FISCAL POLICY IN RE-INDEPENDENT ESTONIA

Kalle Kukk

Development of National Fiscal Policy

Talking about Estonia's budgetary reform in the 1990s, first and foremost, transformation of budgeting principles is kept in mind, as Estonia became an independent state. Under occupation many a relationship with the Soviet Union was reflected in the budget. Therefore, some reorganisation was quite natural. Largely due to the rapid fiscal reform, it was possible already in the early days of the restored independence to apply conservative fiscal policy[1]. Regarding tax policy, another early reform wave took place in the mid-90s.

In the Soviet time, payments from the profit of all-Union enterprises, as well as part of the turnover tax and personal income tax were transferred as revenues to the Soviet Union's budget and funds therefrom in its turn were transferred back to Estonia's budget. Besides, all-Union enterprises and all-Union ministries had a direct fiscal relationship. The budget structure was very broad (see Table 1).

Table 1. Estonian SSR budget revenue and expenditure for 1989 (%)

Revenue		Expenditure	
Value Added Tax	35.5	National economy	55.8
Corporate and organisations income tax, profit distributions etc	20.4	Social and cultural events, science	37.5
State taxes from residents	12.9	Public administration	1.2
Statutory social security resources	10.4		
Other revenue	20.8	Other expenditure	5.5
Total	100.0	Total	100.0

Source: Statistical Yearbook of Estonia 1990

At the time of restoring Estonia's independence, the main objectives of the fiscal reform were to completely restructure the revenue and expenditure sides of the budget and separate the state budget from local budgets[2]. The 1989 Budget Law declared the state budget and local budgets independent. The new tax laws formed a basis for the creation of Estonian tax system. In 1990, Estonia separated its budget from the Soviet Union's budget.

[1] Banerjee, B., Koen, V., Krueger, T., Lutz, M.S., Marrese, M., Saavalainen, T.O. (1995), 'Road Maps of the Transition: The Baltics, the Czech Republic, Hungary, and Russia', International Monetary Fund.
[2] Tang, P., Nilgo, H. (1995), 'Budget Reform in the Collection Transforming the Estonian Economy', Estonian Institute of Economics of the Estonian Academy of Sciences, Tallinn.

With the adoption of the Constitution[3], a number of norms were established, which are still valid today. Chapter VIII of the Constitution stipulates that drafting and adoption of the budget, taxes, etc shall be provided by law. The Constitution provides that local governments shall have an independent budget for which the bases and procedure for drafting shall be provided by law. In 1989–1993, Estonia introduced a fiscal system quite similar to the system in use in developed countries. Nevertheless, several problems remained unsolved: expenditures were often planned from the previous levels of expenditures, preparation of draft budgets did not improve (especially on the local government level) and the revenues and expenditures of the disclosed budgets were not segmented in adequate detail[4].

Estonia's independent tax system falls into two major reform periods[5]. The first period was in the years 1991–1992. In January 1991, new taxes were introduced: value added tax, most of the excise taxes, corporate income tax and social tax. In 1992, the value added tax and income tax were changed. **The second major reform wave took place in 1994, when income tax rates were harmonised and a uniform social tax was introduced.**

The value added tax was originally split between the state budget and local government budgets. In 1991 the pre-tax rate of 7% was allocated to the state budget and 3% to the local budgets. From January to June 1992, the VAT totalled also 10% but was paid to the central government. Since July 1992 on the proposal by the monetary reform committee the value added tax has been 18%. Export has nearly always been subject to a zero tax rate with the exception from January to August 1992.

Most of the **excise taxes** – alcohol, tobacco and fur excise taxes – were also introduced in 1991. The latter was abolished in 1996. Fuel has been taxed since July 1993. The motor vehicle excise tax was levied in 1995–2002. The packaging excise tax was introduced in March 1997. All excise taxes are accrued into the state budget.

Corporate income tax rates were progressive with three grades from January 1991 to June 1992. From July 1992 to December 1993 a uniform rate of 35% was applied and since 1994 it has been 26%. In 1991–1992, 65% of the corporate income tax was paid to the state budget and 35% to the local budget. Since January 1993 the corporate income tax has accrued to the state budget. Beginning from the year 2000 reinvested profits are not levied with corporate income tax.

The personal income tax was progressive with three grades – 16, 24 and 33% in 1992–1993. Since January 1994, a proportional income tax of 26% has been applied. In 1993, the tax-exempt income rate was 2,870 kroons; by 2003 it had risen to 12,000 kroons a year. In 1991–1993, the personal income tax accrued to local budgets. In 1994–1995, 52% of the personal income tax was paid to local budgets and 48% to the state budget.

[3] The Constitution of the Republic of Estonia. It was adopted at the referendum on 28 June 1992.
[4] See Footnote 2.
[5] Taaler, J. (1995), 'Tax Reform' in the collection *Transforming the Estonian Economy*, Estonian Institute of Economics of the Estonian Academy of Sciences, Tallinn.

Since 1996 the division has been as follows: 56% to the local budgets and 44% to the state budget.

The few existing **customs duties** were replaced by excise taxes in 1993; the motor vehicle duty was replaced in 1995. **The aim was to develop Estonia into a non-protectionist state.** Protectionism is, first and foremost, reflected in customs duties. In 2000, the customs duty was reintroduced in a smaller scale for agricultural products – primarily to be prepared for the accession to the EU common economic area.

In 1993, **the land tax** was introduced. Originally the state land tax rate was 0.5% and the local land tax rate 0.3–0.7% of the taxation price of the land. Beginning from 1996 all land tax is paid to the local budgets.

In January 1991, **the social tax** was applied, which at the start was 20% and practically entirely used to fund pensions. The health insurance tax was initially not considered a state tax; and, therefore, the collection was poor compared to the social tax. In September 1993, the Riigikogu adopted the Social Tax Act, which introduced a uniform 33% social tax – 20% goes to pension insurance and 13% to health insurance.

Tax Policy

The vast majority of the public sector revenues are taxes. But also state fees, fines, dividends, interests, revenues from economic activity, foreign aid, etc. **The Estonian tax system is rather simple; it has relatively low tax rates and tax burden** (see Table 2)**, relatively broad tax base, proportional income tax, tax exemption for reinvested corporate income, as well as gradual harmonisation of value added tax and excise taxes with EU requirements.**

Table 2. Tax burden in Estonia (% of GDP)

	1996	1997	1998	1999	2000	2001	2002
Personal income tax	8.3	8.2	8.5	8.6	7.5	7.3	7.2
Corporate income tax	1.7	1.9	2.6	2.1	1.0	0.8	1.2
Social tax	12.2	12.0	12.1	11.9	11.9	11.7	11.8
Unemployment insurance premium	-	-	-	-	-	-	0.5
VAT	10.0	10.4	8.7	8.4	9.3	8.8	9.4
Excise tax	3.3	3.7	3.8	3.5	3.2	3.5	3.6
Other taxes	0.7	0.8	0.6	0.7	0.7	0.7	0.7
Total tax burden	**36.2**	**37.0**	**36.3**	**35.2**	**33.6**	**32.8**	**34.4**

Source: Ministry of Finance

Although the Estonian tax system has been quite stable in recent years, revenue collection has been very uneven (see Figure 1), primarily because of the general state of economy. In 1995, Estonian economy started to recover with economic growth peaking in the second

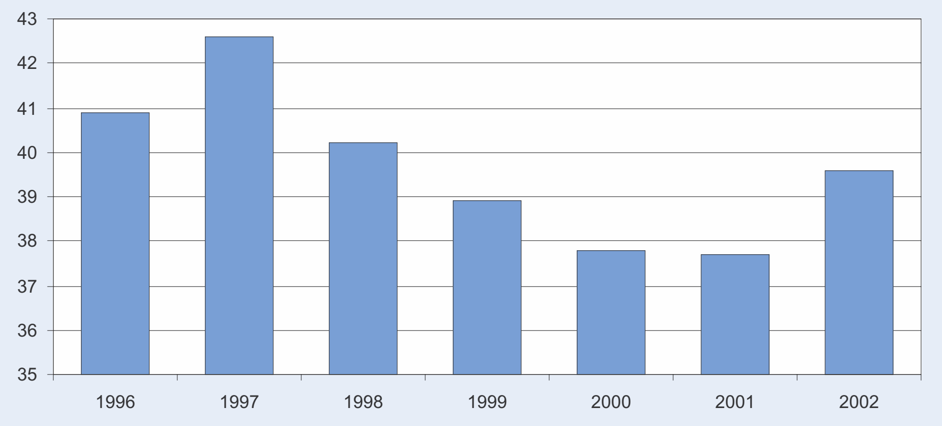

Figure 1. Estonian general government revenue (% of GDP)

Source: Ministry of Finance

half of 1997. Also tax collection displayed relative growth in this period. Although only excise tax rates were raised during this period, economic success had at least a similar impact.

In 1998, economic growth subdued, followed by a recession at the end of the year. This brought about extensive deterioration of tax collection; only corporate income tax paid for 1997 smoothed the situation. Tax evasion and tax fraud spread. Since 2000, rapid economic growth has been accompanied by improved tax collection. Stable economic growth in the first years of the century together with abruptly increased external aid (EU pre-structural funds), higher corporate profitability (dividend income and corporate income tax on dividends) and implementation of unemployment insurance has brought along relative growth in general government revenue.

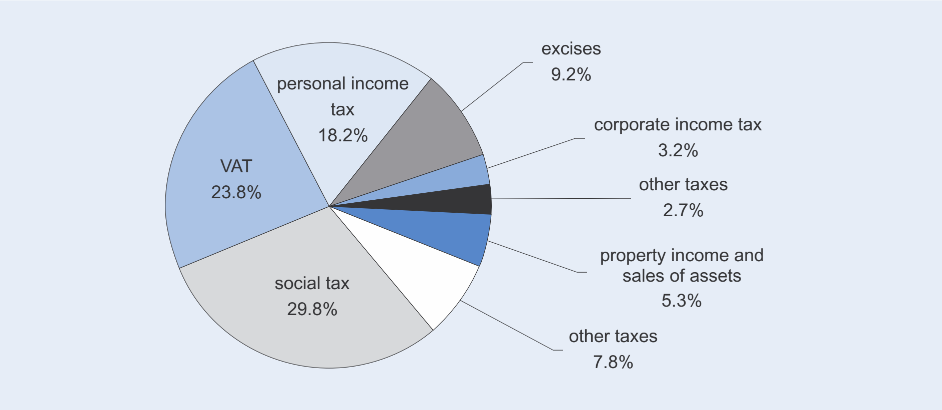

Figure 2. Estonian general government revenue in 2002

Source: Ministry of Finance

In the structure of Estonia's government revenue (see Figure 2) **the social tax revenue** is responsible for the largest share – about 30% of gross revenues. The social tax rate is 33%, including 20% of pension insurance. During the pension reform the system has been modified and now the social tax with the rate of 16% of those who have joined the second pillar pension funds goes for national pensions and 4% is transferred to the second pillar (joined by 2% paid by the employee). In 2002, a supplementary type of social insurance – an unemployment insurance system – was implemented. The **unemployment insurance premium** was introduced and is paid both by the employer (0.25–1%) and the employee (0.5–2%).

The individual income tax accounts for about a fifth of the government revenue. It is a proportional 26% tax, whereas there is a tax-exempt minimum (since 2004 up to 1,400 kroons a month). More than half of the revenue goes to local governments. **The corporate income tax** is levied on dividends and non-business expenditure. Beginning from 2000 reinvested corporate income is not taxed.

The value added tax is responsible for about a quarter of government revenues. The VAT rate is currently 18% and the tax is applied to value added similar to a majority of developed countries. The number of goods and services taxable with a reduced rate (0 and 5%) has gradually decreased. Currently, Estonia applies four excise duties – fuel, tobacco, alcohol and packaging excise duties – the first three are an EU requirement and account for most of the excise revenue.

The gambling tax, customs duty and **heavy goods vehicle tax** (introduced in 2003) account for the smallest part of the tax revenue paid to the state budget. Local government tax revenue includes besides individual income tax also **land tax** and eight different potential **local taxes**: sales tax, boat tax, advertising tax, road and street closure tax, motor vehicle tax, animal tax, entertainment tax and parking charge.

Income on various assets accounts for the largest part of **the non-tax revenue**, eg sale of non-financial assets, interest income, dividends, fees for mining right, revenue from forest, etc. Funds received from the EU budget play an increasingly important role among other revenue. General government revenues include also revenue from state fees, fines and economic activity.

Expenditure Policy

During the years of independence, the ratio of Estonia's general government expenditure to GDP has been around 40% (see Figure 3). Fluctuations have arisen rather from the overall economic status, although political decisions have played a role as well. Economic growth was relatively faster in 1997, and again since 2000. In those years the ratio of expenditure to GDP has remained below 40%. However, in periods of slower growth (in 1996 and 1998) and during the recession (1999) the tendency was to apply an expansive fiscal policy. In 1999, the elections to the Riigikogu took place and expenditure was boosted on political considerations. All this raised the general government expenditure to 43.5% of GDP.

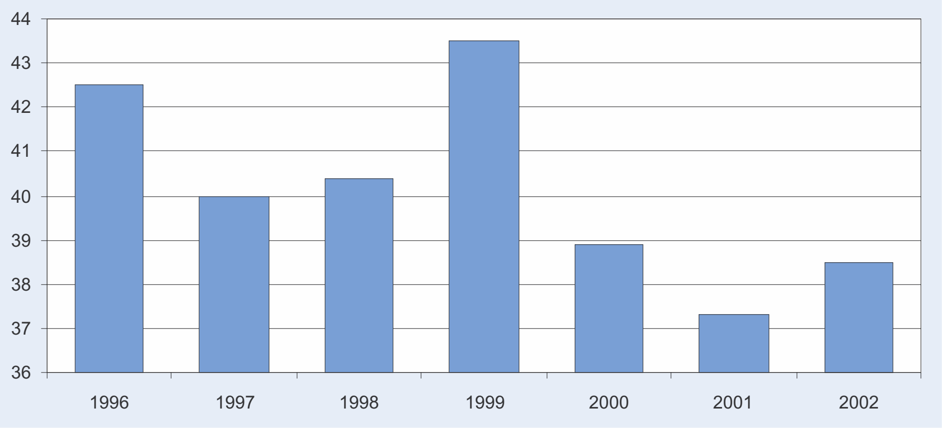

Figure 3. Estonian general government expenditure (% of GDP)

Source: Ministry of Finance

Purchases of miscellaneous goods and services (see Figure 4) account for about a fifth of the general government expenditure. They involve agency operation and maintenance costs, but also defence equipment, students' catering costs, teaching aids. **Personnel expenditure** accounts for another fifth, comprising primarily of wages, fringe benefits and income tax thereof, social tax and unemployment insurance premium.

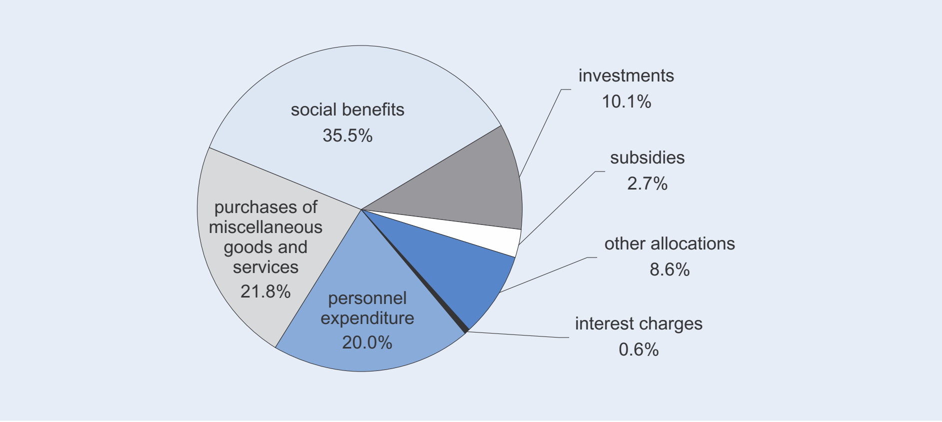

Figure 4. Estonian general government expenditure in 2002 by economic content

Source: Ministry of Finance

The largest component – about a third – of the general government expenditure is **social benefits**, including pensions, expenses for medical treatment compensated for by the Health Insurance Fund, family allowances, sickness benefits, and compensation of medical products, disability allowances and subsistence benefit.

Investments are about a tenth of the general government expenditure. There is certain pressure to increase investments as:

- Estonia as a transition economy has to invest aggressively;
- there are many pending projects;
- more external aid is flowing in from the European Union, on the premise of co-financing.

Other expenditure involves interest charges, subsidies (primarily transport and agricultural subsidies) and allocations for various non-profit institutions (persons in public law, foundations, non-profit associations, international organisations).

By fields of activity, **expenditure of the social sphere** (see Figure 5) has the largest share: social security, education and health account for about two thirds of the general government expenditure. **Economy** (agriculture, transport) and **general government** (legislative power, fiscal policy, foreign policy) expenditure follow with about a tenth of the total. **National defence expenditure** accounted for 4% of the total in 2001. Today, due to the upcoming NATO membership, the share is 2% of GDP. Expenditures on public order and security, leisure time, culture and religion as well as housing and utilities are about as large.

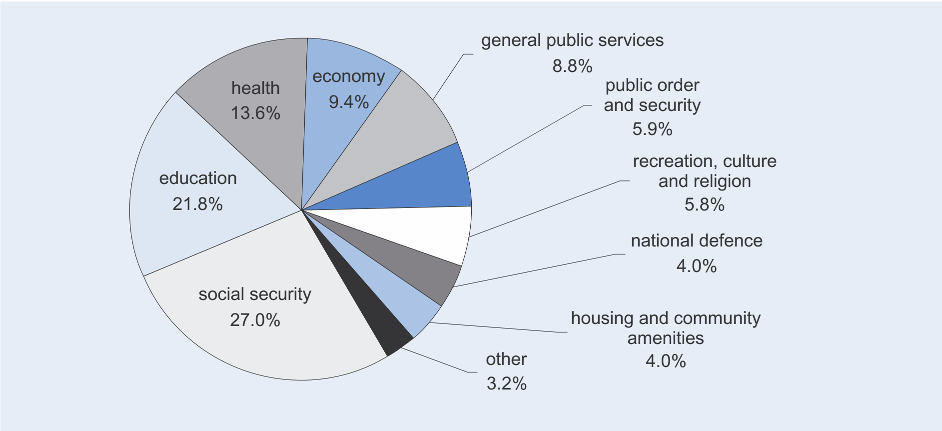

Figure 5. Estonian general government expenditure in 2001 by fields of activity

Source: Ministry of Finance

Among the general government subjects, **the state** (including pension insurance), **local governments** and **health insurance fund** are the main spenders. Besides, pursuant to the State Budget Act[6] the general government consists also of legal persons in public law and foundations funded mainly by the state and local governments. Expenditure by the state (without social insurance) accounts for about a half (see Table 3). In 2001, the expenditure of local governments increased considerably as the state transferred the teachers' salaries to the local budget.

[6] The State Budget Act. Adopted on 9 June 1999.

Table 3. Expenditure by general government subjects (%)

	1996	1997	1998	1999	2000	2001	2002
Government (excl social security)	55.8	56.0	54.0	54.3	53.7	53.9	54.3
o/w allocations to other government sectors	4.9	6.3	6.4	6.4	6.4	10.2	9.9
Pension insurance	17.2	17.5	18.6	19.5	19.5	18.2	17.4
Health Insurance Fund	11.5	11.5	12.1	11.7	12.3	11.5	11.2
Local governments	20.5	21.3	21.8	20.9	20.8	26.5	27.0
General government	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance

Budget Balance and Borrowing

The budget balance is the most significant indicator in assessing the credibility of the government's fiscal policy. A deficit indicates that the government is spending excessively and usually resorts to borrowing. General government deficit and the debt-to-GDP ratio (3 and 60%, respectively) are the two criteria of five used to assess the readiness of the country to accede to the EMU.

Estonia's fiscal policy is characterised by **a stable tax system, oversight of expenditure** and **conservative borrowing**. As a result, government sector budget deficit and debt ratio have been relatively small. A tight fiscal policy is a prerequisite for currency board arrangement. The need to meet the EU requirement outlined in the Stability and Growth Pact[7] to adhere to the medium-term objective for budgetary positions of close to balance or in surplus, assumes conservative fiscal policy as well.

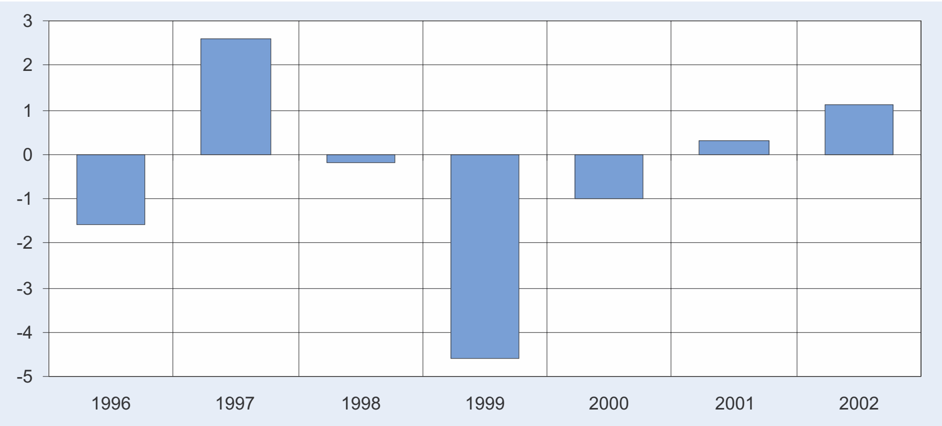

Figure 6. Estonian general government deficit/surplus (% of GDP)

Source: Ministry of Finance

[7] EU Council Regulation of 7 July 1997 'On Speeding up and Clarifying the Implementation of the Excessive Deficit Procedure'. EU Council Regulation of 7 July 1997 'On the Strengthening of the Surveillance of Budgetary Positions and the Surveillance and Coordination of Economic Policies'.

Throughout the years Estonia's consolidated government budget has been more deficit- than surplus-oriented (see Figure 6). The rapidly growing economy created a large revenue surplus in 1997, which allowed establishing a Stabilisation Reserve Fund. According to the State Budget Act, the Stabilisation Reserve Fund can be used only to reduce general economic risks and to finance restructuring. The Fund has been used only once, in 1998, to support agriculture with more than 200 million kroons. Currently, the Stabilisation Reserve Fund is nearly 3% of GDP, being about a quarter of all financial assets (deposits and securities, except shares).

Estonia's gross government debt compared to other countries is very small – about 5–6% of GDP (see Table 4). Among EU Member States and acceding countries it is comparable to Luxembourg, whereas most of the current EU Member States have a debt ratio of about 40–70% of GDP and Greece, Belgium and Italy even more than a 100%. However, Estonia should refrain from raising the debt burden, which by sending interest expenditure upward would ultimately lower the quality of main government functions (education, health, etc). Government borrowing from the domestic market would mean crowding out the private sector[8]. Increasing external borrowing would boost Estonia's foreign debt, which, in turn, would make the international financial sector cautious and the economy more vulnerable. Escalating government borrowing could also bring along an interest rate growth, making credit resources considerably more expensive for the private sector[9].

Table 4. General government debt (% of GDP)

	1996	1997	1998	1999	2000	2001	2002
Central government	6.2	5.2	4.4	4.8	3.3	2.9	3.6
o/w foreign debt	4.9	4.3	3.7	4.2	2.9	2.5	2.9
Local governments	2.5	2.2	2.2	2.3	2.0	2.1	2.3
o/w to central government	0.7	0.7	0.6	0.6	0.3	0.2	0.1
General government	**8.0**	**6.7**	**6.0**	**6.5**	**5.0**	**4.8**	**5.8**

Source: Ministry of Finance

Budgetary Procedure

Budgetary procedure should start several months before the beginning of the next fiscal year by making preliminary economic forecasts and setting budget priorities. The procedure will be complete only when the annual report will be verified and audited. In other words, the budgetary process would take two and a half years as a minimum. It could be conventionally structured as follows:

- Establishing of a mid-term budget strategy;
- Drafting of budget projects and a draft budget;
- Legislative proceeding of the budget in the parliament;

[8] Kopits, G., Symansky, S. (1998), 'Fiscal Policy Rules', International Monetary Fund.
[9] 'Republic of Estonia External Borrowing: Concept for 1999–2003', Ministry of Finance, 1999.

- Drafting of sub-budgets;
- Budget execution;
- Reporting;
- Auditing.

Each budgetary procedure should start with the establishment of fiscal and economic policy framework both for the upcoming fiscal year and the subsequent years. This should be directly linked to the establishment of the budget and ensure certain stability. To this end, a budget strategy is established. On the proposal of the Minister of Finance the government has to approve the strategy seven months before the beginning of the fiscal year at the latest, ie by end-May of the previous year. The budget strategy comprises overall objectives of the government, an overview of the economic situation and estimate of the development, economic growth forecast and budget revenue forecast, fiscal policy objectives, priority cost fields, an overview of public investment programmes and contingent liabilities of the state.

Drawing up of the (draft) state budget is the most complicated link in the budgetary procedure, being probably the most conflicting phase of the entire process. Preparation and drawing up of the budget are (or at least should be) in the focus of good public expenditure management[10]. Budget appropriations submitted by ministries for the next budget quite often exceed the potential real level by tens of percentages. Trade-offs are necessary in drawing up the draft budget, although frequently the final decision remains with the government.

Over the recent decades in quite a few developed countries there have been attempts to implement a more state-of-the-art approach in budgeting than plain cost-oriented planning. Primarily the principles of **zero-based, programme-based** or **performance budgeting** have been attempted to apply. As it is generally recognised that democracy has no economic justification, there is a strong commitment to show that the government does not have to be inefficient in its performance[11]. However, experience displays that it could take tens of years of conscientious work to fully implement new principles.

Establishing the state budget for 2001, for the first time zero-based and performance budgeting were applied. Each agency had to submit the following information for the next fiscal year:

- Agency objectives, ie intended outcome;
- Proposed goods and services, necessary to achieve these objectives, ie output;
- Specific indicators showing how to measure achievement of the objectives;
- Resources necessary for the achievement of the objectives, ie input;

This approach is still applied to strategic planning.

[10] Potter, B.H., Diamond, J. (1999), ‘Guidelines for Public Expenditure Management’, International Monetary Fund.
[11] Premchand, A. (1993), ‘Public Expenditure Management’, International Monetary Fund.

The main provisions for drafting state budget provided in the State Budget Act are:

- The bases for a budget project of a ministry are the budget strategy, strategic development plans, the strategy of the ministry, and the action plans and investment plans of the ministry and the state agencies within its area of government;
- Negotiations shall be held between representatives of the Ministry of Finance and the relevant ministry or constitutional institution concerning a budget project;
- Following negotiations the Ministry of Finance shall, on the basis of the budget projects, compile a draft state budget and submit it together with an explanatory memorandum to the government;
- The government shall submit a draft state budget to the Riigikogu not later than three months before the beginning of the fiscal year.

The following is the procedure for legislative processing of draft state budget in the Riigikogu as provided for in the State Budget Act:

- It is deliberated at three readings;
- A motion to amend a draft state budget shall not cause a state budget deficit, an increase in the state budget deficit or a reduction in the state budget surplus;
- The Riigikogu shall pass a state budget as an Act;
- If the Riigikogu has not passed a state budget by the beginning of the fiscal year, expenditure of up to one twelfth of the expenditure of the previous fiscal year may be incurred per month in the new fiscal year until such time as a state budget is passed.

Usually the Riigikogu passes the state budget in its entirety. In other words, the total expenditure and general breakdown (operating expenditure, investments, etc) per institution is approved. Further cost breakdown in the budgets of ministries is the responsibility of ministers. Such an approach will ensure better flexibility for efficient planning of activities.

For budget execution the State Budget Act provides that:

- Supervision over and auditing of the receipt of state budget revenue shall be exercised by the Ministry of Finance;
- A minister does not have the right to change the purpose of expenditure prescribed in the state budget;
- State agencies have the right to use appropriations designated in the budget only during the same fiscal year, with the exception of transferable expenditure;
- It is prohibited for state agencies to take loans or assume other liabilities, provide collaterals, make donations and grant loans or acquire other financial assets;
- State agencies have the right to enter into procurement contracts using the appropriations of the following year to the extent of up to 50 per cent of the corresponding appropriations for the given fiscal year;
- The execution of the state budget is the calculation of state budget revenue, the maintenance of records of expenditure made from the state budget and of state financial assets and liabilities, and the making of payments from the state budget.

In practice, it is quite common to amend the budget and compile supplementary budgets within the fiscal year. This can be called a deviation from a regular budgetary procedure.

A transparent and sound fiscal policy entails that all circumstances, which could affect the financial situation in the upcoming year are considered during budgeting; and, consequently, there is no need to interfere during the fiscal year[12].

Pursuant to the State Budget Act, in order to amend the state budget without amending the total volume of expenditure, the government may initiate a draft State Budget Amendment Act no later than two months before the end of the fiscal year. If the amendment of the budget is related to an increase or reduction in the total volume of expenditure, a supplementary budget may be passed during the fiscal year on the proposal of the government. A draft supplementary budget, which would increase expenditure, shall be submitted to the Riigikogu no later than three months and the one, which would decrease expenditure, no later than two months before the end of the fiscal year.

Reporting and auditing are most significant in making budgetary procedure more transparent. In compliance with the State Budget Act the state annual reports include annual reports of accounting entities and consolidated state annual report, comprising also report on the execution of the state budget. Audit on annual reports shall be conducted by the State Audit Office. The consolidated annual draft report shall be presented to the State Audit Office by 30 June at the latest. The State Audit Office shall provide an estimation and audit report by 31 August at the latest. The audited consolidated annual report shall be submitted to the government for an approval. The government shall submit the approved consolidated report to the Riigikogu.

Local Governments

The Constitution of the Republic of Estonia provides that all local issues shall be resolved and managed by local governments, which shall operate independently pursuant to law. Although no one from the central government level can directly interfere with local budget related issues, there is a need for some regulation. **Time has shown that local governments do not always perceive general fiscal or economic policy development or consider it insignificant.** Such an approach creates dissonance in the economy.

Problem solving should not involve setting restrictions on the activity of local governments but rather enhanced cooperation between different levels. The state and local governments should reach an agreement in fiscal policy principles, including revenue, expenditure and borrowing policies. If we leave aside negotiations on the equalisation fund going on between the state and local governments, there are few references in the applicable legislation to local government rights and possibilities to influence central government. The following are a few examples from the Local Government Organisation Act[13]:

- The relationship between local governments and the state is based on law and contracts;

[12] Kukk, K. (2001), '*Eelarvereform Eestis 1999–2001*' Master's Thesis, Tallinn.
[13] The Local Government Organisation Act. Passed on 2 June 1993.

- Local government can make proposals for the adoption of legislation;
- Local governments are consulted in planning and resolving issues directly related to them.

It should be primary for the state to determine local governments' expenditure policy and keep it under control. In case of success it would be considerably easier to define the local government financing need, adjusting local government revenue base and the size of state budget funds. An accurate expenditure estimate could avoid an unexpected deficit and a necessity to resort to extraordinary measures. A sound expenditure policy would ensure expedient spending.

The Local Government Organisation Act provides that the functions of a local government include the organisation, in the rural municipality or city, of social assistance and services, the supply of water and sewerage, housing and community amenities, provision of public services and amenities, public transport within the rural municipality or city, maintenance of streets, the maintenance of pre-school child care institutions and basic schools, welfare services for the elderly, the maintenance of community centres and libraries, etc (see Table 5).

Table 5. Estonian local governments' expenditure by fields of activity (%)

	1996	1997	1998	1999	2000	2001
Education	41.6	39.0	39.9	39.4	38.9	45.4
Housing and community amenities	19.5	13.9	13.2	15.7	15.3	15.0
Recreation, culture and religion	8.5	8.7	10.5	10.8	11.4	10.4
Social security	4.2	10.3	11.5	10.6	10.6	9.1
General public services	11.8	11.4	11.3	10.8	11.2	9.2
Other expenditure	14.4	16.7	13.7	12.7	12.5	11.0
Expenditure total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Ministry of Finance

Unfortunately little attention has been turned to substantial aspect of spending – efficiency and quality in the use of resources. To achieve this, it is necessary:

- To map expenditure;
- To transfer local-level-related expenditure from the state to the local government;
- For local governments to merge (in smaller local governments general government spending represents about a half of the total expenditure);
- For local governments to offer joint services;
- To ensure cost-efficiency and performance;
- To enhance supervision of spending.

The transfer of new functions to local governments will undoubtedly raise a question of financing. **The main question is whether the local governments' revenue base should be expanded, the volume of state budget appropriations increased or acceptable loan burden raised.** The share of state budget aids in the aggregate revenue has increased to more than a third after transferring teachers' wages to local government budgets (see Figure 7). In real life, however, even the so-called own revenues are not within the exclusive competence of local governments. Currently the main source of revenue for rural municipalities and cities is personal income tax, whereas its base and rate are authorised by the central government.

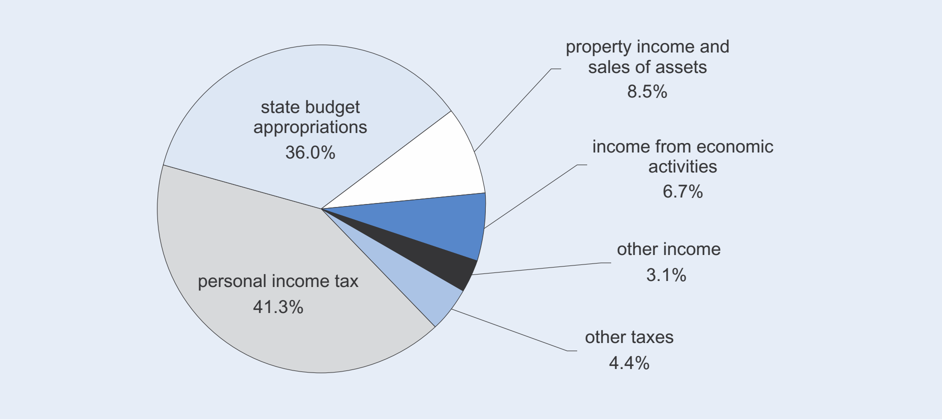

Figure 7. Estonian local governments' revenue in 2002

Source: Ministry of Finance

Similarly, local governments cannot determine the tax base for the land tax either, although they can set the rate. Local governments are relatively free to impose local taxes but no anticipated outcome is seen – very few local governments have imposed them.

As the collection of personal income tax per capita in wealthier and poorer local governments varies about eleven times[14], there is a need for state budget support. However, an excessive rise in support could be dangerous, as according to the research the general government spending level depends on the support and not on the distribution of expenditure between the levels of government[15]. The reason is that **local governments have not reduced own revenue upon growth of transfers from central government but have rather funded spending, whereas usually spending grows more than transfers.**

The State Budget Act provides for appropriations to local governments that:

- Expenditure related to duties of the state imposed by law on a local government shall be funded through appropriations from the state budget;
- Appropriations shall be made from the state budget through the budget equalisation fund or as appropriations intended for specific purposes;
- The size and the distribution of the budget equalisation fund shall be determined on the basis of an agreement between the representatives of the local governments and the Government of the Republic;

[14] See Footnote 11.
[15] Ahmad, E., Hewitt, D., Ruggiero, E. (1997), 'Assigning Expenditure Responsibilities//Fiscal Federalism in Theory and Practice', International Monetary Fund.

- If a local government exceeds the volume of liabilities, which may be assumed or if a local government has unperformed financial obligations before the state, the government has the right to reduce payments made from the budget equalisation fund.

Although every year in Estonia local governments as a whole have had budget deficit, the level of gross debt remains relatively low – an average of 2.2% of GDP (see Table 6). However, the experience of other countries reveals that **local government borrowing is one of the most imminent threats to the national fiscal and economic policies.** In recent years, a few of Estonian local governments have become insolvent (Tootsi rural municipality, the cities of Kallaste, Narva-Jõesuu, Paldiski and Püssi).

Table 6. Main financial indicators of Estonian local governments (% of GDP)

	1996	1997	1998	1999	2000	2001	2002
Revenue	7.8	8.4	8.5	8.6	7.8	9.3	9.7
Expenditure	9.0	8.5	8.8	9.1	8.1	9.9	10.4
Balance	-1.2	-0.1	-0.3	-0.5	-0.3	-0.6	-0.7
Debt	2.5	2.2	2.2	2.3	2.0	2.1	2.3

Source: Ministry of Finance

The Rural Municipality and City Budgets Act regulates local government borrowing[16]:

- Liabilities of a local governments shall not exceed 60% of the proposed budget revenue for the fiscal year (without loans and allocations from the state budget for a specific purpose);
- Loan servicing costs shall not exceed 20% of the proposed budget revenue for the fiscal year;
- The collateral for a loan shall be neither an immovable or a structure which is a movable;
- A copy of a loan agreement entered into shall be presented to the Ministry of Finance;
- Issues of debt instruments shall be registered with the Financial Supervision Authority;
- The government has the right to suspend making of payments from the budget equalisation fund to a local government if a copy of a loan agreement is not submitted or issue of debt instruments is not registered.

Local government expenditure policy has been expansive, ie all the revenue collected has been spent even during the peak of economic growth. Such an attitude amplifies difficulties occurring under unfavourable economic conditions, as an aggressive cut of the cost base is a difficult and unpleasant action. Cost financing through borrowing has sent a few local governments into serious difficulties. In order to avoid such a situation and solve existing problems, legislation to handle local government insolvency should be drafted.

[16] The Rural Municipality and City Budgets Act. Passed on 16 June 1993.