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**Fiscal Design Across Levels of Government
Year 2000 Surveys**

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GENERAL INTRODUCTION TO THE SURVEY

In accordance with decisions made by the “Fiscal Decentralisation Initiative for Central and Eastern Europe” (FDI), the OECD has initiated surveys on fiscal decentralisation for the purpose of providing international comparisons on the design of fiscal systems across levels of government.

FDI is a joint initiative of the OECD, the World Bank, the Council of Europe, the Open Society Institute, UNDP, USAID and OECD Member countries to assist transition economies in Central and Eastern Europe in carrying out intergovernmental reforms. The main objectives of the Initiative are: to encourage local democracies to improve the capacity of local governments to plan and administer expenditures and raise revenues; and to support local governments in their efforts to become more responsive and accountable to their constituencies.

Thereby the survey has been written in response to a questionnaire designed by the OECD and follows the structure outlined in the questionnaire.

The survey specifically indicates the state of the following fiscal decentralisation issues:

- The design of fiscal systems.
- The profile of sub-national revenues.
- The profile of sub-national expenditures.
- The match between locally-managed expenditures and the corresponding revenues.
- The institutional arrangements for ensuring fiscal discipline and budgetary constraints.
- The design of intergovernmental fiscal relations.

The surveys in 2000 took place in six countries in Central and Eastern Europe: three OECD Member countries - the Czech Republic, Hungary and Poland - and the three Baltic states - Estonia, Latvia and Lithuania.

The survey was carried out between April 2000 and January 2001.

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1. EXECUTIVE SUMMARY

1.1 Main features of local finance and intergovernmental relations

The basic provisions concerning local government level in Estonia are laid down by the Constitution of 1992. The Constitution recognises the principle of local government and states that all local issues shall be resolved and managed by local authorities, which shall operate independently pursuant to law.

Estonia is currently divided into 247 local government units. Estonia has had a one-tier local government system since 1994. Among the 247 local governments, there are 42 towns and 205 rural municipalities. Towns and rural municipalities are equal in their legal status.

As there is no regional government level in Estonia, the co-operation of municipalities within a county is of great importance to municipalities both in their relations with central authorities and in co-ordinating their own activities. Local authorities have a constitutional right to form associations or establish joint institutions. Associations of local authorities within counties carry out tasks set by the central government as well as by local authorities.

The basic functions of local government include the organisation of social services, welfare services for the elderly, housing and utilities, the water supply and sewerage, the provision of public services, physical planning, public transport, and the maintenance of local roads and streets. Local authorities maintain pre-school childcare institutions, primary and secondary schools, libraries, community centres, museums, sports facilities, shelters, care homes, health care institutions and other agencies and institutions founded and/or owned by the local government.

Most local government responsibilities are full and exclusive, but there are some tasks shared between the municipalities and the central government. In addition to local functions, municipalities carry out a few central government administrative tasks which can be passed on to local authorities by a contract between an authorised central government body and a specific local government unit.

1.2 Major empirical findings

In Estonia, general government revenues consist mainly of taxes – the share of taxes is approximately 90%. The Estonian tax system has been relatively stable since 1994. The share of local government revenues in general government revenues has been above 20% during recent years. Personal income tax – 56% of which is local government revenue – amounts to about 60% of local government total revenues.

Amongst taxes, land tax also forms quite a significant share. With regard to local government non-tax revenues, property income and sales have traditionally been important. In Estonia, local governments rely somewhat on grants from central governments but not very much – the share of these has been 22-23% of local government total revenues, over the last few years.

Personal income tax constitutes, on average, ninety-one percent of the total tax revenue paid to municipal budgets. There are considerable differences in the income per capita between municipalities. The receipts from personal income tax per capita differed by about 11 times between the richest and poorest municipalities, in 2000. The trend is for income to grow faster in those municipalities which are located closer to Tallinn.

Revenue from local taxes only represents a small share of the local budget. The total proportion of municipal taxes does not exceed one percent of local government revenues. Several taxes have not been imposed by any of the local authorities during the last few years and thus remain only theoretical.

There is no special regulation for local government non-tax revenues. The most considerable part of non-tax revenues comes from the so-called own revenues, which are used by the institutions collecting these. Although most of the own revenues have been included in the budget there are still some local governments which do not show all of their revenues in the budget. By law, all revenues should be included in the budget.

The financial resources allocated from the central government budget for the support of local budgets are called the Support Fund. The amount of the support fund in a draft central government budget, and its distribution, are determined during the negotiations between the representatives of the associations of local authorities and the Government of the Republic. There have been lots of ideas lately on changing the principles for the distribution of the support fund. There have been discussions to increase the importance of local taxes and on taking more precisely into account the expenditure needs of local governments distributing the support fund.

In addition to the Support Fund, there are allocations intended for specific purposes. The number of specific grants is changing from year to year. Local authorities also fulfil several tasks which are, in principle, the ones of central government but can be executed more effectively by municipalities. The funds for financing these tasks are transferred to local budgets through the budgets of ministries.

1.3 Major problems in the fiscal design

Local government expenditure has made up about 20% of general government consolidated expenditure in recent years. Most of local government expenditures have been made in education – about 40% of total expenditures. Since the beginning of 2001, the importance of local governments has been growing, in this regard, as the Estonian government has decided to move all costs of primary and secondary schools over to the responsibility of local governments. This sees the share of local educational expenditures grow to more than 50% of total local expenditures.

Altogether, there are hundreds of local functions, most of which have to be carried out by all local governments. Certainly there are differences in the costs of covering these functions, based on more or less objective reasons. But because, on one hand, no comprehensive analysis has been done, and, on the other, not a single local government admits that financing is high enough, it is hard to speak about efficiency and effectiveness in municipalities.

In general, the differences in costs are not very big. One exception is certainly in general public services. Expenditures on these services represent around half of total current expenditures in the smallest local governments, whilst the average is only about 13%. Of course, the size of government is crucial in other spending areas, as well, but this is not so clear as in general public services. In education, for example, even people in the smallest local governments are used to having their “own” schools.

There have been thoughts on mapping the functions of local governments for some years, already. At least this would help to find out what the exact tasks of local governments are, and what the costs of fulfilling these tasks have been. In practice, nothing has been done so far.

The general government deficit and the official debt burden have been relatively small in Estonia. Similarly to general government, the local government budget has been close to balanced – even though always in slight deficit over recent years. Accordingly, gross debt has been at the very low level of about 2.5% of GDP, and net debt at around 1.5-2% of GDP. Central government has, in few cases, helped local governments in debt by providing them with additional loans, and only one municipal government has been bailed out so far. In this regard, no uniform regulation has been worked out yet.

1.4 Status of policy reform consideration

During recent years, no finance reforms have been carried out in Estonia. Discussions are held on the necessity of financial, territorial and organisational reforms in the field of local government. As a part of natural development, sixteen local government units have amalgamated into eight units and one local government unit has been divided into two, recently. Since 1996, no changes in the local government budget formation have been carried out.

There is some evidence that smaller local government units have smaller administrative capacity in the level of public service provision and infrastructure conditions. A lot of research has been carried out on the local government socio-economic situation. They state under-performance of some local government tasks in some smaller municipalities, mainly due to scarce financial resources. Some local government units have been faced with problems in fulfilling their financial duties e.g. in relation to the burden of loans on the budget, or buying public services from other municipalities.

In order to improve local administrative capacity, an administrative reform is being prepared in Estonia. There is political consensus on the fact that reforms to improve the efficiency and administrative capacity of local government units are necessary. There is an unavoidable need to reduce the number of local governments. It is obvious that almost all functions are relatively more expensive in smaller local governments. However, this does not necessarily mean that bigger ones are more effective.

At the same time, central government is planning a reform whereby additional tasks will be delegated to the local level of government to order the division of tasks between central and local government. The additional tasks will have to be financed from the central government budget. Central government will affect local expenditure by determining the mechanism for financing the additional tasks. Also, the central government is planning a reform of the mechanism of local government budget equalisation.

The reforms are still under discussion and no final political decisions have been taken yet.

2. THE TECHNICAL FRAMEWORK – CLASSIFICATION OF LEVELS OF GOVERNMENT AND ECONOMIC TRANSACTIONS

2.1 Classification of levels of government and economic transactions

2.2 Development of gross domestic product

Table 2.1 Gross domestic product, 1997-1999. Market prices

	GDP (EEK millions)
1997	64,324
1998	73,325
1999	75,360

2.3 Design of the country reporting

Estonia is a parliamentary republic. According to the Constitution, the parliament, *Riigikogu*, is the legislative body of the Republic of Estonia. The head of the state is the president who is elected by the parliament or by an electoral body, if necessary. The electoral body consists of members of the *Riigikogu* and representatives of the local governments. The supreme executive power is vested in the Government of the Republic consisting of 15 ministers (including the prime minister). The Prime Minister is the head of the Government and is presented by the president to parliament and is authorised by parliament.

In accordance with the Local Government Organisation Act and the Territory of Estonia Administrative Division Act, Estonia is divided into 15 counties and 247 local government units. Estonia has had a one-tier local government system since 1994. Towns and rural municipalities are the units of local government. Towns and rural municipalities are equal in their legal status. All municipalities are part of a county. Among the 247 local governments, there are 42 towns and 205 rural municipalities. During recent years, sixteen municipalities have amalgamated into eight.

Towns and rural municipalities may be divided into municipal districts (with a limited right to self-government) in order to carry out public services.

The size of local government units is very different (see Table 2.2). The biggest towns in Estonia, by population, are Tallinn (411,594) and Tartu (100,577). The smallest municipality is Ruhnu, a rural municipality on the island of Ruhnu, with 72 inhabitants (1st January, 1999).

Counties as the intermediate level are part of central government administration in the regions. There are no directly elected bodies on the regional level. There are, however, regional co-operation units of local governments within every county.

The county governor represents the central government and implements its policy at the regional level. The Government of the Republic appoints the county governor to office after approval by local government representatives. County administration serves as the administrative apparatus of the county governor. There are 15 county governors in Estonia. Until 1993, there were county self-governments with elected councils but they were abolished by the new Local Government Organisation Act.

Table 2.2 Municipalities by size, 1999

Number of inhabitants	Number of municipalities	Proportion of municipalities	Proportion of the whole population in municipalities within the population range (%)
– 999	25	10	1
1 000 – 1 999	96	39	10
2 000 – 4 999	88	36	19
5 000 – 9 999	22	9	10
10 000 – 49 999	11	4	12
50 000 – 99 999	3	1	12
>100 000	2	1	36

In accordance with the Government of the Republic Act, the county governor fulfils the following tasks amongst others:

- co-ordination of the co-operation between the regional offices of ministries and other agencies of executive power and local governments in the county;
- giving his or her opinion on the appointment to and release from office of the heads of regional offices of ministries and other agencies of executive power located in the county.

As there is no regional government level in Estonia, the co-operation of municipalities within a county is of great importance to municipalities both in their relations with central authorities and in co-ordinating their own activities. Local authorities have a constitutional right to form associations or establish joint institutions. The formation of associations is specified in the Local Government Organisation Act.

Associations of local authorities within counties carry out tasks set by the central government as well as by local authorities. Tasks set for the associations by central authorities are the evaluation of higher officials of administrative agencies in the municipalities of a county and the officials of the bureau of the local government association in the county (except the head of the bureau); concordance of national planning policy statements and making a proposal to the county governor for the distribution of the regional support fund between the municipalities of a county. Tasks set by member municipalities range over a variety of fields. The associations exercise construction supervision, co-ordinate public transport within a county, participate in the drafting of county development plans, are engaged in the development of the use of information technology, provide technical and legal advice, promote tourism, arrange inner-county cultural and sports events, participate in educational projects, etc.

The advantage of inter-municipal co-operation is having the flexibility to co-operate in any field and through several types of co-operation (buying a service from another municipality, hiring a common expert or specialist, founding profit and non-profit associations). Inter-municipal co-operation is dynamic and

flexible because it can be evaluated and adjusted within a reasonable length of time after changes in the external framework e.g. new laws, new technology, new actors, new demands.

The disadvantages of inter-municipal co-operation are connected to paying for the services provided and, occasionally, the lack of willingness to co-operate, even in cases where co-operation is more efficient than a single local government unit providing the service .

There is no comprehensive analysis indicating and evaluating the volume of inter-municipal co-operation.

In all the 15 counties, there is an association of local authorities. In 13 counties, the association unites all of the municipalities of the county. In two counties, Pärnu and Harju, some municipalities are not members of the association. In addition, the municipalities of Pärnu county are divided into two regional associations.

There are three national associations of local authorities in Estonia:

- Association of Estonian Cities (established in 1920);
- Association of Estonian Rural Municipalities (established in 1921);
- Union of Estonian Associations of Local Authorities (established in 1993).

The basic functions of the national associations are the representation and protection of local government interests and participation in the legislative process concerning local authorities. In 1994, a joint body of the three associations was formed -- the Co-operation Assembly of Associations of Local Authorities -- in order to conduct negotiations with central government and provide co-ordination between member associations.

3. GOVERNMENT FINANCE STATISTICS ON SUB-NATIONAL GOVERNMENTS

3.1 Sub-national revenue

The total revenue of general government amounted to 39.1% of GDP in 1997, 36.8% in 1998, and 35.4% in 1999 (see Table 3.1 Total revenue by levels of government). In other words, the growth of general government revenues has been slower than the growth in GDP. Nominal growth in revenues was 7.4% in 1998 compared to the previous year, and there was a decrease of 1.3% in 1999. The trend has been downwards due to a slowdown in economic activity in 1998, and economic recession in 1999.

General government revenues consist mainly of taxes– the share of taxes is approximately 90%. This means that the decline in revenues has mainly resulted from changes in taxes. The tax burden is due to be lowered further, in the near future. Until 1999, the reason was economic slowdown but from 2000 onwards, political reasons have been behind this – the current government of Estonia declares that the private sector share should be increased.

The Estonian tax system has been relatively stable since 1994 when proportional income tax and a single social security contribution were introduced. After that, the main changes have been as follows: (a) tax-free income of physical persons has been increased, step by step; (b) corporate income tax on re-invested profits was abolished, in 2000; (c) excise rates have been increased regularly, to be more in line with EU rates; (d) customs duties were introduced in 2000. Since the share of non-tax revenues is a relatively small part of total revenues, the changes in these have no relevant impact on Estonian fiscal policy.

The share of central government revenues is between 55% and 60% of general government consolidated revenues in Estonia. The main revenue sources of central government are VAT, personal and corporate income taxes, excises, fees and penalties. The revenue share of social security funds is around 35% of general government consolidated revenues.

The share of local government revenues in general government revenues was 20% in 1997 and 1998, and 22% in 1999. The figure increased because personal income tax was not affected by economic recession as much as some other revenue items. Personal income tax – 56% of which is local government revenue – amounts to about 60% of local government total revenues, and is the main source of funding for local expenditures. Amongst taxes, land tax also forms quite a significant share.

With regard to local government non-tax revenues, property income and sales have traditionally been important. In Estonia, local governments rely somewhat on grants from central governments but not very much – the share of these has been 22-23% of local government total revenues, over the last few years.

Table 3.1 Total revenue by level of government, 1997-1999 (EEK millions)

	Central Government			Social Security Funds			Local Government			General Government (Consolidated)		
	1997	1998	1999	1997	1998	1999	1997	1998	1999	1997	1998	1999
Tax Revenue												
1000 Taxes on income, profits & capital gains	3544	4676	4509				2924	3478	3661	6468	8154	8170
2000 Social security contributions				7735	8876	8923				6427	7454	7257
3000 Taxes on payroll and workforce												
4000 Taxes on property	9180	9300	9203				296	327	347	194	219	288
5000 Taxes on goods and services							25	29	29	9205	9329	9232
6000 Other taxes										0		
Total Tax Revenue	12724	13976	13712	7735	8876	8923	3245	3834	4037	22294	25156	24947
Non-tax revenue												
Oper. surpl. of dept. enterpr. & prop. Income	659	381	279	22	76	20	211	228	215	885	647	484
Fees, sales, fines	789	805	856			11	273	270	312	1062	1075	1179
Contr. to govt. employee pension funds												
Other Non-tax revenue	498	30		221	52	19	162	28	11	881	110	30
Total Non-Tax Revenue	1946	1216	1135	243	128	50	646	526	538	2828	1832	1693
Grants				1031	1403	362	1132	1302	1328			
Total Revenue	14670	15192	14847	9009	10407	9335	5023	5662	5903	25122	26988	26640
Tax revenue as % of GDP	19.78%	19.06%	18.20%	12.03%	12.11%	11.84%	5.04%	5.23%	5.36%	34.66%	34.31%	33.10%
Sub-national tax revenue as % of total tax revenue												

3.1.1 Tax revenue

Taxes on income, profits & capital gains are as follows (see Table 3.2 regarding local taxes):

- personal income tax – the revenue split is fixed by the Income Tax Act.; it may be unilaterally changed by a proposal of central government, however, before the government proposal goes to parliament, it must be negotiated between authorized representatives of local authorities and their associations and the government;
- sales tax – the municipality sets the tax rate within limits given by law; it has not been imposed by any of the local authorities during the last few years.

Taxes on property are as follows:

- land tax – the municipality sets the tax rate within limits given by law;
- motor vehicle tax – the municipality sets the tax rate within limits given by law;
- boat tax – the municipality sets the tax rate within limits given by law;
- animal tax – the municipality sets the tax rate within limits given by law.

Taxes on goods and services are as follows:

- advertisement tax – the municipality sets the tax rate within limits given by law;
- road and street closure tax – the municipality sets the tax rate within limits given by law;
- entertainment tax – the municipality sets the tax rate within limits given by law; it has not been imposed by any of the local authorities during the last few years;
- gambling tax – the revenue split is fixed by the Gambling Tax Act; it may be unilaterally changed by a proposal of central government.

Table 3.2 Classification of taxes of sub-central government. Local government, 1997-1999 (EEK millions)

Category	1997						Total a-e		
	a	b	c	d.1	d.2	d.3		d.4	e
1000 Taxes on income, profits & capital gains						2924			2924
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property		296							296
5000 Taxes on goods and services		21				4			25
6000 Other taxes									
Total	0	317	0	0	0	2928	0	0	3245
(% distribution)	0.00%	9.77%	0.00%	0.00%	0.00%	90.23%	0.00%	0.00%	100.00%
1998									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains						3478			3478
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property		327							327
5000 Taxes on goods and services		25				4			29
6000 Other taxes									
Total	0	352	0	0	0	3482	0	0	3834
(% distribution)	0.00%	9.18%	0.00%	0.00%	0.00%	90.82%	0.00%	0.00%	100.00%
1999									
Category	a	b	c	d.1	d.2	d.3	d.4	e	Total a-e
1000 Taxes on income, profits & capital gains						3661			3661
2000 Social security contributions									
3000 Taxes on payroll and workforce									
4000 Taxes on property		347							347
5000 Taxes on goods and services		25				4			29
6000 Other taxes									
Total	0	372	0	0	0	3665	0	0	4037
(% distribution)	0.00%	9.21%	0.00%	0.00%	0.00%	90.79%	0.00%	0.00%	100.00%

3.1.2 Non-tax revenue

3.1.3 Inter-government financial relations – grants

General-purpose grants have the nature of support funds and regional support funds, both of which are transfers from the central government budget (see Table 3.4).

Specific grants are special purpose subsidies from the state budget and extra-budgetary funds, which are transferred to local budgets through the budgets of ministries or funds, respectively.

Specific grants used for investments are not included in Table 3.4.

Table 3.4 The profile of central grants to local governments, 1997-1999 (EEK millions)

Year	Specific Grants			General Purpose Grant		Total	
	Current			Objective criteria			Discretionary
	Conditional		Not Conditional	Without own tax effort	With own tax effort		
	Standard Costs	Actual Costs					
1997	403			729		1132	
1998	559			743		1302	
1999	534			794		1328	

3.2 Sub-national expenditure

3.2.1 Current expenditure by function and level of government

In Estonia, general government total current expenditure as a share of GDP grew from 33.3% in 1997 to 36.2% in 1999 (see Table 3.6). The relative growth was especially fast in 1999 – in the framework of economic slowdown and parliamentary elections, expenditure increased quite significantly in most areas. Total expenditure real increase amounted to 8.4% in 1998 compared to the previous year (GDP real growth being 4.7% for the same period) and to 5.2% in 1999 (while GDP decreased by 1.1% in real terms).

The current Estonian government intends to diminish the share of general government expenditure in GDP, aiming at a balanced budget and lower importance of the government sector in order to promote the development of market forces. The Government's Fiscal Strategy for 2000-2004 states that its aim is "... to reduce general government expenditure ... and simultaneously raise the quality and efficiency of the government's spending". As a result, general government expenditure is declining in real terms in 2000 and 2001.

Out of general government total current expenditure, 60-65% is spent on social affairs i.e. on education, health, social security and welfare. This is followed by other sectors like general public services, public order and safety, recreational, cultural and religious affairs, transportation and communication, each one representing 5-7% of total expenditure. This leaves 10-15% for all other areas.

The expenditures of central government and social security funds form about 87% of general government consolidated expenditure over the years. It has the main responsibility (where local governments are spending substantially less, relatively) in sectors like defense, public order and safety, health, social security and welfare, agriculture, forestry, fishing and hunting, transportation and communication.

Local government expenditure has made up about 20% of general government consolidated expenditure in recent years. (As central government and social security funds are spending 87%, this leaves approximately 7% of general government expenditure for transfers between central government and local governments.) Local government has the main responsibility in sectors like housing and community amenities, fuel and energy.

Until 2000, most of local government expenditures have been made in education— about 40% of total expenditures. This represents almost half of general government spending on education. Since the beginning of 2001, the importance of local governments has been growing, in this regard, as the Estonian government has decided to move all costs of primary and secondary schools over to the responsibility of local governments (these additional tasks are financed through transfers from central government - at least at the beginning). This sees the share of local educational expenditures grow to more than 50% of total local expenditures. Other important local government expenditure areas are: general public services (about 13% of total expenditures), social security and welfare (12%), housing and community amenities (10%), recreational, cultural and religious affairs (9%).

3.2.2 Expenditure indicators by the three most important policy sectors

The three most important local government policy sectors are: (a) pre-primary, primary and secondary education (it is not possible to distinguish primary and secondary education; as mentioned in Chapter 3.6, the importance of this sector has been increasing since central government gave it additional tasks); (b) social security (consists mainly of subsistence benefit, almost all of which is financed from the central government budget); (c) sanitary affairs and services (see Table 3.7).

Spending on pre-primary, primary and secondary education has been quite stable over the years – about 29% of local government total expenditure. But as a share of the respective general government expenditure, it has fallen from 56% in 1997 to 52% in 1999. This is mainly due to the relatively rapid increase in teachers' salaries, which have been paid from the central government budget until now. Nothing of the expenditures in question has been covered by specific grants until now, either. About 6.5% of expenditures on pre-primary, primary and secondary education has been covered by non-tax revenues, i.e. so-called own resources.

Social security expenditures jumped from 7.3% in 1997 to 9.2% in 1998 as a share of total local expenditures, and from 5.0% to 6.3% as a share of general government social security expenditures, and dropped to the same level in 1999 as in 1997. The reasons behind this fluctuation were that: (a) until 1997 (inclusive), not all subsistence benefits were paid through local government budgets, and (b) in 1999, subsistence benefit was sharply cut as part of the hard budget constraints. Almost 90% of social security spending is covered by specific grants from central government but nothing is covered by non-tax revenues.

In Estonia, sanitary affairs and services are only a matter for local governments and not of central government. This is due to a higher awareness of those needs at a local level. The sanitary expenditures have been between 6.5 and 8 percentage of total local expenditures. There was a relative decline, in 1998, but nominally the expenditures were left almost at the same level. No part of expenditures on sanitary affairs and services is covered by specific grants or non-tax revenues.

Table 3.6 Current expenditure by function and level of government, 1997-1999 (EEK millions)

		Central Government and Social Security			Local Government			General Government (Consolidated)		
		1997	1998	1999	1997	1998	1999	1997	1998	1999
1	General public services	970	980	1326	586	661	725	1455	1531	1931
2	Defence	869	857	632	1	1	1	870	858	630
3	Public order & safety	1524	1458	1979	24	20	19	1541	1476	1996
4	Education	1952	1920	2575	1790	2006	2191	3488	3641	4449
5	Health	3155	3832	4201	57	59	66	3203	3889	4265
6	Social Security & Welfare	6569	7385	8656	509	672	672	6759	7621	8962
7	Housing & community amenities	5	10	13	424	473	556	429	483	569
8	Recreational, cultural & religious affairs	839	963	770	367	447	485	1161	1352	1195
9	Fuel & energy	9	2	5	109	78	52	118	80	52
10	Agriculture, forestry, fishing & hunting	758	1290	625	4	4	4	715	1244	629
11	Mining, manufacturing & construction, except fuel & energy									
12	Transportation & communication	892	1083	1327	198	234	295	1082	1301	1603
13	Other economic affairs	183	165	163	87	114	91	249	261	231
14	Other functions	971	2075	1582	233	217	207	334	1377	771
15	Total current expenditure	18696	22020	23854	4389	4986	5364	21404	25114	27283
16	Total current government expenditure. % of GDP	29.07%	30.03%	31.65%	6.82%	6.80%	7.12%	33.28%	34.25%	36.20%

Table 3.7 Expenditure indicators by the three most important policy sectors. Local government, 1997-1999

	4.1 + 4.2 Pre-primary, primary and secondary education			6.1 Social security			7.3 Sanitary affairs and services		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Local expenditure (on policy sector), EEK millions	1285	1419	1541	320	456	408	347	326	370
	%	%	%	%	%	%	%	%	%
Local expenditure (on policy sector) as a proportion of total local expenditure	29.28	28.46	28.73	7.29	9.15	7.61	7.91	6.54	6.90
Local expenditure as a proportion of total government expenditure on (policy sector)	56.09	54.26	52.26	5.03	6.33	4.84	100.00	100.00	100.00
Local and regional expenditure (all subnational expenditure on the policy sector in question) as a proportion of total government expenditure on (policy sector)	56.09	54.26	52.26	5.03	6.33	4.84	100.00	100.00	100.00
Proportion of local expenditure (on policy sector) covered by specific grants	0.00	0.00	0.00	89.69	87.28	87.25	0.00	0.00	0.00
Proportion of local expenditure (on policy sector) covered by non-tax revenues	6.69	6.69	6.49	0.00	0.00	0.00	0.00	0.00	0.00

4. EVALUATIONS ON SUB-NATIONAL AUTONOMY AND NATIONAL FISCAL CONSTRAINTS

4.1 General presentations of the sub-national government system. Summary on government finance reform policies

4.1.1 Sub-national government system

The basic provisions concerning local government are laid down by the Constitution of 1992. The Constitution recognises the principle of local government and states that all local issues shall be resolved and managed by local authorities, which shall operate independently pursuant to law.

The Constitution enumerates the financing and functions of sub-national governments, as follows:

- only an act of Parliament or an agreement with the local authority may impose compulsory tasks on local government;
- expenditure related to the tasks of central government imposed by law on local government are to be financed by the state budget;
- local authorities may have independent budgets;
- local authorities have the right, according to law, to levy and collect local taxes and to impose duties;
- local authorities have the right to form associations and joint agencies with other local governments.

The major spheres of local government are regulated – within the limits of the Constitution – by laws. The most important laws are:

- The Local Government Organisation Act determining the functions, responsibilities and organisation of local authorities and the relations of municipalities with one another and with central government.
- The Territory of Estonia Administrative Division Act which determines the division of the territory of Estonia into counties, cities and rural municipalities, also regulating the procedure for the alteration of boundaries, the change of the name of local authorities, etc.
- The Local Government Council Election Act regulates the procedure for local elections.
- The Rural Municipality and City Budgets Act, and Rural Municipality and City Budgets and State Budget Correlation Act determine the procedure for the preparation, passage and implementation of rural municipality and city budgets.
- The Local Taxes Act enumerates local taxes providing the procedure to impose and collect them.

While the Local Government Organisation Act determines the fields of responsibility of local governments, the tasks are more specifically regulated by special laws.

Statutory regulations of the central government, passed on the basis of laws, regulate the fields more specifically.

The annual budget determines the allocations for general and specific (including municipal investment) purposes from central to local budgets. Both the allocation mechanism and the sums are determined annually by the budget.

Local government councils have the right to issue local regulations on the basis of their own law-making authority.

The basic functions of local government include the organisation of social services, welfare services for the elderly, housing and utilities, the water supply and sewerage, the provision of public services, physical planning, public transport, and the maintenance of local roads and streets (see Table 4.1). Local authorities maintain pre-school childcare institutions (kindergartens), primary and secondary schools, libraries, community centres, museums, sports facilities, shelters, care homes, health care institutions and other agencies and institutions founded and/or owned by the local government.

Most local government responsibilities are full and exclusive, but there are some tasks shared between the municipalities and the central government. The latter can be exemplified by the function of health care where the main responsibility lies with the central government (financed through the Health Insurance Fund) but where municipalities cover the communal costs of family physicians. Basic education is also the responsibility of local governments. Until the end of 2000, teachers salaries were covered by the central government, after that it is the function of local government wholly.

In addition to local functions, municipalities carry out a few central government administrative tasks which can be passed on to local authorities by a contract between an authorised central government body and a specific local government unit. Contracts have been established between central government and local governments to partially fulfil central government functions in the fields of, for example, keeping records of people required to serve in the Defence Forces, and in the rescue service, and population registration and administration of several other databases. The number of central government tasks performed by local authorities is small. The financing method for the provision of the service is stated in the contract signed by both parties. The central government has made no contracts with associations of local authorities.

Table 4.1 Expenditure assignment – actual status of the legal framework

(X indicates which level of government holds the main responsibility for each service)

		Central Government	Local Government
1	General public services	X national matters	X local matters
2	Defence	X main responsibility	civil defence
3	Public order & safety	X police, justice, fire brigades	local safety (for example fire brigades)
4	Education	X education methodology, tertiary education, research institutions, teachers' salaries, textbooks, vocational education	X pre-primary, primary and secondary education (except salaries and textbooks), hobby schools
5	Health	X treatment costs, hospitals, research institutions	primary health care, polyclinics, local hospitals
6	Social Security & Welfare	X social care institutions, pensions, family allowances, unemployment benefits, other benefits	subsistence benefits, shelter homes, other social care institutions
7	Housing & community amenities		X communal economy, housing, streets lighting, road maintenance, waste treatment, water supply
8	Recreational, cultural & religious affairs	X national libraries, theatres, museums, concert halls	X local libraries, theatres, museums, concert halls; cultural and sports centres
9	Economic services		
10	Fuel & energy		X heating affairs
11	Agriculture, forestry, fishing & hunting	X agriculture, forestry	
12	Mining, manufacturing & construction, except fuel & energy		
13	Transportation & communication	X road, water, railway and air transport, communication, subsidies to transport companies	road transport
14	Other economic affairs	X credits to entrepreneurship	territorial planning, research and development
15	Other functions	X environment costs	environment costs

4.1.2 Finance reform policies

During recent years, no finance reforms have been carried out in Estonia. Discussions are held on the necessity of financial, territorial and organisational reforms in the field of local government. As a part of natural development, sixteen local government units have amalgamated into eight units and one local government unit has been divided into two, during the period of 1996-1999.

Since 1996, no changes in the local government budget formation have been carried out. Increase in local budgets and thus in levels of public local expenditure are, in principle, in correlation with the inflation rate and economic growth.

The importance of income from local taxes in the total tax revenue of municipalities is marginal. Local government units receive the major part of their income from state taxes paid fully or partially into sub-national budgets. The last minor changes in the tax rates of state taxes paid into local budgets were made in 1996.

The capital does not have any additional fiscal powers or privileges compared to other municipalities.

There is some evidence that smaller local government units have smaller administrative capacity in the level of public service provision and infrastructure conditions. A lot of research has been carried out on the local government socio-economic situation. They state under-performance of some local government tasks in some smaller municipalities, mainly due to scarce financial resources.

The number of tasks and the funds for financing those tasks are agreed upon at annual negotiations between associations of local authorities and representatives of ministries. The financing of additional tasks set by law always receive special attention.

The policy of supporting local budgets from the national budget is aimed at equalising the income of all the Estonian municipalities. However, there is a tendency for the local governments which have greater tax income and therefore depend less on central government support, to have slightly better opportunities for public service provision and the development of infrastructure than other local government units which depend more on central government support. Disparities are mostly related to regional economic differences.

Local government units claim higher budgets for tasks set to them by law, and feel that transfers from support funds in order to fulfil these tasks are not in proportion with national requirements on standards set for service provision.

In the beginning of the 1990's, the re-establishment of local democracy was stressed in order to build up the local government system. The standards of service provision will be focussed on later. In order to improve local administrative capacity, an administrative reform is being prepared in Estonia. There is political consensus on the fact that reforms to improve the efficiency and administrative capacity of local government units are necessary.

Some local government units have been faced with problems in fulfilling their financial duties e.g. in relation to the burden of loans on the budget, or buying public services from other municipalities. Local governments are independent in their budget formation. At the moment, only the audit committee of the municipal council carries out controls on the local budget in every local government unit. Central government monitoring of local government action is carried out to a small extent. The central government plans to increase state monitoring of the municipal level by introducing obligatory independent audits on local budgets, and increasing the county governor's range of control over the municipalities of a county.

4.2 Local discretion – tax administration and relation to central government

Pursuant to the Taxation Act, the taxes paid into local budgets are divided into two categories:

- state taxes imposed by law, paid either in full or in part into local budgets;
- local taxes imposed by local councils pursuant to law.

The first group constitutes the main tax revenues of municipalities including:

- personal income tax;
- land tax;
- gambling tax.

Personal income tax is 26 per cent of the income of an employee. Municipalities receive 56 per cent of the personal income tax, collected from the income of the inhabitants of a municipality (see Table 4.3). The State Tax Board collects the tax through its regional offices. Personal income tax constitutes, on average, ninety-one per cent of the total tax revenue paid to municipal budgets. (Revenue generated in 1999 was EEK 3 661 million.)

Table 4.3 Share of personal income tax compared to weight and size of municipalities, 1998

Number of inhabitants	Number of municipalities	% of municipalities	% of population	% of personal income tax
<1000	25	9,9	1,3	0,7
1001-2000	100	39,7	10,2	5,8
2001-3000	52	20,6	8,5	5,3
3001-4000	25	9,9	6,2	4,6
4001-5000	15	6,0	5,6	5,0
5001-6000	9	3,6	3,0	3,1
6001-10000	12	4,8	6,0	6,6
10001-20000	8	3,2	9,7	8,7
>20000	6	2,4	49,6	60,1
Total	252	100,0	100,0	100,0

Local governments must have enough funds to fulfil the functions imposed on them. Therefore, the total expenditure requirements of local governments, the so-called “accounting revenue base”, is determined annually following negotiations between authorised representatives of local authorities and their associations and central government.

Currently, this base includes the most relevant centrally-established taxes and fees plus allocations from the central government budget (see Table 4.4):

- 56% of personal income tax;
- 100% of land tax;
- 70% of oil sale utilisation fees, 100% of fees on construction materials and 50% of water utilisation fees;
- equalisation allocations from the central government budget.

Table 4.4 Overall distribution of “accounting revenue base”, 1997-1999 (EEK millions)

	1997	%	1998	%	1999	%
Personal income tax	2835,8	74,3	3471,5	76,6	3660,9	76,7
Land tax	223,2	5,8	296,7	6,6	310,2	6,5
Natural resources utilisation fees	63,6	1,7	66,9	1,5	65,9	1,4
Equalisation allocations from central government budget	693	18,2	691,6	15,3	736,0	15,4
Total	3815,6	100,0	4526,7	100,0	4773,0	100,0

There are considerable differences in the income per capita between municipalities (see Table 4.5). The receipts from personal income tax per capita differed by about 11 times between the richest and poorest municipalities, in 2000.

Table 4.5 Average personal income tax per capita, 1997-1999 (EEK)

	1997	1998	1999
Town	1,706	1,988	2,162
Rural municipality	1,165	1,413	1,620
Tallinn	2,979	3,609	3,636
Estonia	2,000	2,388	2,529

The bigger municipalities by population had higher incomes per capita compared to the smaller ones. The size of the municipality is an obvious factor reflecting income differences in Estonia. During the period, income per capita in the capital-city, Tallinn (the biggest municipality), was significantly higher than in most other municipalities (but not the highest). Additionally, at the beginning of the period, income depended more on the type of municipality (urban or rural), but at the end of period, it depended on the municipality's distance from Tallinn. The trend is for income to grow faster in those municipalities which are located closer to Tallinn.

Tallinn receives about 41-43 per cent of receipts from personal income tax among municipalities, whilst only having about 28-29 per cent of Estonia's inhabitants.

Because Estonia has not exploited the horizontal equalisation system (i.e. not delivered resources from richer municipalities to the poorer ones), the personal income tax sharing rate has been set mainly by the level of expenditure needs of Tallinn, in order to prevent huge transfers of resources. Consequently, if municipalities are given new functions, the tax sharing rate or the amount of support fund should be increased.

Land tax was formally introduced in 1993. Initially, only fifty per cent of this tax was paid to municipal budgets; municipal councils had the right to establish the tax rate between 0.8 and 1.2 per cent of the centrally-established, estimated taxable value of land, which depended on location and utilisation. Since 1996, land tax has been fully paid into local budgets. Land tax is 0.5-2.0 per cent of the estimated value of land. In the case of agricultural land, the rate is 0.3-1.0 per cent. The local council determines the tax rate within limits given by law. There is no relation to the size of municipalities. (Revenue generated in 1999 was EEK 310 million.)

If a game of chance, skill or betting is organised, 5 per cent of the gambling tax payable for a gambling location shall be paid into the budget of the rural municipality or city in whose administrative territory the

gambling is located. The share of the revenue from gambling tax is minimal (revenue generated in 1999 was EEK 4 million).

Table 4.6 Tax shares of centrally established taxes paid to municipal budgets, 1991-1999

Year	Personal Income Tax (%)	Corporate Income Tax* (%)	Value Added Tax** (%)	Land Tax (%)
1991	100	35	up to 25	–
1992	100	35	up to 25	–
1993	100	–	–	50
1994	52	–	–	50
1995	52	–	–	50
1996	56	–	–	100
1997	56	–	–	100
1998	56	–	–	100
1999	56	–	–	100

Notes:

- * Teachers' salaries were paid from municipal budgets when part of corporate income tax was paid to municipal budgets.
- ** Municipal councils had the right to establish local value added tax (VAT) with a rate of up to three percent when the centrally established VAT rate was nine percent; local authorities were denied to use the right when the VAT rate was centrally established at eighteen percent.

In addition to state taxes, municipalities may impose local taxes, which are determined by law. In June 1991, a government regulation granted the right to approve such decisions to the Ministry of Finance. The above regulation did not include a list of taxes local authorities could establish or any other conditions. The constitution, adopted about a year later, prescribed that only law can establish municipal taxes. In 1994, the Municipal Taxation Act was adopted, prescribing procedures for the implementation and requirements for nine local taxes. The Local Taxes Act provides the list, procedure for imposition and other requirements concerning local taxes. On the basis of this Act, rural municipalities and city councils have the right to issue regulations to impose local taxes.

According to law, local taxes include:

- Head tax – Head tax shall be paid by all residents of a rural municipality or city who are aged between eighteen and sixty-five. The rate or differentiated rates of head tax are established by the council.
- Sales tax – Sales tax shall be paid by natural persons who engage in business within the territory of the rural municipality or city, and by businesses whose head office, according to the information submitted upon registration, is located within the territory of the rural municipality or city. Sales tax is imposed on the value of goods and services sold by the taxpayer to the final consumer, according to the selling price. The rate of sales tax is established by the council but it shall not exceed 1% of the value of the goods and services.
- Boat tax – Boat tax shall be paid by owners of boats, yachts and launches which are up to twelve metres long and are subject to surveys. Councils have the right to establish differentiated tax rates for small ships and to prohibit the survey of small ships belonging to persons who have not paid boat tax.

- Advertisement tax – Advertisement tax shall be paid by natural and legal persons for notices and advertisements posted within the territory of the local government, and on public transport vehicles registered as belonging to natural persons who reside within, or legal persons whose head office is located within, the territory of the local government. The rate or differentiated rates of advertisement tax are established by the council.
- Road and street closure tax – Road and street closure tax shall be paid by natural and legal persons upon the organisation of demonstrations, parades and other events, and in the case of construction or maintenance works, if the closure of a public road, street, square, park, rest area or part thereof is involved. The rate or differentiated rates of road and street closure tax are established by the council.
- Motor vehicle tax – Natural and legal persons who own motor vehicles registered by the state shall pay motor vehicle tax according to the rates established by the council based on unit of motor power, tonnage or the number of seats in a vehicle.
- Animal tax – Animal tax shall be paid by the owners of animals, the keeping of which, within the territory of a rural municipality or city, is subject to taxation. The list of such animals is established by the council. The rates of animal tax are established by the council.
- Entertainment tax – Entertainment tax shall be paid by the organisers of recreational events within the territory of the rural municipality or city to which persons are admitted for a fee, and the owners of recreational establishments located within the territory of the rural municipality or city. Entertainment tax is imposed on sold tickets.

Until lately, there was a ninth local tax – local income tax – but after amendments in the law it was abolished. However, it was never used by any of local governments.

Rural municipality and city governments are the tax authorities for local taxes within their administrative territories which organise the collection of local taxes. A council and a regional office of the Tax Board may, with the consent of the central body of the Tax Board, enter into an agreement for the collection of sales tax pursuant to which the regional office of the Tax Board undertakes to collect such taxes. Expenses related to the entry into and performance of an agreement are covered from the rural municipality or city budget.

Revenue from local taxes only represents a small share of the local budget (see Table 4.7). In Tallinn, for example, only three of the municipal taxes described above have been levied: on advertising (revenue generated in 1999 was EEK14 million), on closing roads and streets (EEK2 million) and on motor vehicles (EEK37 million). In 1999, the total revenue generated by local taxes constituted only 2.3% of Tallinn's total gross revenue. Revenue generated by local taxes constituted about 85% of all local taxes in Estonia. Some local authorities have imposed taxes on sales or on domestic animals but the total proportion of municipal taxes does not exceed one percent of local government revenues. Several taxes (head tax, local income tax and entertainment tax) have not been imposed by any of the local authorities during the last few years and thus remain only theoretical. Some of the reasons behind this are detailed below:

- the financing system does not favour local taxes;
- local taxes are difficult to administer;
- it is hard to organise the collection of local taxes because local authorities do not have their own tax authorities;
- the revenue from local taxes is hard to forecast;
- imposing local taxes is locally unpopular;

- municipalities prefer fees.

Table 4.7 Number of municipalities, where local taxes have been imposed, 1996-1999

	1996	1997	1998	1999
Sales tax	24	23	21	15
Boat tax	3	3	3	2
Advertisement tax	47	49	52	50
Road and street closure tax	15	14	22	14
Motor vehicle tax	2	1	2	2
Animal tax	9	10	6	5
Total	100	110	106	88

4.3 National regulation of the framework for non-tax revenues

Local governments in Estonia are quite free to finance their expenditures through non-tax revenues, even though The Constitution of the Republic of Estonia only prescribes that local governments have the right, in law, to collect taxes and set imposts (the latter, here, means a non-financial obligation for a person).

The current Rural Municipality and City Budgets Act already provides a broader list of different revenues:

- taxes;
- entrepreneurial and property income;
- grants;
- loans and interest;
- other revenues.

(Work is currently underway to change the classification of government transactions and bring it into line with international methodology, in the near future).

The municipalities can have different kinds of revenue since the law only says that the budget of a local government during the budget year must consist of all revenues and expenditures which must be balanced (note that the balance meant here is not in line with international standards). This is probably the hardest constraint regulating local revenues – even if almost all types of revenue are permitted, they must be shown in the budget.

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

The main non-tax revenues are:

- revenue on use of water;
- revenue on subsoil assets;
- rent of land;
- dividends;
- interest;
- fees;
- fines;
- sales of goods and services.

Fees form a very small part of non-tax revenues. The State Fees Act states that fees are generally the revenue of central government. Only fees on a few services defined by law form revenue for local governments. The rates of fees are prescribed by law. The collection of fees is controlled by:

- central government agencies, if institutions administrated by them are the collectors;
- the tax office, if an institution (no matter whether central or local) is the fee collector;
- local government agencies, if institutions administrated by them are the collectors;

Fines are more important revenues than fees for local governments. Only fines based on administrative law (as opposed to criminal law) can represent revenue for local governments. The regulation of that kind of fine is recorded in the Code of Administrative Offences. These fines can represent revenue for both central and local governments. A local government is the collector in the following cases:

- a person breaks a rule made by a local government, based on law;
- a person breaks car parking regulations or uses public transport without buying a ticket;
- other cases defined by law.

The most considerable part of non-tax revenues comes from the sale of goods and services. Sometimes these are also referred to as revenues from economic activities, or the so-called own resources, since these are used by the institutions which collect them.

The source of own resources can be divided into six main categories:

- own resources of educational and scientific institutions (mainly charges for covering the catering costs in pre-primary, primary and secondary schools);
- own resources of cultural and art institutions;
- own resources of sports and recreational institutions;
- own resources of health care institutions;
- own resources of social care institutions;
- many other sales of goods and services.

There is almost no regulation of sales of goods and services (own resources) on a parliamentary or central government level but the exact rules do, of course, have to be defined by local government Acts. One example of an exemption is the catering costs of pre-primary schools, as these have to be totally covered by parents, as stated in the Pre-school Institutions Act.

Although most of the own revenues have been included in the budget, now, there are still some revenues which fall outside the budget (for central government, all own resources have been included into the budget since the year 2000). As mentioned before, all revenues should be included in the budget, by law. There are still some local governments which do not show all of their revenues in the budget but the number of these is diminishing. However, as one of these is the capital-city, Tallinn, the influence of own revenues is quite significant.

This extra-budgetary amount is diminishing year by year, however one has to note that there is the latest data for extra-budgetary revenues for the year 1997 (these are included in line "other non-tax revenue" in Table 3.1, for both central and local governments). The share of own resources was about 3% of all current revenues by then and one can assume that it has not changed very much since (this amount should be added to revenues in 1998 and 1999 to make data more comparable).

4.4 National policies on design of grants systems

Pursuant to the Rural Municipality and City Budgets and State Budget Correlation Act, the financial resources allocated from the central government budget for the support of local budgets are called the Support Fund (equalisation mechanism and grants). In addition, allocations intended for specific purposes have been prescribed. The amount of the support fund in a draft central government budget, and its distribution, are determined during the negotiations between the representatives of the associations of local authorities and the Government of the Republic.

4.4.1 General-purpose grants

The falloff in receipts from shared tax revenues has been compensated for by an increase in central government grants. They are essentially re-distributed via the “Local Budget Support Fund”, set up by law in 1993. The global amount and annual allocations are worked out during negotiations between the Government of the Republic and the “co-operative assembly” created by local government associations to defend their interests.

The purpose of the support fund is to balance excessive differences among the income bases of different municipalities and also to provide the weakest municipalities with the possibility of providing public services to its inhabitants. The revenue from personal income tax, land tax, fees for the special use of water and fees for mining natural resources are taken into account when equalising the budgets.

The size of the support fund in the draft central government budget, and its distribution among local authorities, are determined annually as a result of an agreement between authorised representatives of local authorities and their associations and the central government. If no agreement can be reached, central government determines the size and distribution of the support fund. The amount of the support fund represents 87-93% of all general grants. During the last few years, the proportion of support fund has increased.

The size of the fund should reflect the resources needed by local governments to fulfil the functions imposed on them. So the expenditure needs of local governments should be covered by centrally established taxes and fees and by allocations from the central government budget, i.e. by the “accounting revenue base”. The aim is to achieve a situation where there are no municipalities in which the “accounting revenue base” is less than ninety percent of the municipalities’ average base.

There have been lots of ideas lately on changing the principles for the distribution of the support fund. There have been discussions on changing the “accounting revenue base” (to increase the importance of local taxes) and on taking more precisely into account the expenditure needs of local governments distributing the support fund. There are also some ideas on giving municipalities new functions from central government. However, in reality, the major changes can be made in conjunction with the preparatory work of territorial reform.

The equalisation mechanism is linear. The general grant to municipalities is calculated according to the following formula:

$T_n = (m \times a_k - a_n) 0.9 \times c_n$, where

T_n – the total general grant to the municipality;

m – coefficient of the equalisation;

a_k – the average revenue (state taxes and fees on natural resources) per capita of all municipalities, in Estonian *kroons*;

a_n – the revenue (state taxes and fees on natural resources) per capita received by the municipality, in the current year, in Estonian *kroons*;

c_n – the number of inhabitants in the municipality.

The coefficient of the equalisation " m " is derived from the size of the support fund and indicates the amount of per capita income from state taxes and fees on natural resources that can be channelled to a municipal budget compared to the average to provide resources from the subsidy fund. Almost ninety-five percent of rural municipalities and towns receive allocations from the state budget; unsubsidized local authorities include, for instance, Tallinn and its surrounding rural municipalities, which receive a high proportion of personal income tax, and the rural municipalities in the county of Ida-Viru which receive a high proportion of fees for the special use of water and fees for mining natural resources. The 1999 state budget included EEK734,177 million allocated as subsidies to local authorities, based on the above formula.

As the actual revenue of a municipality may be less than planned, an additional guarantee mechanism is applied in the form of the regional support fund (in all 15 counties). Besides the aforementioned objectives, resources from this fund may be allocated to finance regional joint events and projects. The regional support fund (EEK55 million) has been divided into two since 1999. Funds may be used in order to:

- cover decreases in budget revenue - a special formula is used to calculate the total amount of support;
- finance joint regional events and projects - the county governor and the regional association of municipalities decide on the resources for this purpose.

Support to local budgets follows uniform principles. Only four municipalities on four small islands in Estonia are an exception, as they receive additional support (EEK5 million) due to their geographical location.

4.4.2 Specific grants

In addition to the general support fund, the central government budget also includes special purpose subsidies. The total amount of special purpose subsidies in the 1999 central government budget was EEK116 million, including:

- subsidies for maintenance of homes for the elderly and the handicapped — EEK36 million;
- subsidies for transport companies to compensate for reductions offered to students of municipal schools — EEK40 million;
- benefits for schoolchildren — EEK30 million;
- benefits for students of municipal art and music schools — EEK10 million.

The number of special grants is changing from year to year. In 2000, benefits for schoolchildren and for students of municipal art and music schools are included in the general grants calculated according to the equalisation formula. Subsidies for transport to students of municipal schools are included in the regional support fund

Local authorities also fulfil several tasks that are financed from the central government budget. These funds are transferred to local budgets through the budgets of ministries. Allocations for state social benefits form the largest share of the funds.

The state budget also includes resources for investments. They are not covered in this survey but, in 1999, EEK433 million were assigned for this purpose:

- for projects short-listed by the State Assembly on the basis of government and State Assembly proposals — EEK213 million;
- for counties, the use of which was decided by county governors together with the representatives of the local authority unions of each county — EEK170 million;
- for maintenance of municipal streets and roads — EEK50 million.

4.5 National control on borrowing

4.5.1 *The overall regulatory framework*

The arrangements for borrowing are established by the Rural Municipality and City Budgets Act.

Local budgets have to balance (here meaning that outflows equal projected inflows). Central government has, in few cases, helped local governments in debt by providing them with additional loans, and only one municipal government has been bailed out so far (in 2000). No uniform regulation has been worked out yet.

The Rural Municipality and City Budgets Act states that the total amount of all unrepaid loans and debt instruments issued, and other obligations arising therefrom, together with loans to be taken and debt instruments to be issued, shall not exceed 75 per cent of the proposed budget revenue for that budgetary year. This is with the exception of loans, debt instruments issued and allocations intended for specific purposes, which are made from the central government budget, as provided for in the Rural Municipality and City Budgets and State Budget Correlation Act are not considered as revenues.

In accordance with the same Act, the total amount of repayable loans, loan interest and expenditure for redemption of debt instruments shall not exceed, in any coming budgetary year, 20 per cent of the proposed budget revenue for the budgetary year during which the loans are taken and debt instruments are issued.

The above-mentioned restrictions do not apply to loans for which a state guarantee has been given.

The security for a loan taken by a rural municipality or city shall be neither an immovable asset nor a structure (including construction) which is a mobile asset of the rural municipality or city.

A rural municipality government or city government is required to forward a copy of the rural municipality or city council resolution, on the taking of a loan or other proprietary obligation, to the county governor within three days of the entry into force of such a resolution.

A rural municipality government or city government is required to present a copy of the loan agreement entered into, to the Ministry of Finance, within thirty days of the date on which the contract was entered into.

Rural municipalities and cities are required to register both closed and public issues of debt instruments with the Securities Inspectorate. Closed issues of debt instruments by rural municipalities or cities shall be

registered under the conditions and in compliance with the rules of procedure for the registration of public issues provided for in the Securities Market Act.

The Securities Inspectorate shall inform the Ministry of Finance of an issue of debt instruments by a rural municipality or city within thirty days of the registration of the issue.

If these criteria are fulfilled by a local government taking a loan, no additional controls are made.

4.5.2 *Scope of regulation*

Loans are taken, or debt instruments are issued, to carry out investments prescribed in the rural municipality or city development plan. Loans for current expenditure may be raised for a short term but have to be returned by the end of the budget year.

Subnational authorities are free to select lender institutions. Local governments may also raise loans from abroad.

Local governments may freely choose where to get a loan from. No special terms have been set by central government.

4.5.3 *Deficit and debt of local governments*

Estonia's fiscal policy can be characterised by a stable tax system, an adequate control of expenditures and a conservative borrowing approach. As a result, the general government deficit and the official debt burden have been relatively small (see Table 4.2). In 1995-1996, the government sector budget registered a deficit, essentially on account of large infrastructure investments and excessive borrowing by local governments. The trend turned around in the second half of 1997 when the role of fiscal policy became crucial. The conservative fiscal policy was supported by faster economic growth and improved revenue collection, resulting in a budgetary surplus of more than 2%.

In 1999, the economic recession together with the rapid fall in inflation deteriorated the budget revenue. This was accompanied by the administrative change in the payment of social tax. The budget remained in deficit despite the negative supplementary budget adopted in June, and the transfer of expenditure to the next year. The general government fiscal deficit in 1999 was 4.6%. The deficit was mainly financed from the proceeds of the partial privatisation of the Estonian Telekom thus keeping the general government debt burden stable at around 6.5% of GDP. The latter is very low compared to developed countries.

If it is true that the years 1998 and 1999 revealed several weaknesses in fiscal policy, and government that could not react quickly enough to changes in the economic environment, then it is also true that, in future years, Estonia intends to revive strict fiscal policy. The government has intended to keep the fiscal deficit below 1.2% of GDP, in 2000 (the actual outcome was even better – 0.7% of GDP), and to achieve a balanced fiscal position in 2001.

Table 4.2 Indebtedness of municipalities: local net debt, 1997-1999 (% of GDP)

	1996	1997	1998	1999	2000
General government deficit/surplus	-1,9	2,2	-0,3	-4,6	-0,7
General government gross debt	8,0	6,7	5,9	6,6	5,5
Local government deficit/surplus	-1,2	-0,2	-0,2	-0,5	-0,3
Local government gross debt	2,5	2,2	2,2	2,6	2,5
Local government deposits and securities	1,0	0,7	0,7	0,7	0,4
Local government net debt	1,5	1,5	1,5	1,9	2,1

Similarly to general government, the local government budget has been close to balanced – even though always in slight deficit over recent years. Accordingly, gross debt has been at the very low level of about 2.5% of GDP, and net debt at around 1.5-2% of GDP.

4.6 Local discretion – expenditure

As stated in the Local Government Organisation Act, the functions of local government include the organisation of social assistance and services, welfare services for the elderly, youth work, housing and utilities, the supply of water and sewerage, the provision of public services and amenities, physical planning, public transportation within the rural municipality or city, and the maintenance of rural municipality roads and city streets unless such functions are assigned by law to other persons.

By the same act, the functions of a local government also include the organisation of the maintenance of pre-primary child care institutions, primary schools, secondary schools, hobby schools, libraries, community centres, museums, sports facilities, shelters, care homes, health care institutions and other local agencies if such agencies are in the ownership of the local government.

4.6.1 Pre-primary, primary and secondary education

The expenditures in the area of pre-primary, primary and secondary education represent the most significant share of a local government's total expenses. Some of the principles of organisation of the education system in Estonia are established by the Law on Education, as follows:

- Central government and local government shall guarantee to everyone in Estonia the opportunity to comply with the compulsory education requirement and to acquire continuous education, according to the conditions and procedures determined in laws
- Within the territory of Estonia, central government and local government shall guarantee the opportunity to acquire an Estonian-language education at all levels of education in state education institutions and universities.
- The Republic of Estonia shall guarantee the teaching of the Estonian language in all other-language state education institutions and other-language study groups.
- Acquiring secondary education in state education institutions shall be free of tuition charges.

The same Act prescribes the authority that the different legislative and executive institutions have in the area of education. By this, the Parliament has the authority to:

- determine the principles of the formation, functioning and development of the educational system;
- determine tuition fees in state education and learning institutions, as well as in state universities;

- decide on the establishment, consolidation, distribution and closure of state universities.

The Government of Estonia has the authority to:

- adopt state education development plans and ensure their implementation;
- determine procedures for the establishment, re-organisation and closure of state education institutions; approve the statutes of applied higher education institutions;
- determine procedures for tuition fees, rates of fees and payment procedures in state education and learning institutions and state universities;
- determine the regulation of student loans;
- determine state concessions to schoolchildren, students and teachers, including credit benefits;
- determine remuneration principles for the staff of state education institutions and state universities;
- determine the standard of tertiary education;
- constitute a council for recognising state universities ;
- set the principles of stipend-fund for schoolchildren of state and municipal vocational schools and for students of applied higher schools and universities.

The Ministry of Education organises the drafting and implementation of state education development programmes. The Ministry of Education has the authority to:

- co-ordinate and manage local governments and other ministries of the Republic in the organisation of education; co-ordinate with them proposals for the establishment, re-organisation and closure of state education institutions, according to the procedures determined in law;
- establish, reorganise and close state education institutions, except universities and applied higher education institutions;
- direct and organise the preparation of curricula, study programmes, textbooks, teaching and study aids for state education institutions (except universities); ensure their publication, and issue recommendations for the use of educational literature;
- guarantee a system for the management for state education institutions and for teacher methodology;
- determine procedures through which study programmes shall be recognised and documents proving education shall be issued;
- determine procedures for teacher certification and upgrading of professional qualifications; organise training and in-service courses for teachers;
- contribute to the implementation of state research policies and commission research on education;
- participate in forecasting the requirement for specialists and skilled workers, as well as commission their training;
- co-ordinate the training of specialists and skilled workers in applied higher education institutions and in vocational schools; co-ordinate in-service training and retraining for specialists and skilled workers;
- co-operate with education and research institutions from other countries and from international organisations;
- develop standards for the state funding of education;
- issue and revoke education licenses (operating licenses) for private educational institutions and other legal entities involved in teaching;
- appoint and dismiss heads of state education institutions;
- register universities, their statutes and documents proving the education;
- determine a single assessment system in all levels of education;
- keep a register of schoolchildren and students.

Local governments have the authority to:

- prepare and implement education development plans for their administrative region;

- establish, re-organise and close municipal education institutions, according to the procedures determined in law, as well as register education institutions established in their administrative region;
- guarantee economic servicing and financing of municipal education institutions in their administrative region;
- appoint and dismiss heads of education institutions under their jurisdiction;
- forecast the need for teachers; assist education institutions in their search for staff;
- guarantee housing for teachers, as well as other benefits specified in law;
- organise the guardianship and care of minors, the protection of their rights, the placement of orphans and children without parental care in orphanages, boarding schools or foster families, or organise their adoption;
- keep records of children of compulsory school age, and guarantee control of compulsory school attendance, provide children financial and other assistance for the fulfillment of their compulsory education obligation, organise transportation to and from educational institutions, guarantee medical aid and meals during school hours;
- organise methodology servicing for educational institutions, advise school principals and teachers on matters concerning school regulations;
- organise vocational guidance and counselling of children and adolescents;
- keep records of disabled people and organise their schooling.

State education institutions shall be subordinate to the Ministry of Education or some other executive authority of state power, and municipal education institutions subordinate to local governments.

State education institutions and state universities are financed from central government and municipal funds, as well as from own resources. Education institution own resources consist of revenues from the provision of services, production and research activities, contractual staff training programmes, donors, individual endowments and other sources. Procedures for the use of own resources in state education institutions are determined by the Ministry of Education.

Education institutions owned by legal or physical entities and partly maintained by the state, shall be supervised by the Ministry of Education, the State Audit Office and local government, according to their authority.

Further development of regulation on the area of pre-primary, primary and secondary education can be found in the Basic Schools and Upper Secondary Schools Act, the Pre-school Institutions Act and in many decrees of the Government of the Republic of Estonia.

4.6.2 Social security

Social security forms quite a significant part of local government expenditures, even though almost all of it is financed with specific grants from the state budget, and most of the social security benefits and social assistance benefits are paid at a central government level.

The different social benefits in Estonia are as follows:

- pensions;
- family allowance;
- benefit for disabled people;
- unemployment benefit;
- subsistence benefit;
- other.

Through the Pension Insurance Act, a pension is a monthly, monetary, social security benefit based on the solidarity principle in cases of old age, disability and lack of support. Pensions are mainly covered by social security contributions and are paid out through the central government budget (until 2000, the pension insurance had its own separate budget).

Through the State Family Allowances Act, families with children have the right to family allowance which partly covers the costs associated with the care and raising of children and with their schooling. Since 1999, family allowance has been paid through the central government budget. Before that, it was paid from a separate budget but still financed from the central government budget. The rates of family allowance are set annually in the central government budget. The rules for setting and paying allowances are prescribed by Government.

The regulation of benefits for disabled people is established by the Social Benefits for Disabled People Act. The basis for the calculation of benefits for disabled people is a rate set annually by parliament in the central government budget. Benefits are paid from the central government budget.

The Social Protection of the Unemployed Act states that the rate of unemployment benefit is set by the Government of Estonia. The rules for paying unemployment benefit are prescribed by the Ministry of Social Affairs. The benefits are financed from the central government budget.

Subsistence benefit is the main social benefit, which is paid from local government budgets. The general regulations of subsistence benefit can be found in the Social Welfare Act. Through this act, people whose monthly income is below the subsistence level established by the Government of the Republic based on the minimum consumption expenditure, have the right to receive subsistence benefits.

The grant of a subsistence benefit is based on the income of the person married to the benefit applicant or living in the same dwelling with the benefit applicant in a conjugal relationship, the income of their children and parents who are maintained by them, or of other people using one or more sources of income jointly or with a shared household.

Subsistence benefits shall be granted and paid by rural municipality governments and city governments under the conditions of, and pursuant to, the procedure established by the Government of the Republic, from funds in the central government budget prescribed for this purpose.

Local governments may grant and pay supplementary social benefits, as follows:

- from the local government budget – under the conditions of, and pursuant to, procedure established by the rural municipality government or city government;
- from the central government budget – under the conditions of, and pursuant to, the procedure established by the Government of the Republic;
- from other sources – under the conditions established by the allocator of the funds.

In addition to subsistence benefit, there are some other, minor social benefits which are paid out through local government budgets:

- compensation of transportation costs to disabled people;
- schooling support;
- compensation for electric connection services;
- support to people released from prison;
- other.

As already mentioned, subsistence benefit is mainly financed from the central government budget. There are also some other benefits which are covered by specific grants from the central government budget.

4.6.3 Sanitary affairs and services

There is no national regulation in matters of sanitary affairs and services in local governments. There is only a mention in the Local Government Organisation Act that municipalities have to take responsibility for it. There are no specific grants from the central government budget to cover the costs in this area, and handling these issues is only a task for local governments.

These tasks are:

- maintenance of local streets and roads;
- cemeteries;
- waste treatment;
- other.

4.6.4 Efficiency and effectiveness of local expenditures

It is obvious and commonly known worldwide that the evaluation of the efficiency and effectiveness of public expenditures is a very hard task. Some developed countries have tried to use the new principles of government financial management, like performance budgeting or results-oriented budgeting. Even though these have been very useful, some weaknesses have appeared: (a) the implementation has taken years; (b) the administration is quite complicated; (c) it is done at a central government level, not a local one; (d) the “right price” for an output or outcome still cannot be defined.

The Estonian Government tried, for the first time, in 2000, to introduce zero-based results-oriented budgeting on a central government level. Every agency was asked to describe its:

- objectives, i.e. outcome;
- goods and services provided to achieve the objectives, i.e. output;
- indicators showing how to measure the achievement of the objectives;
- resources needed to achieve the objectives, i.e. input.

It is much more complicated to do the same on a local government level. There have been thoughts on mapping the functions of local governments for some years, already. At least this would help to find out what the exact tasks of local governments are, and what the costs of fulfilling these tasks have been. In practice, nothing has been done so far. Consequently, it is impossible to say anything precise about local expenditures – Is what local governments are doing necessary, or not? Can they do it cheaper, or not? Are the results improving with higher financing, or not? etc.

However, one can make some general remarks about local government expenditures. There are hundreds of local functions, most of which have to be carried out by all local governments. Certainly there are differences in the costs of covering these functions, based on more or less objective reasons. But because, on one hand, no comprehensive analysis has been done, and, on the other, not a single local government admits that financing is high enough, it is hard to speak about efficiency and effectiveness. A simple comparative analysis probably would not help– one would know where costs were higher and lower but the quality of results still would not be clear.

To speak about functions in a broader context, the differences in costs are not very big. One exception is certainly in general public services. Expenditures on these services represent around half of total current

expenditures in the smallest local governments, whilst the average is only about 13%. There is no doubt that this indicates how administration in smaller local governments is relatively more expensive and, once again, shows the need for a sharp cut in the number of local governments.

Of course, the size of government is crucial in other spending areas, as well, but this is not so clear as in general public services. In education, for example, even people in the smallest local governments are used to having their “own” schools (as well as many other buildings), and it is obviously more expensive there, but were the number of local governments to be reduced, some schools would, logically, be closed, too. (However, even now, some local governments buy this service – primary and secondary education – from others in order to be more efficient.)

Spending on social security is not directly dependent on the size of a local government but rather on the living standards of its inhabitants. On the other hand, people tend to be poorer in smaller local governments, which is due to these people usually being placed in rural areas where it is harder to find a job.

There is an unavoidable need to reduce the number of local governments. It is obvious that almost all functions are relatively more expensive in smaller local governments but this does not necessarily mean that bigger ones are more effective.

4.7 General budget co-operation with central government

4.7.1 Main characteristics of the instruments for the central control of expenditure

Local governments are independent in their budget formation. There are no targets set for local expenditure. The central government determines the normative level of provision for certain public services but it does not attach any financial targets to that, nor any other field of local expenditure. Local government is independent in its goal setting and division of expenditure. It decides the rationality of local spending itself.

The procedure for the preparation, approval and implementation of local budgets is set out in the Rural Municipality and City Budgets Act. The relationship of local budgets to the central government budget is regulated by the Rural Municipality and City Budgets and State Budget Correlation Act.

The central government can, however, control local government expenditure by fixing the tax rate of state taxes. The majority of local budget income is received from state taxes, grants from the central government budget and other allocations from central government. Income from local taxes is marginal.

The central government can also control local expenditure through allocations to the Support Fund and by determining the rate of special purpose allocations. Pursuant to the Rural Municipality and City Budgets and State Budget Correlation act, the allocation of financial resources from the central government budget to support local budgets is done through the Support Fund. The purpose of the Support Fund is to balance excessive differences among the income bases of different municipalities and to support the weakest municipalities in providing public services to its inhabitants.

In addition to the general Support Fund, municipalities receive grants allocated for specific purposes.

Relevant macroeconomic control of local governments is exercised through restrictions on sub-national borrowing. Certain limits on loans and securities contribute to Estonia’s overall strict fiscal policy by keeping general government debt and deficit low.

The county governor has the following rights concerning local authorities:

- the right to exercise supervision of the legality of individual acts of municipal units of the given county,
- the right to file a report with the State Audit Office or with an investigative or other competent agency if he/she discovers that the local government has possessed, used or disposed of state assets allocated to a local government unit through the regional support fund, or for a specific purpose, unlawfully or unpurposefully.

The Legal Chancellor supervises the general acts of municipalities. The county governor controls the legality of general acts, on its own initiative or further to complaints from citizens, but it always directs the complaints to the Legal Chancellor.

Local government expenditure is controlled through an internal control mechanism – by its own revision committees.

Central government is planning a reform whereby additional tasks will be delegated to the local level of government. The additional tasks will have to be financed from the central government budget. Central government will affect local expenditure by determining the mechanism for financing the additional tasks.

The reforms are under discussion and no final political decisions have been taken.

4.7.2 *Recent reforms of central-local relations*

In 1990, the Taxation Act was passed, which functioned as a basis for the adoption of legislation concerning tax revenue received by local authorities from state taxes. Personal income tax formed the main share of the local government income base. The tax was initially fully paid to local budgets. In addition to this, a part of corporate income tax was paid into local budgets from 1990 to 1992. At that time, no difference was made between first and second tier local government from the point of view of the central government. The division of the tax base between the county and municipality was based on mutual agreement. In addition to the state taxes imposed by law and paid into local budgets, the local government of both tiers had the right to impose special local taxes.

In allocating funds to local budgets, several old-fashioned principles were preserved e.g. grants from the central budget were distributed among local governments units according to the normative expenditure of maintaining the existing local infrastructure. The allocation was based on the standard expenditures of the previous year. Such a system did not allow the central government and local budgets to be sufficiently separated.

In 1994, the formation of local budgets was changed. Municipalities got their own tax base. Their main sources of income were the land tax and 52 per cent of personal income tax. Since 1996, municipalities have received 56 per cent of the personal income tax from the income of the people residing in the municipality.

Instead of covering normative expenditure, the system of equalisation of tax bases was introduced and local government units were divided into income classes. The new system was applied gradually and was practised all over Estonia by 1996. At the same time, the transfer mechanism dividing municipalities into income classes was replaced by a linear system of support allocation.

In the framework of the local government administrative reform currently under preparation, the central authorities plan to revise the division of tasks between central and local levels of government. A comprehensive plan will cover both the potential new tasks given by law to local governments, and the mechanism for their financing.

The total amount of financing for potential new tasks, as well as the existing tasks, will continue to be distributed through the general support fund, based on budget equalisation formula, and will be settled at negotiations between the representatives of associations of local authorities and ministries. Until 1993, the financing of new local government tasks was decided separately, by task, but since then, the current, more flexible system has been used, where the overall sum of the support fund is fixed at the annual negotiations. The distribution of resources between different tasks will be decided by each municipality itself.

The central government is planning a reform of the mechanism of local government budget equalisation, but concrete steps are still under discussion.

A co-operation unit consisting of representatives of ministries and regional associations of local governments regularly discusses matters concerning local budget formation. The unit determines the allocation of funds from the central government budget to local budgets at its negotiations.

4.7.3 Specific budget co-operation. Central mandates on economic management

As stated in the Constitution, expenditure-related duties of the central government imposed by law on local government are to be financed by the central government budget. The allocation of resources for fulfilling local government functions set by law is determined at negotiations between the Commission of Representatives of Ministries and the Assembly of Associations of Local Authorities. Generally, municipalities do not receive separate additional resources when new tasks are imposed on municipalities by law. Instead, the total sum necessary to carry out both the previous and new functions is agreed on at the negotiations. However, sometimes, on an *ad hoc* basis, municipalities have received additional resources agreed on at separate negotiations for fulfilling certain new functions. The principles for calculating public service costs and allocating resources from the central government budget to local budgets when new tasks are imposed on the subnational level by law are under discussion.

As the local government is independent in budget formation, budgets of local governments do not have to be approved *ex ante* by central government. Only passed local budgets shall be presented to state agencies pursuant to the procedure established by the Government of the Republic. Municipalities present monthly and annual reports on the implementation of the local budget to the Minister of Finance. The taking out of loans has, however, been regulated by central government.

In accordance with a regulation of the Minister of Finance, the annual accounting report must include a balance sheet, a profit and loss statement, annexes of the annual budget report and a management report. Accounting of local governments is carried out according to international standards. Principles of accounting are set by the State Budget Act, Accounting Act, regulation of the Government of the Republic "Statute of Accounting" and several regulations of the Minister of Finance.

The principles of budget structure are stated in the Accounting Act, State Budget Act, Rural Municipality and City Budgets Act and several regulations of the Minister of Finance.

The Rural Municipality and City Budgets Act, Accounting Act and regulations of the Minister of Finance determine annual reporting on the implementation of budgets. Municipalities present their annual reports to the Ministry of Finance by the date set by the Minister of Finance.

In accordance with the Local Government Organisation Act, external audits of municipal budgets will be carried out starting from 2001. The audit will be ordered by the municipal council and carried out by auditing firms. The audit report will be presented to the municipal council.