NAO.

5.4. Conclusion

Financial reporting in Estonia is accurate and timely and in accordance with international accounting and transparency standards. Particularly, the financial reporting practices score very high on transparency, as all important data are released on the website of the Ministry of Finance after only a short delay.

In 2008, the Ministry of Finance introduced monthly financial reporting. The monthly reports will have at least the same level of detail as the present quarterly reports. In addition, they will contain accounting data by programmes and sub-programmes of the operational plans (so in fact anticipating a programmatic reclassification). From the perspective of a results-oriented budget process, it is important that the monthly reports also report on outputs as cost indicators, at least insofar as outputs are actually used to finance the services.

Beginning in 2000, Estonia has developed internal audit procedures in accordance with international standards. The Ministry of Finance co-ordinates the work of internal audit units through its Internal Audit Department. That department is also in charge of the further development of internal audit in the government sector. Given that the procedures and capacities had to be built up almost from scratch, this progress is impressive. Until now, internal audits have mostly been financial audits. The Ministry of Finance intends to start internal performance audits in 2009.

The Concept Paper proposes that internal audit units should no longer be required to issue a declaration of reliability. Indeed, this task does not fit well into the mandate of internal auditors which is to advise the minister or agency head about risks and options for improvement. The Concept Paper proposal is sensible. Checking reliability remains a task of the external auditor. In many OECD countries, internal audit units are not required to issue such statements.

The Concept Paper also proposes to develop further the legislation concerning internal audit, which at present does not adequately cover the role of internal audit. Among other things, the Cabinet would annually decide about priorities for internal audits, and the Minister of Finance – in addition to the line minister – would be given the authority to order internal audits in all programmes of the central government. In addition, the Cabinet would receive from the Minister of Finance an annual overview of internal audit findings, with a special focus on those that deal with various governing areas (horizontal issues). These are all excellent ideas and would, upon realisation, make Estonia a vanguard country in the OECD in the area of internal audit.

Estonia has a well-designed and up-to-date National Audit Act. The National Audit Office is legally and factually independent. It is sufficiently staffed and well organised. Its mandate is comprehensive. Its work methods are in accordance with international (INTOSAI) standards. The NAO sees the discrepancy between the expenditure classification of the State Budget Strategy and the annual budget law as a problem for the transparency of the budget and for effective performance assessment. The NAO is generally satisfied with the response of the government to its recommendations, although a long time is often needed before corrective action is implemented. More energetic follow-up on the part of the government and closer supervision by the State Budget Control Select Committee on timely action would contribute to the effectiveness of the work of the NAO.

Notes

1. The average population of EU countries is growing at a rate of 0.4 to 0.5% annually because of the age structure of the population, immigration and increasing life expectancy. Since the beginning of the 21st century, life expectancy at birth in Estonia has increased by two years but it is still 8.5 years behind the European average for men, namely at 66.9 years, and 3.8 years behind the average for women, namely at 78.2 years (Republic of Estonia, 2007a).
2. The introduction of the euro was originally planned by the Estonian authorities for 1 January 2007. On 27 April 2006, the planned data of euro adoption was postponed to 1 January 2008. On 30 November 2006, the Estonian government decided that, due to uncertainty related to inflation developments, for the time being no new target date would be set for the introduction of the euro (Republic of Estonia, 2007b).
3. Price inflation calculated by consumer prices excluding some sectors with volatile price movements (particularly energy and food).
4. The IMF has advocated to moderate planned tax relief in order to contain demand pressures. Furthermore, it has recommended a surplus of 2-3% of GDP on average in future years. The Estonian authorities considered it politically unfeasible to refrain from planned tax relief and to target such large surpluses.
5. With the exception of 2001 when there was a small deficit.
6. Formally the core ministry is also an agency in the sense of the Government of the Republic Act.
7. Contrary to common perception, outputs are often used to finance services and to estimate their costs, even in traditional budgets based on an economic classification. This applies for instance to social services, education, road construction, prisons, etc.
8. For instance, France, the Netherlands, New Zealand, the United Kingdom.
9. If the organisational structure itself is not logically aligned to existing policy structures and legislation, it is recommended to first change the organisational structure and only secondly the programme classification.
10. Programme evaluation is aimed at the improvement of the efficiency and effectiveness of a sectoral programme, given available resources. Programme evaluation in this sense is different than spending review, which is aimed at priority setting between programmes. The latter typically has to be under the responsibility of the Minister of Finance. For (plans for) spending review in Estonia, see Section 2.4 above.
11. End August would make it possible for the budget bids to have an impact on the decisions on the totals. However, after the totals are decided, they should be enforced rigorously.
12. On the other hand, the Ministry of Finance is represented in the Boards of each of the funds.
13. The United States uses accruals for credit transactions, some employee pension costs and interest on public debt.
14. This argument is sometimes supported by the consideration that, in government, the distinction between investments and durable consumer goods is hard to make, but the argument can also stand on its own.
15. Appropriations amounting to EEK 2.9 billion (1.4% of GDP) were transferred from 2005 to 2006, and appropriations amounting to EEK 4.6 billion (1.9% of GDP) were transferred from 2006 to 2007.
16. The SRF has the characteristics of what today is called a sovereign wealth fund.
17. Until October 1993, a two-tier system was in force with regional (15 counties and 6 republican cities) and municipal levels. In 1994, the regional level was abolished and counties became executive agencies of the central government. The county governors are accountable to the central government and have supervisory and advisory functions in relation to the municipalities.

18. The number of municipalities has declined from 247 in 2001. The central government initiated a special merger grant in 2004 to motivate small local governments to merge, but this policy has not been effective.
19. Under the old law, there were additional thresholds for simplified procedures.
20. These numbers include procurements with simplified procedures which no longer exist. Simplified procedures have been replaced by publication requirements. For this reason, these numbers cannot be compared to the numbers of later years.
21. Regulation of the Minister of Finance No. 105 of 11 December 2003, amended in 2004, 2005, 2006 and 2007.

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