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## Estonia: Fiscal Management and the Budget Process

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## INTRODUCTION

Estonian authorities have made remarkable progress in a relatively short period of time by putting into place the elements of a modern budget process and fiscal management system. This progress is especially notable given the difficult circumstances the country has gone through in the transition period of the last five years.

The most significant changes in budgetary policy took place with the adoption of the Law on State Budget in June 1993. Several other pieces of legislation have come to complement the Budget Law including laws on local budgets, state external audit and the department of treasury. Other reforms have helped establish the basis of a modern fiscal management system. These include a monetary board assuring the independence of monetary policy from fiscal management and eliminating all possibilities of inflationary deficit financing, a well designed and impressively simple tax code, an overall well designed system of decentralized government, and the privatization of many state enterprises.

However, there are still significant steps that need to be taken for making the government budget and the budget process itself effective instruments of fiscal management in Estonia. In some cases, the new budget institutions are at the early stages of development and appear fragile because of lack of resources or trained personnel and lack of tradition. In other cases, the proper institutions for fiscal management have not been developed or are lacking. Addressing these reform issues should significantly enhance the ability of the Government of Estonia to accomplish its objectives of macroeconomic stability, a more efficient allocation of public funds, and growth of the economy's private sector.

This report takes stock and evaluates the reforms in fiscal management already introduced, those scheduled for introduction, and those that the Government still should consider putting in place

to accomplish an effective fiscal management system. Because they have been reviewed recently, this report does not discuss in depth existing budget institutions but instead puts emphasis on recent reform and highlights those problem areas where additional reforms will be necessary.<sup>1</sup>

The first section of the report provides a brief overview of the main accomplishments and failings of Estonia's budget process and fiscal management system.<sup>2</sup> The next three sections of the report review in more depth the three stages of the budget process: policy formulation, forecasting and budget preparation; budget execution and the ongoing effort to introduce a modern treasury function in the Ministry of Finance; and the institutions for budget compliance, namely internal and external ex-post audits and budget evaluation.

## **I. Main Features of Estonia's Fiscal Management System**

### **I.A - Positive features of the budget process**

*Adequate legal framework.* The current budget process is framed adequately by the State Budget Law of 1993 and several other pieces of legislation pertaining to the treasury function for budget execution, to external audit, and to the formulation of local government budgets. Although the Budget Law and other current legislation will have to be reformed, Estonia's legal budgetary framework has no significant gaps.

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<sup>1</sup> A comprehensive review of the budget process and institutions in Estonia was carried out in the World Bank's Estonia: Public Expenditure Review, Report No. 1287-EE, July 1994, Washington D.C.

<sup>2</sup> Many of the issues highlighted in this section are addressed at more length in the other sections of the report.

*Effective control of the fiscal deficit.* Despite substantial pressures since independence, a remarkable achievement of the GOE has been to maintain consistent budgetary discipline. In this respect, Estonia has performed better than most other economies in transition. To a large extent the budget system continues to operate under a sequestering or cash-rationing arrangement.<sup>3</sup> However, the stop-and-go negative consequences of budget sequestering have been minimized in Estonia by a cautious stand on revenue forecasts and expenditure outlays.

*A PIP for capital investments.* The GOE, starting in 1995, has introduced a public investment program (PIP) that plans capital expenditures by the central government for the next three years. This is a fundamental tool to rationalize the use of scarce public funds in the annual capital expenditure budget. The PIP has been consistently updated and the Ministry of Finance has now finalized the PIP for 1997-1999.

*An explicit calendar for budget preparation and reporting.* The Budget Law establishes an explicit calendar for budget preparation by the government, approval by the Riigikogu and reporting on budget execution by the executive to the Riigikogu. So far this budget calendar has been obeyed bringing much needed stability and predictability to the budget process. Here again Estonia has been doing better than many other countries in transition.

*The introduction of a modern treasury function.* The GOE has created a Treasury Department within the Ministry of Finance in 1996. This is a key step for modernizing and controlling the entirety of the budget execution process. Some responsibilities of the new treasury, such as cash management, are fully operational but some others, such as a single ledger and reporting, are yet to

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<sup>3</sup> Expenditure appropriations in the budget are authorized only after making sure that enough revenues have been collected to cover them.

be implemented. The GOE is also evaluating what should be the scope of the new treasury vis-a-vis debt management and the budget execution process for extra-budgetary funds.

*The proper institutions for budget audit.* Estonia has the proper external audit institution. The State Audit Office has been operating since 1992. This is an independent organization with the mandate to carry ex-post audit of all state budget organizations, extra-budgetary funds, all other institutions that receive budget funds and enterprises in which the state has majority ownership. Internal ex-post audits have been carried out by the Control Department of the Ministry of Finance since 1995. Although both institutions of ex-post audit need to develop further, they provide the right institutional framework for this important area of fiscal management.

#### **I.B -Main shortcomings of the budget process**

*The process of setting Government priorities.* There is at the present time a lack of an explicit statement of Government priorities for budget policy. The Office of the Prime Minister and the Cabinet get formally involved in the budget process at too late, after the line ministries and other government agencies have formulated their budget requests to the Ministry of Finance and the Ministry of Finance has put together a complete first draft of the budget document. Although there is a political consensus formed by the Government and the majority coalition in the Riigikogu on the general parameters of budgetary policy, this is not an adequate substitute for an explicit cogent statement of the Government's objectives and priorities. An explicit statement would rationalize budget decisions and facilitate difficult policy issues such as civil service reform, the scope of the public sector and privatization.

*Lack of well-defined sectoral policies.* Most ministries and other spending agencies lack well-defined explicit policy objectives and strategies to accomplish them. Often, line ministries have produced studies and strategies in areas of their responsibility but seldom are these integrated in a prioritized sectoral policy statement. The lack of well-defined sectoral policies detracts from the efficient use of budget resources and makes project selection into the PIP more accidental.

*Fragmented budget decision process.* Efficient use of public resources requires that all possible or potential programs and government agencies compete fairly, openly and simultaneously at budget preparation time. Estonia's budget process fails a strict test of comprehensiveness and universality. Fragmentation takes place through the earmarking of revenues for particular activities, such as the sale of forestry products to the Forestry Fund or gambling taxes for cultural activities, approval of foreign loans individually rather than as part of the budget, and general exclusion of fee revenues from general budget funds.

*Perverse incentives for decision makers.* The efficient use of government resources also depends on the correct incentives given to government officials to spend and manage the resources entrusted to them. This is a difficult area of the budget process but many countries have been experimenting with ways to set the right incentives in government operations. There are several areas in the Estonian budget process where incentives are set wrong. This is the case with local borrowing where there is the perception that the GOE would rescue irresponsible local governments that default in their debt obligations. The GOE may be fanning these perceptions by routinely rescheduling debts of local governments that are delinquent in on-lending operations, and by charging them below

market interest rates and no late penalties.<sup>4</sup> Perverse incentives also exist in the budgeting of personnel. Line ministries that economize on the number of employees see their salary fund decreased without any compensation in other parts of their budgets. Because of the lack of budget evaluation and performance measurement, ministries and spending units also have at present an incentive to maximize budget requests, although to a large degree these requests are controlled by the Ministry of Finance.

*Weak forecasting capabilities.* The most critical step in budget formulation is to forecast effectively the resources that will be available in the future. However, the Ministry of Finance still lacks the technical expertise to produce rigorous forecasts of the macroeconomic environment and revenue collections. The Ministry of Finance also lacks the ability to simulate the revenue, and economic and distributional impacts of alternative fiscal policies.

*Lack of a multi-year budgetary framework.* The Ministry of Finance requests from spending units at budget time expenditure plans for the two following years. However, this information is not used in any practical way by the Ministry of Finance. Many OECD countries use a multi-year budget framework to better integrate budget and sectoral policies, plan for maintenance and operation implications of new facilities, monitor for potential imbalances in the budget, forecast the implications of policy changes such as wage and pension compensation, and analyze the sensitivity of expenditure to changes in macroeconomic scenarios.

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<sup>4</sup> The Foreign Loan Department of the Ministry of Finance has followed the practice of not charging interest on defaults or postponed payments from on-lending operations to local governments for as long as the central government has funds in the project. The general policy has been to use discretion to allow rescheduling for those municipalities considered in need. About 20 percent of the municipalities that have participated in on-lending programs through the Ministry of Finance are now delinquent.

*Budget coverage.* There are several troublesome issues in budget coverage. First, the role of the public sector vis-a-vis the private sector remains murky, in part because of budgetary inertia. There are a number of government functions inherited from the past regime that should be discontinued or privatized, such as agriculture and veterinarian services, port pilots, small airports, and Estonian TV and Radio. The government also continues to issue loan guarantees for enterprises. Second, the assignment of expenditure responsibilities between the central and local governments still has not been entirely restructured; for example, fire and civil protection services continue to be a central government responsibility. Third, there continue to be extra-budgetary funds, other than the medical and pension funds, outside the purview and rigor of the budget process; such are the cases of the of the Environmental Fund and the Forestry Fund.

*Insufficient budgetary control of the social funds.* Officials at the Ministry of Finance and members of the Riigikogu expressed concern about the lack of budgetary rigor and scrutiny of the Pension Fund and the Medical Fund, and spending units under them. The lack of relative scrutiny of the medical and pension funds is evidenced by the fact that their financial plans take just a few pages by comparison to the voluminous budget document for the rest of the central government.

*The need to finalize implementation of the new Treasury.* Progress to date with the technical implementation issues of the new Treasury remains slow, especially in the area of computerization. The Government needs to commit the necessary additional resources to ensure the completion and implementation of the new Treasury.

*Strengthen the budget control and audit functions.* The current design of the fiscal management system properly assigns the ex-ante control functions to the spending units and to the

new treasury department, ex-post internal audits for all spending units to the Ministry of Finance, and ex-post external audit to State Audit Office, which is an independent agency.

*The need to develop a budget evaluation function.* Budget evaluation practices are practically nonexistent at the present time in Estonia. This is largely a result of a budgetary tradition that did not question the effectiveness of programs and did not try to find the most economical way to accomplish budget objectives. Many countries have extended the functions of the external audit institution and the Ministry of Finance to evaluate the performance of budget programs to ensure that policy objectives are being met and that taxpayers “get value for money.” The findings from performance audits offer important feedback to policy makers in the next cycle of budget formulation.

## **II. Budget Preparation**

This section develops in more detail current practices, main issues and problems, and recommendations for reform at the budget preparation stage.

### **II.A - Brief review of current institutions**

*The Budget Calendar.* The fiscal year is from January 1 to December 31 of the calendar year. Budget preparation starts in February. The Ministry of Finance prepares in February a report on the main macroeconomic developments and the main parameters for Government’s economic policy for the following year. The line ministries also start their initial data gathering in February.

*The budget circular and negotiation.* By June the Ministry of Finance sends to all line ministries a budget circular with instructions to fill out budget requests and overall expenditure ceilings. All ministries are given three ceilings: for personnel, for other current expenditures, and for

capital investment.<sup>5</sup> These limits are set with significant inertia and do not appear to come from an explicit set of government priorities or well set sectoral policies.<sup>6</sup> The line ministries must submit their budget requests by the end of July.

The submissions by the line ministries and the decisions of the Ministry of Finance are subject to negotiation. The dialogue of the Ministry of Finance with the line ministries includes discussion of programs and projects and special needs; the Budget Department has several specialists working with each line ministry. However, these again do not seem to be guided by any government policy document stating expenditure priorities. The Budget Law establishes a well detailed process for how to solve disagreements. If a difference cannot be resolved between the ministers of finance and the particular line ministry, the matter is taken to the entire cabinet for resolution.

*Budget submission and approval.* The Government must present the draft of the state budget to the Riigikogu no later than three months before the beginning of the budget year (Article 115 of the Constitution). The government has submitted the budget proposal to the parliament on time in September for the last five years. Initial review of the budget proposal submitted by the Government is carried out by the Budget Committee of the Riigikogu and it involves meetings and hearings with officials of the Ministry of Finance and other ministries when necessary. This part seems to have gone smoothly given the good relationship between the two sides. After approval by the Budget

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<sup>5</sup> This represents a significant improvement over the previous practice (until 1994) which consisted of providing allowable growth rates for many different types of current expenditure categories in the budget circular. The previous practice was not to give any ceiling for capital project requests. Line ministries were free to submit wish lists.

<sup>6</sup> The Ministry of Finance does not have the “authority” to change budget shares across line ministries by more than 10 percent. Actually, the political agreement within the Government coalition in the Riigikogu was that, for 1997, changes in budget shares will not exceed plus-minus 3 percent of the previous year’s allocations.

Committee, the budget bill has to be approved in three readings by the plenary session of the Riigikogu.<sup>7</sup> If the Riigikogu fails to adopt the new budget by the beginning of the year, the government is allowed to incur expenditures each month equal to one-twelfth of the expenditures in the previous year's budget.<sup>8</sup> However, parliamentarians have an incentive to approve the budget on time. Article 119 of the Constitution establishes that if the Riigikogu fails to adopt the new budget within the first two months of the budget year, the President shall declare special elections to the Riigikogu.

The two social funds, the Medical Fund and the Pension Fund, function without a budget. Instead they must prepare a "financial plan" using the procedures and timetable prescribed by the MOF. The MOF has authority to make changes in the financial plan submitted by these funds, but few if any are made. The financial plans for the medical and pension funds must be attached to the central government budget proposal and they must be approved by the Riigikogu at the same time it approves the central government budget.

*Supplementary budgets and budget amendments.* Supplementary budgets during the fiscal year are allowed by article 115 of the Constitution and article 39 of the State Budget Law. The procedures for submittal and approval of supplementary budgets are the same as for the main budget bill. Supplementary budgets must be submitted to the Riigikogu not later than three months before

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<sup>7</sup> The first reading discussion must be finished in one day. What follows is a process of amendment proposals. The Budget Committee votes on each of the amendment proposals. During the second reading members may voice their opinion on any item in the budget. In the third reading the budget is approved by a majority.

<sup>8</sup> This continuing resolution provision is Article 117 of the Constitution. The State Budget Law restates this provision as an expenditure-per-month which is the smallest of one-twelfth of last year's budget or one-twelfth of the proposed (and yet approved) budget.

the end of the fiscal year. The submittal of supplementary budgets by the government has become routine over the past five years. In some years there have been two supplementary budgets. This practice has been quite useful in the environment of the transition with fast developing issues and the difficulty of forecasting revenues and expenditures with accuracy. However, the process of approval for supplementary budgets is intensive and time-consuming and has distracted the Ministry of Finance and the Riigikogu from other policy and administrative concerns.

The State Budget Law (article 38) also allows both amendments to the budget and the reallocation of appropriations, provided that the Government submits to the Riigikogu a bill of changes. The difference between supplementary budgets and amendments is that the latter do not require additional funds but just their reallocation.

*Limitations to legislative budget initiative.* All draft amendments to the budget and budget drafts are required to provide alternative sources of financing or reductions of alternative concrete expenditures by article 116 of the Constitution.<sup>9</sup> This has been an effective provision that has helped maintain overall fiscal discipline. Many other countries in the West as well as transition countries have introduced similar or even more stringent limitations to budget initiatives by legislators. An important loophole in this rule is that the current statutes of the two social funds enable them to vote or award themselves amendments for increased expenditures out of the reserves or surpluses built up from previous years.

*Budget classification.* The Budget Department is finalizing the conversion of the old budget classification to the new budget classification which for the most part follows the IMF's GFS

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<sup>9</sup> The State Budget Law (article 19) also has the same clause requiring that any initiative by legislators to increase expenditures or to cut revenues in the proposed or approved budget must be accompanied by other expenditure or revenue measures to maintain the current budget balance.

economic and functional classifications. The new budget classification will require the reform of the State Budget Law which still lists loans and surpluses from previous years as current budget revenues.

*Forecasting.* This task is carried out by the Macroeconomic Department of the Ministry of Finance. The main activity is to forecast budget revenues for the next year. This forecast must be completed by October before the budget proposal is submitted to the Riigikogu. No updates of the forecast are produced after submittal of the budget. The forecasting tools used by the Macroeconomic department are too limited.

*Borrowing.* All foreign loans have to be approved separately by the Riigikogu. The State Budget Law (article 31) allows the Government to submit a bill on borrowing to the Riigikogu to cover budget deficits. There has been practically no domestic borrowing. The accounting and servicing for foreign loans is carried out by the Foreign Loan Department of the Ministry of Finance, which has not been integrated in the new Treasury Department.

*Budget balance.* The State Budget Law does not contain any specific budget deficit rules nor does it define precisely the concept of budget deficit. The definition of budget balance in the Budget Law is peculiar since it includes any unspent balances from the previous years as part of the revenues in the current year. There are plans to adopt a more conventional definition of budget balance.

*Budget reserves.* The State Budget Law establishes two types of reserves. First, there is the Reserve Fund of the Government of the Republic in each year's budget. The Government has authority to commit funds from the Reserve Fund but appropriations require separate accounting and all unspent amounts are to be returned to the Reserve Fund. Second, there is the State Budget Bank reserve which is to be used for cash management purposes. The size of the State Budget Bank

reserve is established by the Riigikogu and it must be replenished to its full size by the end of the fiscal year.<sup>10</sup>

*Disposition of fees and charges by administrative units.* Revenues from charges or fees for services by central government agencies are not considered part of the budget. Spending units are given discretion to use these funds subject to potential regulations from the Ministry of Finance. There is no current information on the scope or financial importance of these funds, nor comprehensive monitoring of these activities.

## **II.B - Issues and Problems**

*The lack of explicit government priorities.* As stated in section I, currently the entire budget process is void of an explicit statement of government priorities for budget policy. The review and approval by the Cabinet of the budget draft put together by the Ministry of Finance and the political discussions of the majority coalition at the Riigikogu are not adequate substitutes for a well structured policy document setting government priorities for the next three years. The current approach creates a budgetary culture of inertia and compromise rather than change and initiate.

*The lack of explicit sectoral policies.* As also stated in section I, most line ministries lack an explicit policy document with explicit objectives, strategies and programs in their areas of responsibility. The lack of well integrated objectives and programs reduces the effectiveness of budget appropriations, does not provide adequate information regarding which project should be included in the PIP, and makes it difficult to evaluate the effectiveness of budget expenditures.

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<sup>10</sup> However, the Riigikogu may authorize the government to use part of the State Budget Bank reserve to cover revenue deficits in the state budget.

*Fragmentation of budget decisions and the budget coverage.* Rather than being comprehensive and universal, Estonia's budget process is fragmented. The likely result is a suboptimal allocation of scarce budget resources that does not reflect Government's expenditure priorities. What this means in practical terms is that the government continues to spend in programs that have a lower return or priority than other potential programs which are denied these funds.

Efficient budget decision making will require the elimination of earmarked funds. Efficient budget decision making will also require the elimination of all extra-budgetary funds with the exception of the Medical Fund and the Pension Fund. Keeping these two outside the general budget can be defended on the (arguable) basis that they have an element of insurance with a correspondence between member contributions and benefits. Earmarked and extra-budgetary funds are normally undesirable because they break with the generally accepted principles of universality and integrality of the budget. In short, earmarked funds and extra-budgetary funds are not subject to the same level of scrutiny as regular budget funds.

Efficient budget decision making will also require that the Riigikogu not vote separately for each foreign loan. This practice can easily lead to a myopic approach to the use of resources. The Riigikogu should approve all foreign loans at budget time. In practice, interested government agencies, with the possibility of foreign financing, approach the Foreign Debt Department of the Ministry of Finance for prior approval and submittal to Parliament. The Foreign Debt Department has kept very hard standards as gatekeeper and has submitted to the Riigikogu very few proposals. But despite this rigorous procedure, there is a danger of suboptimal budgetary decisions. Even when foreign financed projects are desirable, their priority in government policy objectives can be low vis-

a-vis that of other projects that have not been financed or have not received enough financing from the general government budget.

Last, efficient budget decision making will require the inclusion of revenues from fees in the general budget. This will bring these revenue-raising activities under oversight and control of the Ministry of Finance and the Riigikogu. At the present time most fees are not included in the budget and Ministries and other agencies are quite free to spend these funds. The only restriction is that they cannot be spent on salaries. The use of cost recovery mechanisms is a desirable practice especially in the delivery of economic services where there are well identified beneficiaries. However, its use is also subject to drawbacks such as abuses and corruption, the discouragement of demand for services with positive social externalities, and the fact that often they can be an unstable financing source. Clearly the danger of giving spending units discretion over fees and charges and keeping them out of the budget is that administrative agencies may seek to raise their sources of revenues in a chaotic manner void of the oversight used for other budgetary resources.

There has been some discussion on this issue within the Ministry of Finance but no clear policy has emerged. One proposal is to regulate the use of these funds in separate accounts. But as long as the Ministry of Finance does not penalize fee raising efforts by reducing general budget allocations, there is no fundamental reason to keep these funds and what they purchase outside the purview of the Riigikogu. The funds actually collected and their disbursement could be carried out by the agencies themselves in separate accounts with appropriate reporting. But, by including fee revenues in the budget, both revenue-raising authority of government agencies and the use of these funds would be subject to regular budget scrutiny.

*The need to reign in the Medical Fund and the Pension Fund.* The earmarking of payroll taxes or social security contributions can be justified because of the direct insurance linkages between contributions and pension and health benefits. But these linkages in Estonia are few and weak. The linkages between contributions and benefits would be increased, of course, if the pension fund were reformed from a “pay-as-you-go” system to a fully funded retirement scheme. However, the Medical Insurance Fund and the Pension Fund should not operate under the premise, as appears is the case now, that they have an entitlement to spend whatever resources are raised from contributions.

The social extra-budgetary funds do not operate with a budget but rather with a financial plan. This apparently has allowed them to increase the level of expenditures without seeking approval of the Riigikogu. The size of the extra-budgetary funds depends on the decisions of the line ministries (Ministry of Health and Ministry of Social Affairs). The funds had a surplus over the last two years. However, it appears that there will not be any surpluses in 1997. The social funds in 1996 used the fund surpluses from 94 and 95 to increase expenditures.<sup>11</sup>

The rapid expenditure increases of most of the social funds over the past few years have raised concerns that they are all too willing to spend freely as much revenue as they manage to collect from payroll contributions. Lacking the forced discipline imposed by an ex-ante approved budget and with no actuarial projections for benefits and non-programmatic costs for a three-year rolling budget, the risk exists that the social funds will not allow any cuts in social security

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<sup>11</sup> The situation seems more serious in the case of the Medical Fund. Hospitals seem to have freedom to set rates for compensation for services and some hospitals exhaust their budgets three months before the end of the year. Doctors have given themselves 30 to 60 percent increases in wages during 1996 alone. Incentives are also perverse because hospitals get reimbursed per number of days per patient.

contributions and may go into deficits that will eventually have to be picked up by the general central government budget.

The social funds should be brought under much closer scrutiny by the Ministry of Finance, and eventually the Riigikogu, to ensure that resources are efficiently spent and to facilitate the possible reduction of social security taxes. These taxes in Estonia are, at a combined rate of 33 percent, high by international standards and hurt the competitiveness of Estonian exports and the attraction of foreign direct investment.

*Lack of medium-term budgetary framework.* The Ministry of Finance uses the PIP as a medium-term planning instrument for capital expenditures. However, there is no equivalent planning-forecasting instrument on the current expenditure side of the budget. At the present time, the Ministry of Finance requires line ministries and spending agencies to provide expenditure forecasts for years two and three when they submit their budget requests for next year.<sup>12</sup> However, this information is not used by the Ministry of Finance to compose a three-year current budget framework. In 1993 there were plans to introduce a three-year framework for the submissions of budget requests by the line ministries.<sup>13</sup> But these plans were never implemented.

A multi-year budget framework could provide the same kind of stability the PIP has provided so far. Even though a multi-year current expenditure framework does not become in any way binding for the budgets of future years, it works as a useful tool for anticipating budgetary pressures,

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<sup>12</sup> Actually, article 10 of the Budget Law states that line ministries must submit with their annual budget proposal a “plan of activities and economic development for the current and the next two years.”

<sup>13</sup> This is reported in Estonia: Public Expenditure Review (1994, p. 77).

forecasting the current expenditure implications of capital investment projects, and anticipating the impact of other policies such as employee compensation.

*Limited forecasting and fiscal policy analysis capabilities.* Revenue forecasts for the coming year constitute the crucial stage for setting spending plans and keeping the desired overall budget balance. Revenue forecasts can also pre-warn the government of forthcoming revenue shortfalls and give enough time to take provisional measures or seek a budget amendment. Admittedly, revenue forecasting in the current transition environment is a difficult task. However, both the methodologies used and the frequency of the forecasts by the Macroeconomic Department of the Ministry of Finance could be improved. The methodology used by the Macroeconomics Department is based on in-house estimates of the national accounts for production, employment and income. Most revenue series are forecast on the basis of a single aggregate variable.

The Macroeconomics Department produces only one forecast for next-year revenues by September of the previous year. Forecasting revenues should be a continuous activity of the Macroeconomic Department. Monthly updates could incorporate what has been learned from the behavior of the revenue series in the previous months. The forecast updates should incorporate not only changes in economic variables but also innovations in the tax laws and tax enforcement. The monthly forecast updates should be shared with the treasury department for cash planning purposes.

*Issues on borrowing.* The fact that all foreign loans have to be approved separately by the Riigikogu, we have seen, has led to the fragmentation and myopia in budget decisions. In the past five years there may have been borrowing for projects that were justified in isolation but they were

not priority for government in the context of the overall budget priorities or even sectoral policies.<sup>14</sup> Currently the GOE plans to take on no more foreign loans in part as a reaction to the fast pace of indebtedness of the past five years. The GOE should pay close attention to the sustainable level of national debt, but it is questionable that the optimal level of this indebtedness has been exceeded, considering the huge need for infrastructure development in the country and the key role that these investments will play in the rate of economic growth. The problem with foreign borrowing is no different from the problems in general budgeting. There are no explicit sectoral policies to guide for value and priority and borrowing decisions are fragmented or made in isolation.

*Issues on local government borrowing.* Local governments are limited to borrowing levels that commit them to debt service of no more 20 percent of their total revenues. The Government has also issued a decree making clear that it will not act as a guarantor of local government debt. In the case of on-lending operations, the government is already entitled by law to garnish funds from central transfer to effect repayment of loans by local governments. Despite these measures, there appears to be a widespread perception that local government borrowing could run out of control and that the Government will not let local governments default because of the undesirable consequences for local residents if local governments are not able, for example, to pay teachers or doctors. A scenario of runaway local borrowing, of course, would have grave implications for macroeconomic stability.

This is a difficult issue especially in Estonia because it has been couched in terms of untested behavioral conjectures. One way to help dispel the perception that the GOE will indeed act as a

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<sup>14</sup> Some have defended the lack of clear policy objectives for foreign borrowing early in the transition because needs were so overwhelming.

guarantor of local government debt is to make legal provisions for the default of local governments, such as a local government bankruptcy law, and for the central government not to come to the rescue the first time a local government actually defaults. A second way is for the GOE to get tough with repayment schedules and conditions in on-lending projects with local governments. It is quite deserving for the Ministry of Finance to actually have followed the opposite policy in on-lending projects. According to the Department of Foreign Loans in the Ministry of Finance, about 20 percent of the municipalities are late with interest payments. Some municipalities are trying and many others already have rescheduled payments in on-lending operations. The Ministry of Finance has not made even once partial use of its power to garnish transfer funds from delinquent municipalities.

*Issues on budget balance.* Besides the definitional problem of including unspent balances from the previous year as part of current revenues, there has not been any problem yet with budget balance. In fact, as was already pointed out, the fiscal performance of Estonia's central government has been quite remarkable. There was only a small deficit for 1995 and there will probably be another small deficit for 1996. Also the adoption of a currency board in Estonia has imposed more constraints in the conduct of monetary policy and also fiscal policy. This arrangement eliminates de facto the possibility of financing fiscal deficits by increasing the money supply.

Is there a need to introduce more explicit budget balance rules in the Budget law? Some countries have been trying different approaches to set legislative limits on the deficit. A constraint applied in some countries at the central level, though more often at the subnational level, requires a balanced recurrent budget. Deficit financing is only allowed for capital investments. However, deciding what is a capital expenditure and what is a recurrent expenditure is not always simple. In addition, as long as government is financing some investments with own revenues, all funds will be

fungible. A different approach used in other countries is to set limits to the size of the deficit or to the level of the national debt. But it is difficult, if not impossible, to devise a sensible limit that will be right in all economic situations. It has also been argued that setting specific quantitative limits is an invitation to reach these levels.

*The conversion to the GFS budget classification system has not been completed.* For the 1997 budget, the Ministry of Finance is using the GSF budget classification though not fully. There are still several problems for translating from the old to the new classification although the conversion is about 70 to 80 percent complete. Most of the translation problems the Budget Department is having relate to the consolidated budget and extra-budgetary funds. Unfortunately, the Budget Department has lacked the necessary technical assistance to make the full conversion in time for the 1997 budget.

## **II. C - Recommendations**

*On setting government priorities.* The Government, in particular the Office of the Prime Minister, should make it a tradition to issue a “Government Policy Priorities” document within the first two weeks of each January that outlines the major policy thrusts of government policy for the next year. This document should also be the main vehicle for setting boundary lines between the core public sector and all other activities in the public sector that should be privatized or discontinued. The initial allocation of expenditure ceilings by the Ministry of Finance to line ministries in the budget circular should reflect the explicitly stated priorities of Government.

The overall statement of policy priorities would allow the government to move beyond the item-by-item budget proposals and parliamentary appropriations and, instead, move to using the

budget as the overall instrument of economic policy including the management of the macroeconomy.

*On establishing explicit and updated sectoral policies.* Each line ministry and spending agency with independent budgetary authority should produce a sectoral policy document that states clear objectives, strategies for how to achieve those objectives, programs for implementing the strategies, and to the extent possible, measurable performance benchmarks to evaluate the effectiveness of budget expenditures. The “Government Policy Priorities” document should also become the basis for the revision and updating of the sectoral policy statement by each line ministry and autonomous spending agency. Sectoral policy statements should be updated and completed by the end of February. This would ensure that line ministries have formulated a coherent policy strategy that conforms with the overall objectives of the government before they submit their recurrent budget requests and select the capital projects to be submitted to the PIP.

*On the comprehensiveness and integrality of the budget.* The GOE should eliminate all earmarked funds and all extra-budgetary funds with the exception of the Medical Fund and the Pensions Fund. The Riigokogu should eliminate the requirement of separate approval of foreign loans. These should be approved at budget time with the rest of the government financing sources and expenditure plans. To the extent possible, revenues from fees should be included in the general budget. Each government agency with authority to charge fees should submit a forecast for these revenues, and a plan for how they will be spent, with their budget requests to the Ministry of Finance.

*On strengthening the financial plans and oversight of the social extra-budgetary funds.* The Ministry of Finance should have a clearer and more definite control of the budget decisions involving

extra-budgetary funds. The issue is what type of further controls should be introduced given the special nature of the agencies. The Medical Fund and the Pension Fund should be asked to formulate three-year financial plans supported by actuarial projections of future liabilities and revenues. The multi-year financial plans should be appendices accompanying the central government budget document and the financial plans presented for approval to the Riigikogu. These funds should still be required to submit their budgets formally through the Ministry of Finance, following general requirements. Even though approval by the Riigikogu may be at a higher level of aggregation to preserve implementation flexibility, the financial plans submitted to the Ministry of Finance should have the same level of information and disaggregation as any other budgetary unit. In the formulation of the social fund budgets it will be important to distinguish between programmatic entitlement expenditures and all other expenditures of the funds. The programmatic entitlement expenditures cannot be altered without prior changes in the laws governing those benefits. All other expenditures should be treated in a fashion similar to those of other spending agencies in the budget.

The funds should be prohibited from amending the overall level of expenditures in their financial plans without prior approval of the Riigikogu and recommendation from the Ministry of Finance. The enforcement of budget procedures and discipline by the Medical Fund and the Pension Fund will require strengthening the divisions of the Budget Department now overseeing these funds.

*On introducing a multi-year rolling budget framework.* The GOE should introduce an effective three-year rolling budget document, with detailed plans providing desegregated targets for expenditures by all spending units. Budgeting for current expenditures in a multi-year framework would be a significant step for better planning and deficit containment.

*On forecasting capabilities.* There is a need to strengthen the macroeconomic forecasting unit in the MOF. This unit should not only perform all short, medium, and long-term forecasting, but it should also carrying out all analytical work for the design of the government's fiscal policy. This analytical work ranges from macroeconometric estimates of the impact of government expenditures and taxes on aggregate demand, inflation and employment, flow of funds models, and micro-simulations of the impact of alternative tax structures on revenues and the distribution of tax burdens.

Several steps will be required. Individual tax revenues could be forecast using monthly collections and time series analysis. It will be necessary to prepare and update comprehensive fiscal data bases including not only central budget expenditures and revenues and extra-budgetary funds, but also local budgets and public enterprises. For macroeconomic forecasting and policy analysis it will be necessary to maintain statistical macro series including the national accounts and employment. The Macroeconomic Department should coordinate all macroeconomic modelling with that performed elsewhere including the Bank of Estonia. Other analytical tools such as an input/output model of the economy and micro-simulation models based on actual taxpayer returns and household expenditure survey data will be advisable.

*On borrowing.* The GOE should continue to borrow in the future. It is perfectly sound to for example to borrow for projects that will provide services to several generations of taxpayers. Borrowing may also be used for stabilization purposes. In addition to borrowing according to well defined policies, the GOE needs to stop making borrowing decisions on a project-by-project basis. Borrowing decisions must be made at budget time when the relative worth of each project and all types of expenditures are evaluated and compared. Borrowing may be appropriate if there are budget

expenditures, such as capital infrastructure development, which are part of well defined Government priorities and sectoral policies and there are no current funds in the budget to finance them. The decision has to be informed by a comparison of all other relevant alternatives including the decision on what should be the size of the public sector now and in the future and what is the sustainable level of debt service for the country as a whole.

Foreign borrowing should be used predominantly to finance projects that have been included in the PIP and in the Government's annual budget. Only after the decision has been made for inclusion of the program in the Government budget, should foreign borrowing be considered as a possible financing source. Timing problems could be addressed by inclusion of specific programs (desired or chosen by foreign lending institutions) in the PIP.<sup>15</sup> This procedure would prevent the approval and execution of suboptimal or lower priority projects. The legal requirement of Parliament's approval for all foreign borrowing still could be met by the submission of foreign financed projects as part of the annual government budget.

It is also important that the GOE include in this estimation of sustainable debt services an estimate of potential liabilities arising from government loan guarantees to the private sector and from on-lending operations with local governments. At the present time, there is incomplete information on government guarantees for the private sector.

*On local borrowing.* The way to deal with the potential threat of runaway local borrowing is not to eliminate the possibility of borrowing for local government. This would be the equivalent of the proverbial "throwing out the baby with the bath water." Sound and controlled local borrowing

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<sup>15</sup> At any rate funds are fungible in the government's budget for as long as the level of foreign financed projects does not exceed the level financed with domestic resources.

is a key ingredient in the decentralized system of government in Estonia and it should not be removed.

The strategy of the government should be to increase the monitoring of local borrowing, require frequent reporting by municipalities and lenders, and legislate administrative penalties for local officials who do not respect current restrictions and limitations.

Furthermore, the GOE should make legal provisions for the default of local governments, such as a local government bankruptcy law. The GOE should also get tough with the repayment schedule of local governments that are late in servicing their debt in on-lending projects with the Ministry of Finance. This will help send a message of low tolerance toward irresponsible behavior by the municipalities. Last the GOE should not come to the rescue, at least for a good deal of time, of any municipality that does default.

*On budget classification.* The Ministry of Finance should accelerate the resolution of conceptual bottlenecks for the conversion from the old to the new budget classification and field test the new budget classification with all budgetary institutions beginning 1997.

### **III. Budget Execution**

#### **III.A - Current practices and design**

*Expenditure control.* Once the budget is approved by the Riigikogu, the MOF is in charge of budget execution and it informs all ministries of the funds approved for them in the budget. Significant progress has been made in the area of budget execution and expenditure control. In particular, a modern treasury system has been in operation since April 1996.

*Treasury function.* The new treasury department started operations in April 1996. Some areas of the treasury are quite developed and others are still lagging significantly:

- C Cash management is operational. The treasury department is depositing funds for two days and up to a month. The treasury has centralized accounts with three banks: the account with the Bank of North Estonia is the general account for the bulk of revenues and expenditures; the account with Union Bank is for small disbursements; and the account with the Savings Bank is also for small disbursements, especially in the islands region. The treasury department is now producing a forecast for daily revenue collections and it receives daily updates on balances from the banks and the treasury's field offices.
- C Forecasting and financial planning are still not well developed. Most of the information is still processed manually. All budget spending units are required to produce a month-ahead plan for disbursement of authorized expenditures. The treasury department and the field offices produce weekly forecasts of expenditure needs. However, these forecasts are not centralized and integrated because the necessary information system has not yet been developed.
- C Reporting systems are still not working, again because data are not computerized and the right software has not yet been developed.

### **III.B - Issues and problems**

*Limitations on cash management.* Cash management flexibility is limited because the treasury department is not allowed to borrow short term. Instead the treasury department has to work with the State Budget Bank Reserve. The level of this reserve is set by the Riigikogu. In November 1996 the liquid reserves were at EEK 52 million. However, EEK 500 million would be needed for a budget coverage of 20 days.

*Coverage of the new treasury.* The treasury function covers most of the central government budget execution. There are however, important exceptions.

First, the extra-budgetary funds are not integrated into the central government treasury. There were plans to incorporate the Environmental Fund in the treasury in July 1996 but this move has

been postponed. However, plans have been developed for the integration of the Environmental Fund and the Forestry Fund. The integration of the latter will be more time-consuming given the complexity of its current operations.<sup>16</sup>

There are no concrete plans yet for the integration of the Pension Fund and the Medical Fund into the treasury. However, the GOE has made the decision to centralize all social security contributions in the tax administration service. When, and if, this happens the centralization of collections will facilitate enormously the integration of the social extra-budgetary funds into the treasury. Nevertheless, the integration of the Medical Fund should be a complex operation given the multiplicity of accounts that currently exist.

Second, there are seven or eight central government accounts connected with loans, most of which are managed by the Foreign Loan Department, that have not been incorporated into the treasury single account. These accounts hold idle balances, though not large in size.

*Lack of computerization of the treasury department.* The lack of computerization has meant that the tracking of revenue flows, bank balances, and expenditure commitments is all done manually. This hurts the timeliness of information flows and therefore the effectiveness of the treasury in financial management and control. The lack of a computerized information systems has also meant the postponement of financial planning and centralized accounting, which are at the heart of the treasury function.

*Flexibility in budget execution.* The State Budget Law (art. 30) allows line ministers to reallocate budget appropriations across chapters in their budgets as long as the appropriations have

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<sup>16</sup> The Forestry Fund has at present 240 districts all with individual budget accounts, on which not a lot of information exists. The strategy is to develop a smaller treasury for this fund before integration into the central government treasury is tried.

not been specified by the Riigikogu. Similarly, article 30 allows the heads of spending units or departments to reassign funds as long as they have not been determined by the minister. In practical terms, these provisions have given flexibility in budget execution to spending units other than in wage and salary compensation and capital investment projects. These provisions have been effective in reducing incentives for line ministries to bargain with the Ministry of Finance on individual budget items. Line ministries still have no incentive to economize in the wage fund because its size depends on the number of employees and no additional funds are allocated when the number of employees is reduced.

*Budget sequestering.* From the beginning of the transition the GOE has operated on the basis of a conservative fiscal stand. A budget sequestering mechanism has been in place whereby authorizations of disbursement in excess of revenue collections have not been not allowed. This type of practice is laudable given the need to maintain discipline over the budget deficit. However, cash rationing or sequestering runs the risk of letting the gate keepers in the budget execution department change budget priorities and in extreme cases to redo the budget entirely. Fortunately, none of these problems appears to have materialized in Estonia. The availability of surpluses and the existence of a budget amendment mechanism has come to alleviate any problems experienced by other countries in transition that have used cash rationing or budget sequestering.

*Unfinished projects.* As in many other countries in transition, Estonia has been plagued by a host of unfinished projects.<sup>17</sup> This represents an inefficient use of resources. An approach to combat unfinished projects is the adoption of commitment accounting. Many budget systems in

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<sup>17</sup> The capital investment budget drawn from the PIP for 1997 will get budget support for EEK 1.2 billion and EEK 1 billion from international loans. However, it is estimated that to finish all current unfinished projects EEK 7 billion would be necessary.

OECD countries distinguish between program authorizations, with validity extending beyond the annual budget cycle, and fund appropriations opened for the year and necessary for the execution of the annual budget. Commitment accounting guarantees funding for authorized programs over several years and therefore avoids the occurrence of unfinished projects. Estonia does not practice commitment accounting, but actually there are several provisions in the State Budget Law which would seem to facilitate its adoption.<sup>18</sup>

*Accounting* One of the most important functions of the new treasury will be to maintain proper accounting of all transactions (receipts and disbursements) at the time they take place, registering them on the single ledger. Proper control of budget execution will require the existence of a good system of public accounts. This accounting system must be capable of producing accurate, detailed information for the officials implementing programs, providing controls over an organization's spending, and summarizing the information for higher authorities and the public at large on a regular, timely basis. The Ministry of Finance has been working with a Swedish firm (AGRESO) on implementing a system of accounting based on the Norwegian system. A pilot system has already been completed and there are plans to extend the system to all administrative units. Further work will be needed on the integration of the accounting system with the treasury's information and reporting systems, which, as mentioned, are still under development themselves.

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<sup>18</sup> Article 9 (2) requires line ministries to submit in their budget proposals expenditure estimates for multi-year projects. Article 26 allows ministries and budget institutions to contract on the account of next year's budget allocation for durable goods. These contracts, however, should not exceed 50 percent of the allocation for the item in the current budget although the Government may give permission to exceed this amount. Finally, article 33 (2) allows the Ministry of Finance to extend the availability of unspent budget funds, among other areas, for capital investment purposes.

*Reporting.* Budget execution is subject to conventional reporting requirements. Article 43 of the State Budget Law establishes that the Government must submit a report for the state budget execution to the Riigikogu by July 1 of the fiscal year following the accounting year. The annual report for the execution of the financial plans of the extra-budgetary funds are attached to the central government's budget execution report. The reports are discussed first in the Budget Committee and then approved by the plenary session of the Riigikogu. The current difficulties for consolidating several accounts, including extra-budgetary funds, and the transitional status of the budget classification system, have made the reporting requirement more difficult and time-consuming for the Ministry of Finance than should be the case.

*Debt management.* At present debt management is not part of the new treasury department. Debt management is assigned to the Foreign Loan department which is not a part of the treasury. The Foreign Loan Department, quite properly, concentrates on the registration and service of foreign loans. At present there are no domestic debt issues. The Foreign Loan Department is understaffed and it is unlikely that it could take on important task of registering and monitoring borrowing by local governments.

### **III.C - Recommendations**

*On borrowing for cash management purposes.* At the top of the limitations on the treasury is the legal prohibition on borrowing for financial management or bridge financing purposes. A key function of the treasury is to smooth out a discontinuous and lumpy revenue inflow to a more

continuous and evenly spread time profile of expenditure commitments. The treasury department should be allowed to borrow short-term for cash management purposes if the need arises. Borrowing could be from commercial banks or from issuing (short-term) treasury bills. The advantage of issuing short-term treasury bills is that it would help develop Estonia's money markets. Initially these issues should not be of such significance as to affect the liquidity of the financial system and so should not interfere with the model for monetary policy adopted by Estonia.

*On the coverage of the treasury.* The treasury department should move forward with the plans to integrate the Environmental Fund and the Forestry Fund into its single account. However, caution is warranted given the complexity of the task. It will be more desirable for the treasury department to concentrate its efforts at the present time in making all facets of the treasury function operational rather than expanding its scope. Similarly, the integration of the Pension Fund and the Medical Fund will be complex and very time-consuming. The strategy of the GOE is appropriate in centralizing the collection of contributions for social security in the tax administration before attempting the integration of the social extra-budgetary funds into the new treasury. Nevertheless, there is no good reason to delay the integration of the Foreign Loan Department into the single treasury account, unless conditions from international lenders demand entirely separate accounts.

The Government strategy of transferring responsibility for collection and enforcement of social security contributions to the tax administration is a desirable one. Since it will take a considerable investment to modernize the registration, collection and audit procedures of the tax enforcement apparatus, efficiency from economies of scale can be reaped by focusing these investments in one single administration rather than three separate administrations. However, the integration needs to be implemented with adequate preparation and the proper incentives and checks

and balances should be in place to ensure that the tax administration performs properly as an agent for the social extra-budgetary funds. The social security contributions should be deposited directly in the subaccounts of the social funds in the single treasury accounts. The social funds should receive full reporting from the tax administration on contributors' rolls and their current accounts for contributions.

*On developing the information system for the new treasury department.* One of the most urgent tasks for the treasury department and a priority for the Ministry of Finance should be the full development of a computerized information system. Without such a system, it will be impossible to operationalize the single ledger, and centralize information for financial planning and forecasts.

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*On flexibility in budget execution.* The current degree of flexibility in budget execution is quite appropriate. Expanding this flexibility any further may be desirable but it should not be done until budget programs are defined better when measurable performance benchmarks and the entire budget evaluation function (discussed in Section IV) are implemented.

*On unfinished projects.* The GOE should consider the adoption of commitment accounting to reduce the wastage of resources implied by unfinished projects. Commitment accounts should be used for capital investment projects in the current year PIP.

*On the accounting system.* The full development of a complete system of accounting is one of the important pending tasks for the new treasury department. Needless to say that this activity should also be a priority for the Ministry of Finance.

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<sup>19</sup> The treasury department has been in conversations with a Finnish firm (ERANS) to buy financial planning software for a cost of \$150,000.

*On debt management.* Traditionally debt management is one of the functions assigned to the treasury. In the future, the Foreign Loan department should be merged into the new treasury and its functions expanded to monitor borrowing by local governments and to enforce the legal constraints on their borrowing activities. The reorganized debt management division of the treasury should also be in charge of on-lending programs with local governments, the registration of all direct contingent liabilities of the central government on foreign loan operations, and the maintenance and registration of all government assets.

#### **IV. Budget Audit and Evaluation**

Three main functions should be carried out at the compliance stage of the budget cycle. First, internal control should be performed by the ministries and institutions themselves, to check the legality of disbursements, and internal ex-post audit should be carried out by the Ministry of Finance or a specialized agency. Second, external ex-post audit should be carried out by an institution that is independent of the executive branch of government to verify the legality and correct use of budgetary funds. This is a fundamental component of good budget systems since the executive branch of government cannot be expected to be strict and objective about its own operations. Third, the evaluation of the performance of budget programs should be carried out by several institutions, with emphasis on improving the effectiveness of government expenditures. These three functions of budgetary compliance are complementary and reinforcing.

Of the three functions, only the first two, internal audit and external ex-post audit are at present being carried out in Estonia. For all practical purposes, no budget evaluation is performed in Estonia.

#### **IV.A - Internal Audit**

*Current practices.* The ministries and other budget institutions carry out internal controls to verify that expenditures in their institutions are budgeted and that proper contracting and procurement procedures are followed. The Ministry of Finance is charged with the internal control of all borrowing transactions on behalf of the Government.

Internal audit proper is carried out by the Control Department of the Ministry of Finance since 1995. This department carries out internal audits of all state agencies with the objective of preventing and uncovering breaches of administrative and accounting regulations and the fraudulent use of funds. Internal audits are carried out by specialized personnel who have no participation in the planning or operation of any of the programs they audit. The Control Department prepares reports on the results of these audits, with the optional participation from the ministry or the spending unit being audited. The Department has annual and quarterly audit plans but it will also conduct internal audits as ordered by the Minister of Finance. The audit reports are discussed by the Internal Control Board of the Ministry of Finance. If endorsed by the Board the audited unit may accept or reject the reports' recommendations. If the recommendations are rejected, the Internal Control Board is reconvened to reconsider the case and recommend proper action to superior authorities.

*Problems and Issues.* The most serious concern about internal audit at the present time is the lack of resources. The Internal Audit and Control division of the Control Department at the Ministry of Finance has only six employees. Since its inception in April 1994 only 100 audits have been carried out.

The methodology for carrying out internal audits has been developed in a Decree of September 25, 1995. But the Ministry of Finance still has a large task ahead in developing manuals for internal audit, establishing internal regulations and training personnel in ex-post audit.

*Recommendations.* It is critical to strengthen the internal audit function now carried out by the Control Department of the Ministry of Finance. This will involve at least doubling its size, providing training and developing further manuals and procedures for internal audit. To increase the effectiveness of ex-post internal audit, it will be necessary to define more precisely the legal framework backing these ex-post audits and the procedures to be followed, to implement the recommendations of the audit once it has been endorsed by the Internal Control Board of the Ministry of Finance. The current legal framework for internal audit also needs more clear rules and regulations for the conduct of public officials in the handling of public funds and conflict of interests, and administrative sanctions.

#### **IV.B - External audit**

*Current institutions and practices.* External ex-post audit of budgetary institutions is carried out in Estonia by the State Audit Office. Budgetary institutions include all central government agencies, inclusive of extra-budgetary funds and county governments, and state-owned enterprises when the participation of the state exceeds 50 percent. Local governments are not covered by the State Audit Office.<sup>20</sup>

The State Audit Office was created in accordance with the Constitution which provides that the Office shall be an independent institution (article 132). The Auditor General is appointed by the

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<sup>20</sup> Local governments have their own internal audit committees.

Riigikogu on a proposal by the President of the Republic and serves for a period of five years. The Auditor General appoints all auditors and prepares an annual audit plan. Although the State Audit office is independent, it must present to the Riigikogu an annual report on “the use of state funds and the preservation of state assets” over the past year at the same time the Riigikogu reviews the report on budget execution for the past year presented by the Executive.

Although the Office of State Audit has complete freedom to formulate the annual audit plan, it considers proposals for audit from the Executive and the Riigikogu, and it also considers cases exposed in the mass media.

The typical audit starts with a preparation stage when background information is gathered. A group of auditors conduct a site visit and collect documents and materials for the audit. Finally, an audit document is put together and discussed with the audited institution. After the audit results are signed by all auditors, the audited institution is asked for an official explanation of the problems and findings of the audit. The audit and explanations are submitted to the Auditor General and eventually to the ministry or supervising agency and to the Ministry of Finance. The State Audit Office has no judiciary powers and thus does not impose penalties. However, it may recommend dismissal of employees or the start of disciplinary proceedings in the case of public officials. If the audit detects any criminal activities, a copy of the audit is sent to the proper authorities and, in the case of tax evasion, to the tax administration. Depending on the importance of the case, copies of the audits may be sent to the Cabinet and to the Riigikogu. The Auditor General decides whether or not to report the case to the mass media.

*Problems and issues.* The structure and procedures of the State Audit Office are adequate and quite similar to those of supreme audit institutions in Western countries.<sup>21</sup> If there is a problem with the State Audit Office, it is staffing and compensation of employees. It has been difficult to find qualified candidates for auditor openings mostly because salaries are not competitive with the private sector. At the same time, the Office has not been able to fill a number of vacancies, the frequency of audits for state institutions is lower than what would be desirable. Audits of ministries and extra-budgetary funds will have a cycle of at least three years.

In terms of audit plans, perhaps a disproportionate amount of resources in the State Audit Office have been dedicated to auditing state-owned enterprises, many of which are audited on an annual basis as opposed to budget institutions which, as indicated, are audited on average once every three years.

*Recommendations.* The inability to hire well qualified professionals is a serious problem that requires the immediate attention of the GOE. As a stop-gap measure, the State Audit office should institute its own training programs. Additional resources for the more frequent audit of budgetary institutions could be mastered if the audit of (some) state enterprises by the State Audit Office is divested to private accounting and audit firms.

#### **IV.C - Budget Evaluation**

*Current practices.* At present in Estonia there is little formal budget evaluation. Actually the current legal framework for the budget process ignores this function. For example, the State Budget

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<sup>21</sup> The Office has had exchanges with the supreme audit institutions of Germany Sweden and Finland.

Law only addresses the stages of budget preparation and approval and budget execution. It is silent with respect to the audit and evaluation of the state budget. However, external audits are addressed separately in the Law on the State Audit Office. At the same time, it appears that all audits of the State Audit Office have been conventional compliance audits. Current audit procedures are not expected to produce suggestions on ways to economize funds in the implementation of programs nor are they expected to analyze whether existing programs have been effective in reaching policy objectives.

*Problems and Issues.* True budgetary accountability and the efficient use of public resources requires going beyond the traditional ex-post audit function. Conventional ex-post audit makes sure that budgetary resources are used according to norms, and in particular, that there is no fraudulent diversion of funds. This function is very important, but it needs to be complemented by an evaluation of the performance of public expenditure programs.

The evaluation function should be seen as a complement of the traditional functions of internal and external compliance audits in Estonia. Many governments around the world and most OECD countries have embarked in recent years on programs such as “getting value for money” that aim to improve the economic efficiency of the budget. The focus of the evaluation function is on the effectiveness of public expenditure programs. Budget and public policy evaluation use rigorous methodologies in combination with ex-post performance data. These approaches allow the re-examination of the relevance of the program objectives vis-a-vis the problems and needs initially identified, and the correspondence between the resources allocated to the program and final performance. The final objective of budget evaluation is to provide critical analysis and information that is fed back to policy makers and used in the reformulation of budget programs.

*Recommendations.* A budget evaluation function should be developed in the Ministry of Finance and in the State Audit Office. Because very different types of expertise will be needed to perform program evaluations, it may be desirable that these institutions have a small permanent staff dedicated to evaluation but that they hire consultants from the private sector or abroad to staff evaluation teams. The Ministry of Finance evaluation unit could specialize in evaluations that are carried out in a shorter period of time and whose results can be easily fed into future budget decisions. Effective evaluation will be facilitated by the existence of well developed sectoral policies with explicitly stated outcomes. Effective evaluation will also require well trained officials.