

## **Republic of Estonia: Report on Observance of Standards and Codes—Fiscal Transparency**

This Report on the Observance of Standards and Codes on Fiscal Transparency for the **Republic of Estonia** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **June 14, 2001**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Republic of Estonia** or the Executive Board of the IMF.

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REPUBLIC OF ESTONIA

**Report on the Observance of Standards and Codes (ROSC)  
Fiscal Transparency Module**

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June 14, 2001

**Executive Summary**

This report provides an assessment of fiscal transparency practices in Estonia in relation to the requirements of the IMF *Code of Good Practices in Fiscal Transparency* based on the authorities' response to the IMF fiscal transparency questionnaire, documents provided by the authorities, and discussions with the Estonian authorities.

Estonia has achieved most of the requirements of fiscal transparency and, with planned improvements, should move significantly closer to full observance of the Code. Among the group of countries in transition, Estonia is a leader in terms of adopting accrual accounting and has moved quickly and decisively to adopt the sound fiscal management practices needed to meet the demanding EU standards for accession. A large amount of fiscal data and information, including the budget strategy documents, economic forecasts, fiscal data covering central and general government operations and central government debt, and taxpayer rights and compliance information, can be found on websites.

There are several areas where transparency can be improved and the government is making efforts toward this end. A new State Budget Law, to be adopted in 2001, should clarify the definition of general government, ensure full coverage of all budget and extrabudgetary activities, and improve budget classification. The staff has suggested improvements in the budget documents to provide more details and analysis, to improve fiscal reporting especially on the government balance sheet and debt, provide guidelines for investment and reporting of budget reserves, and strengthen medium-term budgeting. In the longer term, the authorities are encouraged to enhance the quality and use of accrual accounting in the aggregative budget analysis, push ahead with administrative reforms to clarify the lines of ministerial responsibility and accountability, clarify the status of regular economic forecasts, implement a formal midyear review of the economic and financial outlook, promote better cooperation and coordination with subnational government (particularly with regard to sharing the general government deficit/surplus), strengthen the setting of performance objectives and subsequent measurement, and continue developing the internal and external audit capacity with a view to improving the quality of data and fiscal reporting.

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**ABBREVIATIONS AND ACRONYMS**

BOE	Bank of Estonia
ESA	European System of Accounts
EU	European Union
GFS	Government Finance Statistics
MOE	Ministry of Economy
MOF	Ministry of Finance
NPIs	Nonprofit institutions
PEP	Pre-Accession Economic Programs
QFAs	Quasi-fiscal activities
SAO	State Audit Office
SDDS	Special Data Dissemination Standard
SOE	Statistics Office of Estonia
SRF	Stabilization Reserve Fund

## I. INTRODUCTION<sup>1</sup>

1. This report provides an assessment of fiscal transparency practices in Estonia against the requirements of the IMF *Code of Good Practices on Fiscal Transparency*. The authorities have completed the fiscal transparency questionnaire prepared by the IMF staff. The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of the questionnaire response and additional information provided by the authorities. The second part is an IMF staff commentary on fiscal transparency in Estonia.

## II. DESCRIPTION OF PRACTICE

### A. Clarity of Roles and Responsibilities

2. **General government activity can be generally distinguished from the rest of the economy.** However, there are several areas where the distinction between public and private activities involves difficult classification issues. In Estonia, there are a number of foundations that rely to varying degrees on budgetary funding. In some cases, these foundations replace operations previously funded through extrabudgetary funds. The Statistics Office has generally included the operations of these bodies in general government, including those funded from private contributions, whereas the Ministry of Finance (MOF) has measured only the grants paid to these bodies from the budget. Similar issues arise in the treatment of some other bodies such as hospitals and universities that receive part of their revenues from the private sector. The planned amendments to the State Budget Law that have been submitted to parliament clearly define general government and will resolve any differences in approach between the MOF, the Bank of Estonia (BOE), and the Statistics Office. The authorities expect to pass these amendments by end-June 2001.

3. **Quasi-fiscal activities (QFAs) are not reported in budget documents, but they are very limited.** There is only one public financial institution, the Compensation Fund, which manages revenue from past privatization. This Fund is now used mainly to redeem bonds issued in earlier years and any residual assets will be liquidated at the beginning of 2003 and transferred to the Stabilization Fund.

4. **Privatization is virtually complete but there are still about 45 public enterprises remaining.** Privatization is governed by three laws: the *Law on Privatization*, which creates the Privatization Agency, the *Law on State Property*, and the *Law on the Uses of*

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<sup>1</sup> This review was prepared by an IMF team consisting of Jon Craig and Taryn Parry (both FAD), Robert Burgess (EU2), Adalbert Knöbl, IMF Senior Resident Representative to Estonia, and Kalle Kukk, Economic Analyst in the IMF Estonia Office.

*Privatization Receipts* (see Box 1).<sup>2</sup> The Privatization Agency will be closed from November 2001, and the sale of government-owned assets will then be through the *Law on State Property* (not the Law on Privatization), which does not require privatization proceeds to be passed through the budget; rather, projects will be handled on a case-by-case basis, as illustrated in Box 1, which describes two current experiences with privatization under the *Law on State Property*.

### Box 1. Current Privatization Issues

One complicated deal (still under negotiation) involves the sale of a power plant, including a coal shale company, that will likely require the purchaser to provide financing but also commits the government-owned parent company, Estee Energi, to reinvest the proceeds of privatization back into the company. Details of the arrangement will be made public after the deal is completed. The proposed arrangement closes off consideration of other possible budgetary options for the use of the proceeds from the sale of the power station.

By contrast, the privatization of a railroad company may actually improve transparency. This company has been split and sold as two separate companies—one for freight and the other for passengers. The passenger company will not be profitable without subsidies, so the sale required a government commitment to maintain a certain level of subsidies for a number of years. These subsidies will be on budget and the arrangement is currently the subject of debate in parliament. The split of the company reveals the loss-making side of the business (previously cross-subsidized by freight shipments) and permits parliament to identify an objective—maintenance of a passenger railway—and the costs for the budget.

4. **The central bank is independent and does not carry out QFAs.** According to the *Law on the Central Bank of the Republic of Estonia*, the central bank is independent of government and reports only to the parliament. While there is no law prohibiting privileged access of the public sector to financial institutions, this has never happened. Furthermore, there is no evidence of any government or industry interference with the work of the BOE.<sup>3</sup> The Law on the Central Bank also defines rigorous reporting and auditing requirements.<sup>4</sup>

<sup>2</sup> Estimated cash receipts from privatization from 1993 to 2000 are EEK 4,536.3 million. The following table illustrates the current rules for distribution of privatization proceeds but, as of January 2002, 100 percent of privatization receipts (mostly from installment payments) will be earmarked for the SRF:

	Proceeds of the Privatization Agency	Proceeds from Land Privatization
SRF	60 percent	60 percent
Entrepreneur Development Foundation	25 percent	---
Government Ownership Reform Fund	15 percent	25 percent
Local authorities	---	15 percent

<sup>3</sup> See Estonia, ROSC on Monetary and Financial Policies, June 2000 at [www.imf.org/external/np/rosc/est/trans.htm](http://www.imf.org/external/np/rosc/est/trans.htm).

<sup>4</sup> Information and reports can be obtained on the BOE's web site: <http://www.epbe/ee>.

5. **Government regulation of the nonbank private sector is mostly clear and efforts are underway to reduce and clarify business licensing.** The privatization of public utilities has brought with it a need for an effective regulatory framework and, for example, prices for both electricity and oil shale are now subject to regulation. The Ministry of Economy (MOE) is currently surveying all regulations that impact the private sector, and plans to issue comments in May 2001. In some industries, such as tourism (hotels), certain present regulations may be judged to be unnecessary, and, in other areas, such as business and training schools, measures may be recommended to improve the transparency of regulations. There are less than ten regulatory agencies that cover both consumer protection and business regulation.

6. **Government equity holdings are extensive and are systematically reported.** There are approximately 70 joint stock companies: 45 where the government is a majority holder of stocks and around 25 where the government is a minority owner. Most of these companies are in the communications, energy, or transportation industries. The *Law on Participation of the State in Private Legal Entities* provides transparent rules for the management of these joint-stock companies, sets out the responsibilities of the government ministries involved, and states procedures on how to distribute the dividend of state-owned holdings. This law also requires these companies to send financial reports to the MOF on an annual basis, and the MOF provides data on its equity holdings on its website. The MOF has recommended that the government progressively disengage from these activities unless there is a strong justification for government involvement.<sup>5</sup>

7. **Roles of the executive, legislative, and judicial branches are clear.** Estonia is a parliamentary republic and the roles of the different branches of government are well understood and established in the constitution adopted in 1992 and subsidiary legislation.<sup>6</sup> The Riigikogu, the parliament of Estonia, authorizes the budget proposed by the cabinet of ministers of the executive branch. The executive is accountable to parliament for ensuring that the budget execution does not deviate from that authorized. The Estonian court system adjudicates budget laws, including tax appeals and other challenges to administrative decisions or activities. A unique feature of the Estonian system is the appointment by the Riigikogu of an independent Legal Chancellor with the principal task of determining whether legislation adopted by both the central and local governments is in conflict with the constitution or any law. In addition, the Legal Chancellor acts as an ombudsman to examine complaints from the public concerning infringement of basic rights and liberties.

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<sup>5</sup> Justification would be based on three possible arguments: (i) it would be income optimizing; (ii) a large natural monopoly is under-regulated (or the regulatory agency is relatively weak); and (iii) in a few cases, the company performs mainly public functions. Where the government retains its shareholdings, the MOF recommends that the ministry shareholder approve 1–3 year business plans.

<sup>6</sup> For a discussion of the main features of the Estonian government, see the official web page <http://www.riik.ee/en/>.

8. **Fiscal management is clearly defined in the constitution and specific budget legislation.** The existing *State Budget Law*, which came into force in January 2000, provides a clear mandate to the minister of finance to exercise control over fiscal management. The law places an emphasis on financial compliance and spells out in detail the steps required to prepare, present, execute, report, and audit the budget. The law states that the budget should cover *all* government revenues and expenditures, but this principle has not been fully enforced. In practice, the coverage of the budget was extended in 2000 to include the social security and health insurance funds and own (nontax) revenues received by ministries and agencies but did not require full coverage of all funds, including especially those receiving privatization revenues that have remained outside the budget. The proposed amendments to the *State Budget Law* would extend the coverage of the budget to include all revenue, expenditure, and financing transactions of the general government sector—as defined by the European System of Accounts (ESA)—including own-source revenues, foreign loans, and grants.<sup>7</sup> The revised law will also make provision for a new classification that will be consistent with international principles.

9. **The multi-layered structure of government complicates the accounting function and blurs accountability.** There are several administrative layers of central government in Estonia. Each ministry has oversight over a number of agencies and inspectorates that are responsible for providing services. Fifteen county governments have oversight of a number of central government administrative agencies' activities (e.g., police services) implemented in regional areas. The Ministry of Internal Affairs is responsible for the general coordination and organization of the county governors' work.<sup>8</sup> As noted earlier, there are also about 30 foundations, which are Nonprofit Institutions (NPIs) managed by boards comprising both private and government representatives, that receive substantial contributions from the budget. In all, there are approximately 600 administrative units. The auditor-general has commented on the difficulties that this structure creates for both the quality of accounting and for accountability. Historically, many of these agencies made their annual financial reports directly to the MOF but were administratively responsible to ministers or country governors. In 2001, revised lines of responsibility and reporting were adopted, and these agencies now report initially to a minister or county governor with a copy for information to the MOF.

10. **Mechanisms governing intergovernmental fiscal relationships are well established.** The constitution specifies that the (presently 247) local governments shall have

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<sup>7</sup> External grants are presently small (but are expected to become significant as a result of the EU accession process). Some are received in the form of grants-in-kind, and these are not easily captured by the existing cash-basis recording system.

<sup>8</sup> After the adoption of the constitution, the second level of local government was reorganized into regional units of central government. County "governments" are now central government administrative units at the regional level.



independent budgets and a right to impose taxes.<sup>9</sup> Local government budgets have to be presented to the MOF but formal approval is not required. The *Local Government Organization Act* specifies the expenditure assignments and organization of local government and the relation of local governments with one another and with state bodies.<sup>10</sup> Revenue assignments are set down in the *Local Taxes Act* that provides for eight local taxes, some of which are ill suited to the local level and are not utilized. The *State Budget Law* also provides the minister of finance with powers to determine bookkeeping regulations for local budgets and requires the central government to compensate local governments for any costs imposed on them by decisions taken in the central government budget context.

**11. Despite substantial interdependence, intergovernmental cooperation in setting fiscal targets is lacking.** The sizable gap between local expenditures and revenues is filled by tax-sharing arrangements, transfers from the central government, and borrowing. The *Rural Municipality and City Budgets* law gives the procedures for preparation of local budgets and the rules and conditions applying to local borrowing.<sup>11</sup> The *Taxation Act* provides details of the tax-sharing arrangements, including a 56 percent share of the personal income tax, a 100 percent share of the land tax (the rate of which can be set, within limits, by the local governments), and varying proportions of natural resource taxes. Transfers to local governments are described in the *Law on the Correlation Between Municipal and City Budgets* and the *State Budget Law*. These transfers include formula-based grants for equalization that are linked to relative revenue capacities, as well as earmarked grants. The annual consultations with local governments tend to focus on the level of transfers with little or no discussion of borrowing proposals. Given the goal of European Union (EU) accession and its corresponding restrictions on the deficit of general government, there is an increasing need for coordination of national and local government fiscal targets.<sup>12</sup>

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<sup>9</sup> The populations in many local government areas are very small and the voluntary merging of local governments has been encouraged. Proposals to undertake a proactive approach to reducing the number of local governments are under discussion.

<sup>10</sup> Some functions fall exclusively to national government (e.g., defense and foreign relations), some exclusively to local government (e.g., garbage services), and some are shared (including health and education provision).

<sup>11</sup> Presently, there are three controls on borrowing in excess of 12 months: proposals must relate only to investment projects; the stock of debt must not exceed 75 percent of projected revenues; and debt service payments cannot exceed 20 percent of projected revenues in any year. Currently, while many local governments borrow, only ten municipalities have exceeded the limits on borrowing and in only two cases were bailouts granted.

<sup>12</sup> In 2001, the central government has sought to offset deficits at the local level by adjusting its own budget to maintain a general government balance.

12. **The coordination of the State Budget and Stabilization Reserve Fund (SRF)<sup>13</sup> is a source of uncertainty in the budget process.** The flows in and out of the SRF are recorded in general government financial statistics as the change of deposits abroad. However, the present budget law can be read to suggest that the SRF should operate as a separate or “dual” budget running parallel to the state budget with its own procedures for approval and execution. The Fund can receive revenue from various sources including transfers from the budget (if revenues exceed expenditures at the end of the budget year), 60 percent of privatization revenue, allocations from Estonian Bank profit to the state budget, interest on invested funds, and other receipts. The Fund can be used to “avoid or relieve” socio-economic or emergency needs. The law specifies that the use of the Stabilization Reserve should be decided by parliament on the basis of a proposal of the government (based on the decision of the Council of the Stabilization Reserve). The manner in which the Fund would be coordinated with the state budget is unclear (e.g., in relation to the achievement of specified fiscal targets).

13. **Mechanisms for the coordination of the budget and the central bank are defined in the Law of the Central Bank.** The Law prohibits direct financing of the public sector by the central bank. Nor can the central bank be held liable for any financial obligations of the state. The role of the central bank as a currency board demands transparent fiscal policy. Therefore, according to the Law, while the central bank participates in economic policy of the state by conducting independent monetary, credit, and banking policy, the government should not make important economic policy decisions without consulting the central bank. The minister of finance has the right to attend the board meetings of the central bank with observer status and the right to speak. The Law on the Central Bank defines how profits are to be determined. However, the central bank has some discretion in determining the amount of profit transferred to the budget because it can allocate its profits to reserves beyond the minimum allocations specified, and it can also allocate its profits to special funds within the Central Bank. Although some general mechanisms were decided in 1999, it can be difficult for outside observers to understand the precise calculations used to determine the amounts to be transferred to the budget.

14. **The legislative basis for taxation, regulation, and administrative procedures is clear and observed in practice.** The tax laws provide detailed procedures that do not leave discretion to tax officials. Any deviation from these procedures would be illegal and punished. Estonia introduced in 2000 an innovative new system of business taxation—profits retained within an Estonian company are not taxed. In this context, it can be noted that Estonia will be subject to, and already complies with the EU’s Code of Conduct for Business Taxation, which guards against harmful tax competition.

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<sup>13</sup> The management of the SRF is governed by the State Budget Law, the Government’s Decree on Reserve Management, and the Basic Principles of Stabilization Reserve Management, which fixes the restrictions on risk and sets relevant benchmarks, etc.

15. **There is no code of conduct specific to tax officials, but they are subject to a code of ethics as part of the *Law on Public Service*.** The rights and obligations of taxpayers are clear, and the information is available on the tax board's webpage, including the *Law on Tax Administration*. A new draft Taxation Act has been drawn up by the MOF that attempts to give more balance between taxpayer rights and obligations. Appeals can be sought through an internal administrative review or by appealing through the court (a more costly and time-consuming option). All taxpayers are treated equally under the law and in the actual administration of tax collection. Information is provided to taxpayers through various sources, including a web page (<http://www.ma.ee>), information days, pamphlets, free seminars in Tallinn and other cities, information numbers, and e-mail.

16. **Ethical standards are set for public officials** in the "Ethics Code for Public Servants" adopted in 1998. The *Law on Public Service* regulates potential conflict of interest issues (such as membership of political parties) and the declaration of interests. Compared with other transition countries, Estonia has been successful in managing and containing corruption. An *Anticorruption Law* has been implemented and, according to the World Bank, Estonia has been able to contain administrative corruption and limit the actions of special interest groups on formulation of laws, regulations, and policies.<sup>14</sup>

#### **B. Public Availability of Information**

17. **The budget documents provide a comprehensive and detailed coverage of fiscal activity.** The budget document provides consolidated data on budget and extrabudgetary activities. Student loans<sup>15</sup> are the only government guarantees of financial sector assets, and details are presented in the budget. Data on contingent liabilities relate solely to government loan guarantees and do not include possible costs of court decisions, environmental damage, or other possible future liabilities. QFAs are very limited and are not reported. Although the tax division of the MOF makes some estimates of the cost of tax concessions, there is no systematic reporting of tax expenditures. The aggregative classifications of data in the budget documents presently follow national definitions. The budget documents show the published budget estimates for the current fiscal year (since the budget is released before the year is finalized) plus actual outcomes for the previous year. The forward-looking estimates cover the budget year plus three out-years. While the budget contains the transfers and tax shares to local governments, the documents do not present or analyze developments in local government budgets.

18. **Information on central government debt and financial assets is published.** Public debt is not large, and there are no debt swaps or debt arrears to report. The MOF publishes

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<sup>14</sup> See "Anticorruption in Transition: A Contribution to the Debate," World Bank 2000. Estonia is also ranked highest among transition countries in the Transparency International Corruption Perception Index 1999.

<sup>15</sup> These loans are subsidized with the students paying a fixed interest rate (currently five percent) and the government meeting the cost of any remainder through the budget.

data on central government domestic and external debt and guarantees on its website on a quarterly basis, in the Economic Outlook twice per year, and in budget documents. The present definition of debt will need to be expanded to include financial leasing in order to comply with the new GFS definitions. Information on unfunded pension liabilities of public sector employees monitored would also be required as a memorandum item under the new GFS framework.<sup>16</sup> In both cases, the amounts involved appear likely to be small and capable of being compiled by the authorities. Comprehensive data have not been routinely collected on local government debt.<sup>17</sup> The MOF produced indicative estimates of a balance sheet for the central government ministries and agencies for the first time in 2000; however, the information provided was neither consolidated nor fully comprehensive, and some of the data was not reliable.

**19. Improvements in debt management and reporting are underway.** A 1999 decree on State Financial Management provided regulations for the management of assets and liabilities and established a Risk Management Committee with representatives from the MOF and the BOE. With the amendments to the State Budget Law, a new classification will be introduced that covers all financial assets and liabilities. In addition, amendments will be made to the *Rural Municipality and City Budget Law* that will include capital leasing under the rules that are applied to borrowing. Starting in 2001, local governments will also be required to report annually on the stock of debt (financial liabilities) as of December 31 of each year. While the treasury presents a report on asset and liability management to the Risk Management Committee, the Council of SRF, and the Loan Committee within the MOF, there is no systematic analysis or report on debt management strategies or risk exposures in the budget documents.

**20. Formal commitments for regular publication of fiscal data have been made.** Estonia subscribes to the Special Data Dissemination Standard (SDDS) and the organic budget law requires publication of fiscal data. Advance release date calendars for fiscal reporting are published by September of the preceding year. The MOF provides Government Finance Statistics (GFS) classified data on general government and central government financial operations (both classified by economic type of transaction on a monthly basis), and central government debt on a quarterly basis on its website (<http://www.fin.ee>). However, there is no functional analysis of budget operations. The activities of the SRF are also reported on the MOF website.

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<sup>16</sup> In the final version of the new GFS Manual, unfunded pension liabilities of a government employer retirement scheme are to be included as an actual liability. However, social assistance and social security pension obligations are still not treated as liabilities, even if they cover government employees, as is the case in Estonia. In such cases, the obligations concerned are to be listed in a memorandum item. In the case of Estonia, therefore, it seems likely that a memorandum item will need to be computed for the public employees covered by the social security pension.

<sup>17</sup> The information that is published on local government debt on the MOF website is based on reported changes in local government debt, not a survey of the stock of local government debt.

### C. Open Budget Preparation, Execution, and Reporting

21. **The annual budget process is open, having a traditional focus on financial compliance that is complemented by a medium-term framework.** The annual budgetary process is based on a rolling fiscal strategy covering the coming budget year plus three forward years.<sup>18</sup> In addition, the budget papers include material on the macroeconomic outlook, the details of the investment budget, information on loans and guarantees, the detailed annual budget law covering revenue, expenditure and financing estimates for the coming year, and an explanatory letter to justify the estimates, including the operations of the state social security and health insurance funds. The 2001 Budget also included, for the first time, a set of strategic performance plans for ministries and agencies. The budget is published at the time it is submitted to parliament in September. A revised summary document is published at the start of the new fiscal year to incorporate any changes introduced during the budget debate. During the year, the MOF may bring supplementary budgets to the Riigikogu.<sup>19</sup> However, there is no mid-year economic and financial update of the budget data.

22. **Fiscal targets are clearly specified in the fiscal strategy.** The budget documents include a separate strategy statement that sets down the medium-term fiscal objectives. The following principles were pursued while preparing the state budget for 2001: maintain a balanced general government budget, no increase in the tax burden, a secure stable tax system, a conservative loan policy, and utilization of state finances reasonably and efficiently.

23. **The costs of ongoing and new policies are clearly distinguished in the budget documents.** Most new policies will involve capital costs and should be included in medium-term plans that are approved by the cabinet. New policies are costed separately and debated separately from ongoing policies. Specific criteria, including cost-benefit analysis, are applied to making investment decisions. The MOF seeks to maintain investment spending at about 10 percent of total budget expenditure, but this is not implemented as a formal rule.

24. **Medium-term macrofiscal planning is underway as part of the requirements for EU accession.**<sup>20</sup> The procedures to be followed in the preparation of the budget are still evolving. In 2001, the Pre-Accession Economic Program (PEP) document was submitted to

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<sup>18</sup> The fiscal year aligns with the calendar year.

<sup>19</sup> Additions to estimates must be brought forward before the end of September each year, while decreases can be proposed until the end of November.

<sup>20</sup> The EU Commission requirements for EU accession include the preparation of annual pre-accession economic programs (PEP) based on a medium-term economic framework that encompasses comprehensive macroeconomic developments, a description of fiscal policies, and detailed five-year fiscal projections.

the EU at the end of April<sup>21</sup>. However, the role that the PEP forecasts will play in guiding the 2002 budget preparation is unclear. Ministries submit recurrent and investment expenditure estimates for the budget year and the three subsequent years, but the focus remains on the budget year in the budget examination process. Although ministers give the multi-year phasing of investment projects, the recurrent expenditure estimates for the remaining forward years are regarded as indicative only and are not articulated in the same detail as the budget year.

25. **Performance budgeting is at an early stage of development.** The 2001 State Budget included strategic action programs for ministries and agencies specifying desired outcomes, objectives, and inputs. The intention is for annual objectives to be based on medium-term strategic plans, and for the annual plans to guide budget decisions. In 2002, actual performance indicators will be measured. The first comprehensive report on performance activities (evaluating actual results compared to initial objectives) will be produced in July 2003 for objectives stated for the 2002 budget. The definition and measurement of indicators will be improved over time, with the focus falling initially on those ministries and agencies with concrete outputs.

26. **The budget process does not examine or report on fiscal sustainability issues.** Debt levels are very low and the issue of sustainability is not an immediate concern. However, Estonia is experiencing population aging issues similar to other EU economies, and the sustainability of the current pension scheme was the subject of separate analysis. The budget papers include an analysis of the changes proposed in the social security system but do not include a comprehensive analysis of the impact of these reforms, or reforms in other areas such as health care, on long-term expenditures. Similarly, the budget papers do not include a comprehensive analysis of how the costs associated with EU accession will be funded.

27. **Recurrent expenditures are controlled within budget authority.** Ministries are required to submit cash plans to the treasury, and cash is released in accordance with these plans, although there is some flexibility from month to month. The law requires ministries to avoid making commitments in excess of their appropriation. Budget outturn broadly reflects the budget document; deficit targets are met and bills are paid on time. The Budget Department of the MOF controls budget revision, and supplementary budgets are used infrequently.

28. **Analysis of sensitivity of the budget estimates to economic and fiscal risks is being developed but is not yet included in the budget.** The PEP documents prepared for the EU includes an analysis of the impact of different growth and interest rates on projected budget aggregates, but this analysis is not presently included in the budget papers.

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<sup>21</sup> The PEP is available on the Ministry of Finance website ([www.fin.ee](http://www.fin.ee)).

29. **The national treasury has adopted strict processes to ensure timely monthly reconciliation.** The treasury produces reports on central government transactions 15 days after month-end. These accounts are fully reconciled with both original estimates and bank records of actual balances at the end of the period. Local government provides separate monthly reports and these are used to produce data on general government operations with a lag of about one month. The State Budget law requires that annual reports for the previous fiscal year be published by June 1. These reports are then presented to the auditor-general who must provide an opinion on the accounts by September 1. Public investment guidelines for investment of surpluses held in reserve funds have been issued by the MOF, and reports are prepared on the investment of treasury funds.

30. **Accrual accounting has been adopted for ministries and agencies reporting on 2001, but the aggregate budget is still prepared on a cash basis.** The Estonian government is relatively advanced in its accounting practices and began a move to adopt accrual accounting principles at the ministry and agency level in 1997. The accrual accounts cover only expenditures at this stage and cannot be systematically consolidated into a reliable balance sheet. Data must be extracted from different sources to put together an indicative statement of assets and liabilities, and some physical assets (e.g., roads) are not covered. At present, the aggregate fiscal data used in the budget, as well as the parliamentary appropriations, remain on a cash basis, and there are, as yet, no firm plans to move these presentations onto an accrual basis. The accrual accounts are prepared using a set of national standards that broadly accord with published international accounting standards for public sector accounts. However, no comprehensive statement of accounting policies is provided in the budget or final accounts document.

31. **Internal control procedures are in place and are being fortified.** Prior to 1999 the internal audit function was virtually nonexistent in Estonia. A detailed plan has been drawn up to improve the internal audit capacity with assistance from the EU. Amendments to the *Government of the Republic Law* were adopted in 2000 to define the internal control and audit function and give the MOF formal authority to coordinate these activities. Subsequently, a regulation was adopted establishing general rules and standards of internal audit for ministries and agencies.<sup>22</sup> A best practice manual for internal audit work has been prepared, the salary structure for internal auditors defined, and new staff employed. About 100 staff are now employed.

32. **Fiscal data quality and reporting is generally sound, but further improvements can be made.** Although the overall aggregates produced by the treasury are accurate and fully reconciled, the detailed accounts for individual units, particularly the smaller agencies and local governments, appear less satisfactory. The State Audit Office (SAO) reported some problems with accuracy in posting and in the consistency of interpretation of some

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<sup>22</sup> Establishment of this legislative framework was a short-term priority identified in the 1999 accession partnership with the EU.

accounting rules. The full impact of the recently established internal audit process may take time to be reflected in the quality of accounts. The Statistics Office noted that the absence of accurate detailed information made it difficult to prepare comprehensive public finance statistics showing cross-classification of functional data by economic type of transaction. The MOF also noted that transfer payments to local governments are made through the various ministries, and these payments are not always separately specified in the annual accounts. This complicates the task of compiling ex-post consolidated general government budgets. Finally, the development of the government balance sheet is still in an early stage of development, and further work needs to be done to improve the quality of this data.<sup>23</sup>

**33. The structure of civil service pay and employment practices is well documented.** A legal framework adopted in 1996 regulates Estonian public employment.<sup>24</sup> Pay and conditions are clearly specified and performance evaluations are being implemented. Senior staff salary levels can be viewed on the web. Vacancies are generally advertised, and there is open competition for most positions.

**34. Public procurement legislation has introduced greater competition but requires some further development.** Estonia has taken steps to open up its procurement practices to greater competition and has already given the EU national treatment as part of the Europe Agreement.<sup>25</sup> It has also signed the Government Procurement Agreement as part of its WTO accession process. However, further changes are required to fully align with its requirements, and new legislation scheduled for later this year is expected to address these issues.<sup>26</sup> The EU has indicated that there are no major problems with the implementation of the legislation.

**35. The budget contains all defense expenditures financed by public revenues.** The Estonian government has a stated objective of raising defense spending in the medium term to 2 percent of GDP from 2002. A small amount of NPI expenditures on national defense financed from private sources is not included in the budget.

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<sup>23</sup> The preliminary data for 1999 (the initial year for which data have been prepared) were partly estimated by the MOF and, in his 1999 annual report, the auditor-general stated that, in his opinion, the government balance sheet did not present an accurate picture of government assets and liabilities.

<sup>24</sup> It consists of the *Law on the Public Service Act*, the *Government of the Republic Law*, and the *State Public Servant Official Title Law and Salary Scale Law*. The *Law on the Public Service* and the *State Public Servant Official Title and Salary Scale Law* regulate the rights and duties of public servants, their recruitment and evaluation, and the salary scale for different grades of employment. The *State Public Servant Official Title and Salary Scale Law* distinguishes public servants into various categories and grades.

<sup>25</sup> Estonia was the only eastern European applicant country that did not request a transition period for public procurement.

<sup>26</sup> For further details see "2000 Regular Report on Estonia's Progress Towards Accession," EU Commission, November 2000, available at <http://www.oecd.org/puma/sigmaweb/index.htm>.



#### **D. Independent Assurances of Integrity**

36. **The SAO is legally independent.** The constitution and the *State Audit Office Act* specify that the SAO is an independent institution headed by the auditor-general, who is appointed for a five-year term, and released from office by the parliament on a proposal of the president. The budget of the SAO is decided by the cabinet and is not subject to vetting by the MOF. The SAO<sup>27</sup> reports to parliament and is responsible for auditing the entire public sector but, in practice, concentrates its efforts on the state budget.<sup>28</sup> The auditor-general may participate in government meetings, with the right to speak on issues related to his duties. The EU has suggested that the parliament needs to adopt specific procedures to ensure better follow-up of the auditor's comments and recommendations on the quality of budget reporting. The SAO has adopted a strategic development plan covering the period to 2003 designed to align audit practices with internationally recognized principles and standards. However, the scope for development of more sophisticated auditing techniques (such as performance and value-for-money audits) is limited in the near term. With its limited resources, the office has sought to concentrate its resources on higher-risk areas, including transfer payments.

37. **Local governments are accountable externally in three ways.** First, county governors may exercise supervision over the legality of the activities of local governments and the use of state assets. Secondly, the SAO audits specific grants and the use and disposal of state assets that have been transferred to the control of local governments. Thirdly, the legal chancellor reviews the conformity of local government legislation with the constitution and the law. In addition, the *Local Government Act* also requires local governments accounts to be audited annually by an outside auditor.

38. **Macroeconomic assumptions and forecasting methodology are not subject to formal external scrutiny.**<sup>29</sup> Details of the medium-term scenarios and assumptions underlying the budget estimates are published in the budget documents.<sup>30</sup> The medium-term projections are prepared by the MOF in consultation with the BOE and other ministries, but there is no formal forecasting committee.

39. **The national statistics office is not given legislative assurance of independence, but in practice it operates independently.** The *State Statistics Act* creates the Statistics Office of Estonia (SOE), giving it power to determine methodology and require submission

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<sup>27</sup> Currently, the State Audit Office consists of three departments—covering financial, performance, and risk audits—and employs about 70 auditors.

<sup>28</sup> See Web page at <http://www.riigikontroll.ee/>.

<sup>29</sup> However, the forecasts and assumptions are often informally discussed with other forecasting bodies by the MOF.

<sup>30</sup> The planning document prepared for 1999 is available on the MOF web site <http://www.fin.ee>.

of data surveys, but also providing for confidentiality of information. The SOE reports to the MOF, but also cooperates with the central bank and other public agencies in the production of statistics. The budget of the SOE is determined in the same manner as other agency budgets. There is no formal requirement for the MOF to provide data to the SOE.<sup>31</sup>

### III. IMF STAFF COMMENTARY

40. **Estonia has established many elements of a sound and transparent fiscal management system that meets many of the requirements of the IMF's Code.** Planned improvements should move it substantially toward full compliance with the Code. Beginning in 2001, the preparation of annual pre-accession economic programs (PEP) requires a medium-term economic framework that encompasses comprehensive macroeconomic developments, a description of fiscal policies, and detailed five-year fiscal projections. Other recent reforms in the area of public financial management include the introduction of accrual accounting in 1997, and efforts to develop results-oriented budgeting, internal and external auditing. Transparency has been supported by the creation of a well-functioning treasury with adequate controls on in-year expenditures.

41. **Transparency can be further improved through new initiatives and consolidation of existing procedures.** In the near term, improvements are needed in the areas of budget coverage, classification and coordination, and in raising the quality and content of the budget documentation. In the medium-term, improvements are needed in accounting and reporting procedures, mid-year review of the budget and ministerial accountability, performance measurement, improved cooperation with subnational governments, and further strengthening of the internal and external audit capacity. The government is already taking action on many of these areas, and the following staff suggestions are intended to complement these efforts.

#### A. Recommendations for Immediate Consideration

42. **The authorities should give priority to passing the planned amendments to the State Budget Law.** Public financial management is based on a sound legal framework. However, planned amendments to the State Budget Law could improve fiscal transparency by:

- fully consolidating remaining extrabudgetary funds into the budget presentation;
- including foreign-financed capital expenditures in the budget;
- improving the budget classification (consistent with GFS and ESA); and
- providing a clear definition of general government.

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<sup>31</sup> The website for the SOE is <http://www.stat.ee>.

43. **The SRF should be on budget or steps should be taken to coordinate its activity with the state budget.** Although the flows in and out of the SRF are recorded in general government financial operations, the operation of dual budgets (see paragraph 12) conflicts with international best practice. The staff recommends that all expenditure from the SRF be through budget appropriation to ensure that: (i) all spending is subject to the same rules and oversight procedures; and (ii) the relevant spending ministry manages all expenditure related to its mandate. The staff recognizes that the SRF was created to safeguard resources; however, if the SRF is maintained as a separate budget entity, its operation should be fully coordinated with the annual and medium-term budget process and all requirements for appropriated funds should also apply to the expenditures of the SRF. This can help prevent problems of mismanagement of extrabudgetary funds that has occurred in other countries. Clear rules should be maintained to ensure that expenditures from the fund are planned in a manner that enables the authorities to adhere to fiscal targets.

44. **The State Budget Law should clearly define general government so that all reporting on general government activities is consistent.** Since Estonia is pursuing accession to the EU, it would be advantageous for the coverage of general government to conform to the EU standards (ESA95). A reconciliation table should be constructed to show both ESA and GFS definitions of the overall general government balance.<sup>32</sup>

45. **The State Budget Law should incorporate clear guidelines to ensure the transparency of public objectives in the sale of state assets.** The criteria to be followed in the use of the SRF funds are now reasonably clear and transparent. However, the criteria for determining the use of proceeds of the sale of public utility assets (such as the rail and energy assets) are neither consistent nor transparent. There is a need to adopt a set of procedures for the future sale of assets which: (i) make clear the public objectives being pursued in the relevant projects; and (ii) make it clear that the funds should normally flow initially to the budget unless there are clearly identifiable criteria justifying their reinvestment in the enterprise concerned.

46. **Several improvements can be made in the budget documentation:**

- Expanding the coverage of contingent liabilities to include, for example, costs of losing any important court cases, possible environmental cleanup costs, or other potential liabilities.

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<sup>32</sup> The ESA95 and the new GFS definitions do not differ in concept. Both manuals apply the principle that the boundary between government and public enterprises should be determined according to whether the unit involved is a market producer or not. Both manuals also adopt a similar approach to the definition of the boundary between the public and the private sectors based on whether the government controls the entity concerned or not. However, for consistency in Europe, ESA95 applies a 50 percent rule to define the boundary in both cases. The GFS Manual has no such specific rule. In some cases, this can lead to different treatment of particular entities.

- Including estimates of the tax expenditures in the budget discussion paper, and improving on the quantitative estimation and analysis of tax expenditures.
- Adding a statement on QFAs even if such activities are very limited.
- Expanding the analysis of fiscal risk arising out of macroeconomic developments, and including sensitivity analysis showing what to expect if key assumptions turn out to be different.
- Two years of actual outturn prior to the budget year should be presented in the budget document.
- In order for parliament to have a complete picture of all government activities, the budget documents should provide an analysis of actual and prospective fiscal developments on general government operations—that is, covering extrabudgetary activities and subnational government in addition to the central government.
- A more extensive analysis of fiscal sustainability in the budget discussion paper that covers the implications for population aging and EU accession.
- Consideration may also be given to providing a more extensive and easily understood explanation in the budget document of the mechanisms used to determine the share of central bank profit paid to the budget.

47. **Both debt and investment management policies underlying the state budget should be made fully transparent.** The budget reports should monitor the financial and other risk characteristics of the government's obligations, particularly in regard to foreign-currency and short-term or variable rate debt. It is suggested that the framework follow procedures and techniques set down in the recently issued Fund/Bank Debt Management Guidelines, with the overall aim of enabling debt managers to identify and manage the trade-offs between expected cost and risk in the government debt portfolio.<sup>33</sup> At the same time, the investment operations of the cash and contingency reserve funds identified in the State Budget Law should be absolutely transparent.

48. **Some further improvement can be made to the quality of fiscal reporting.** The MOF deserves credit for producing a balance sheet of the government. While it is not unusual to have some problems when initiating a new activity, high priority should be given to improving the coverage and accuracy of the balance sheet of the government. Data on government debt should be expanded to include leasing, and information on unfunded pension liabilities for parliamentarian, special constitutional appointees, and public servants could be provided. Although the data provided meets SDDS requirements, it would also be

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<sup>33</sup> See "Guidelines for Public Debt Management," prepared by the staffs of the IMF and the World Bank, February 1, 2001.

desirable to provide finer classifications of some aggregates. As noted earlier, data quality problems have constrained the capacity of the SOE to produce its annual public finance bulletin which, inter alia, contains cross classification of functional expenditure data, especially in health, education, and defense, by economic-type classifications. To facilitate the free flow of this data at all times, the MOF might consider making a formal agreement with the SOE to provide the needed information—similar to the agreement currently applying between the BOE and the SOE.

49. **The status of macroeconomic forecasts released by the MOF should be clearly disclosed.** As the authorities are required to provide periodic forecasts to the EU (as part of the PEP process) and other users, including the IMF, great care must be taken to ensure that the status of the estimates, including the degree of government endorsement, is well documented in any public releases. To assist this process, consideration may be given to formalizing consultation arrangements with other relevant agencies, including the BOE, regularly engaged in forecasting.

50. **Medium-term planning at the ministerial level and the accuracy of out-year expenditure estimates need improvement.** Ministries should be required to submit more detailed budget estimates for at least two years beyond the budget year, and these estimates should be examined in the MOF and discussed by cabinet along with the current budget estimates. The ultimate aim must be to develop the quality of the out-year estimates so that they can be used as a firm planning base for allocation of resources.

## B. Considerations for the Medium Term

51. **It would be desirable to set a timetable for a move toward full accrual accounting in budgeting and reporting.** Estonia has made significant advances in adopting accrual accounting at the ministry and agency level, but it would be desirable to move to adopt this approach in national budgeting and decision making and to present properly consolidated national balance sheets for government assets and liabilities. As has been the case with other countries, cash accounts would continue to be maintained, and the Riigikogu may continue to appropriate funds on a cash basis. Priority should be given to:

- adopting internationally accepted standards for accrual accounting;
- improving methods for valuation of assets;
- providing training to ensure the correct recording of transactions; and
- working with the Riigikogu to ensure that the needs of the parliamentary appropriation process are preserved during the transition.

52. **A formal mid-year review of the economic and financial outlook should be implemented.** This document would provide parliament with updated macroeconomic forecasts and projections of budget outturn, including any supplementary estimates and

expenditure shortfalls. It would provide a framework for consideration of any needed adjustment to fiscal policies during the present year and also serve as a base for the preparation of budget estimates for the coming year.

53. **Lines of ministerial responsibility and accountability with respect to agencies should be further clarified.** The authorities have recently begun results-oriented budgeting, but this approach can only have a full impact if the lines of responsibility are clear. In particular, there will be a need to ensure that ministries take an active role in setting and monitoring the performance of around 600 government agencies now in existence.

54. **Cooperation and coordination with the subnational governments needs to be further developed.** Steps should include:

- broadening the dialogue with subnational government on expenditure responsibilities and borrowing arrangements in the setting of the annual fiscal targets; and
- elaborating the government's plans to restructure the municipalities and to better integrate the operation of county and municipal governments in the planning and control of public expenditure at the local government level.

55. **Continuing development of the internal and external audit system is required.** Strengthening of internal and external audit needs to be continued to maintain fiscal data quality and integrity. This should include investigation on the adequacy of internal audit standards to support the disbursements of EU grants.