Overview of the Use and Preservation of State Assets in 2015-2016

Summary by the Auditor General on the perspectives of national economy and problems related to state assets

Report of the National Audit Office to the Riigikogu Tallinn, 2016

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Foreword

With the current year about to end, Estonia's public debt is the smallest across the EU, accounting is in order and the employment rate is about to hit its maximum - however, labour productivity is modest and, compared to the rest of Europe, remains on the same level as five years ago. In its latest annual report, the Bank of Estonia noted that the Estonian economy is standing at the crossroad and its essential growth factor - productivity - has failed to grow for quite a while.

In 2015, Estonia's economic growth was nearly two times smaller than the EU average, and Estonia's purchasing power - more specifically, the gross domestic product per capita adjusted for purchasing power - has dropped. This indicator describes the income level of a country and its population in comparison to other countries, taking into account the price level differences. Compared to earlier forecasts, the targets set for the Estonian economy and public finances for the next few years have been cut back slightly which will make it difficult to increase public revenue at the desired pace.

Therefore, the public sector will experience even more pressure as regards its maintenance expenses and functioning. The state budget will continue to grow whereas money that can be used flexibly will still be scarce. The share of expenses appropriated in advance will increase from the current 78% to 80% in 2020. Although the National Audit Office (NAO) and the Ministry of Finance (MF) have, for years, indicated that the large share of fixed expenses is a problem, the government has failed to make the use of the state budget more flexible.

In a few years, the social and healthcare sectors will account for one half of state budget expenses which leaves little room for supporting the development of the state's other sectors of activity. According to the MF's forecast, in 2020, the expenses on all other sectors, as a percentage of GDP, will remain on the same level or become smaller than in 2016. A large portion of public investments is still made using EU support.

The government executives cannot ignore the need to thoroughly revise many, if not all, government functions and commitments towards its staff, and find ways of performing these functions more efficiently. Once the government functions and their substantive aspects have been determined, it will be possible to identify the number and competencies of individuals required for performing such functions. And, of course, the required amount of money.

If Estonian businesses fail to make investments that support future growth, and the state neglects reforms that foster economic growth, we could find ourselves in a situation where we need to ask how to maintain the current level of economic development instead of how to accelerate it.

Estonia's demographic situation further complicates the attainment of development goals and sets more rigorous demands to government members who need to act in a well-considered and constructive manner. To do this, they need fresh ideas that actually work.

The state performs its responsibilities towards its citizens by imposing legislation and using assets. State assets are not limited only to collected revenue that the government - as authorised by the Riigikogu - uses to advance life in Estonia. For example, the state owns billions of euros worth of land and forests, thousands of buildings, structures, tens of companies, foundations, etc. The state's ability to use its assets wisely determines how much the state and its citizens gain or lose in terms of money and services.

The decisions of the Riigikogu and the government and the way these are made determine whether assets are used in the best possible way to support Estonia's sustainable development, unreasonable expenses are avoided, the set development targets are attained, and the income of the entire population increases. In the course of its work, the NAO has witnessed well-reasoned decisions that ensure effective use of state assets as well as the launching and/or implementation of reforms on the basis of inadequate information or in a hurry, and the delaying of necessary decisions.

In this annual overview, the NAO has focused on improving the efficiency of government functions and enhancing the preparation and implementation of reforms concerning the operation of the government sector, enhancing the quality and transparency of decisions related to state assets, and using the state's and taxpayers' money more efficiently and profitably.

Among other topics, you will find an overview and lessons concerning the state real estate reform that began 15 years ago, and the land reform that started even earlier. The NAO has analysed the management problems of and the development of state-controlled companies and foundations.

The heads of government are long aware that simple cosmetic changes are not enough any more. The life itself forces us to make fundamental changes.

I hope that this year's overview provides decision-makers with advice on making well-reasoned choices. Nevertheless, in order to be able make any choices we need to have ideas first. Enjoy reading!

Alar Karis
Auditor General

November 2016

Table of Contents

Shrinking and ageing of Estonia's population puts the national economy under an ever increasing pressure 4

In 2015, Estonia's productivity and purchasing power dropped in comparison to the EU average 4

Estonia's economic growth perspectives for 2016 and the following years have suffered from a cutback as compared to previous forecasts 7

Available funds are still scarce in the state budget and investment capacity depends on foreign aid 9

State accountancy is solid but this implies merely that accounting rules have been respected and does not necessarily indicate the expedient use of state assets 13

The state holds assets worth nearly 30 billion euros and the way of using these assets greatly affects Estonia's development 13

NAO audits indicate that state accountancy is solid whereas state assets could be used more expediently 14

Government reform should lead to more efficient and profitable use of state assets 14

To ensure the country's development it is necessary to revise the operation of the government sector and the state's functions - successful implementation changes requires adequate information, courage to make decisions, and willingness to take responsibility 14

Performance of government functions always entails the use of state assets where unreasoned decisions and violation of the State Assets Act are not acceptable 16

Shortcomings in making decisions concerning state assets entail unnecessary costs and forfeiture of revenue 18

State real estate reform - 15 years of failure to identify the most efficient solution for real estate management 18

The expected outcomes and objectives of the state real estate reform have proven illusive - property expenses went up and little thought was given to optimising the use of premises 19

The government lacks a long-term plan - it has no idea how much and what kind of real estate it needs to perform its functions and how to finance the renovation of such properties 21

Real estate of local governments - the concentration of population in cities has left many local authorities in possession of useless and degrading buildings 21

Land - the government's land needs are still not identified and the land reform is pending 22

State-controlled companies - engaging in business ventures must be necessary for performing government functions, profitable, and legitimate 23

Financing of AS Estonian Air - the government could have avoided the loss of approx. 85 million euros 24

State-established foundations - often, there is no analysis as to whether this legal form is the most appropriate for performing public functions 26

Government's vehicle fleet - state agencies buy or lease vehicles without proper analysis that would identify the most economical solution 26

Public procurement - transparent and well-considered joint public tenders with clear responsibility yield savings 27

State budget - more efficient use of state revenue calls for more transparent budget drafting and more substantive reporting 29

Audits referred to in this annual overview 31

Shrinking and ageing of Estonia's population puts the national economy under an ever increasing pressure

In 2015, Estonia's productivity and purchasing power dropped in comparison to the EU average

1. After regaining independence, the Estonian parliament and government have tried to catch up with the developed countries in Europe and put Estonia amongst the rich European countries in terms of economic prosperity of the population and the state. In simpler terms, to attain this objective, the Estonian economy needs to grow faster than the economy of the countries against which we compare ourselves and whom we wish to catch up with.

2. However, the country's gross domestic product (GDP) is not the only indicator for assessing the nation's economic situation. One of the most common methods for comparing the level of development of countries that is applied by Estonian authorities and EU institutions is combining the following three indicators:

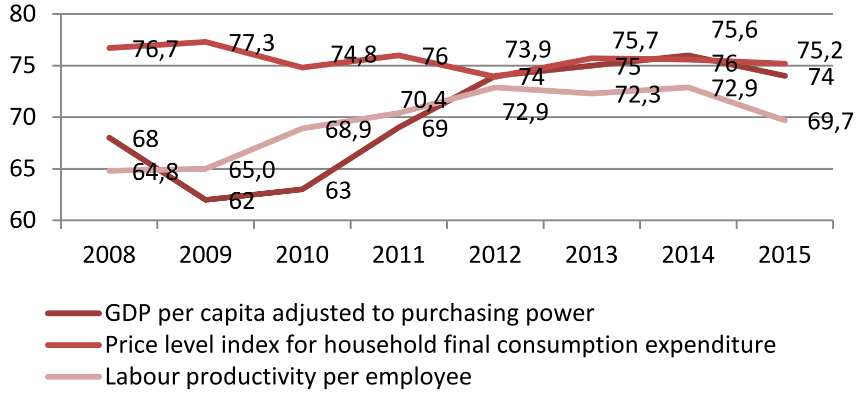
Household final consumption expenditure shows how much households spend on necessities - goods, services, accommodation, utilities. The indicator characterises the cost of products and services as well as the wealth of households.

- GDP per capita in purchasing power parities[1] which shows the level of income of the country and its citizens in comparison with other countries whilst taking into account the price differences;
- productivity of labour as one of the preconditions of increasing the country's wealth;
- price level index for household final consumption expenditure.

Compared to the EU average, labour productivity remains on the same level as five years ago

3. The data from Eurostat - the statistical office of the European Union - shows that in 2015 Estonia drifted further away from the EU average in terms of these three indicators. Labour productivity that had reached 72.9% of the average for EU-28 in 2014 dropped to 69.7%. This is lower than in 2011 (see Figure 1).

Figure 1. Estonia's convergence or harmonisation of essential economic indicators with those of the EU in 2008-2015 (EU-28 = 100%)



Source: Eurostat, as at 3 November 2016.

[1] The indicator "GDP per capita in purchasing power parities" is construed as the country's purchasing power but that interpretation is not quite accurate. According to Statistics Estonia, assessing GDP against purchasing power allows comparing the GDP values of countries by removing the price differences between them. If we agree that GDP per capita shows how much value is created by the community members, the indicator describes, subject to certain reservations, the wealth of the country and its citizens.

4. The purchasing power indicator for Estonian households that had attained 76% of the EU average in 2014 dropped to 74% - the same level as in 2012. In 2015, the price level index for final consumption expenditure hardly changed: forming 75.2% of the average for EU-28. A year before it was 75.6%.

In 2015, Estonia's GDP growth was only a bit more than one half of the EU average

5. Low productivity impedes economic development and is one of the obstacles to Estonia's progress towards the level of wealthy countries. In 2015, the Estonian economy grew by 1.4% which is only a little more than one half of the average for EU-28. In the neighbouring countries - Latvia and Lithuania - the GDP growth was 2.7% and 1.8%, respectively (see Table 1). 21 EU Member States outpaced Estonia's economic growth.

Table 1. Real GDP growth in Estonia and some EU Member States in 2010-2015 (%)

	2010	2011	2012	2013	2014	2015
Estonia	2.3	7.6	4.3	1.4	2.8	1.4
Average for EU-28	2.1	1.7	-0.5	0.2	1.6	2.2
Latvia	-3.8	6.2	4.0	2.9	2.1	2.7
Lithuania	1.6	6.0	3.8	3.5	3.5	1.8
Finland	3.0	2.6	-1.4	-0.8	-0.7	0.2
Sweden	6.0	2.7	-0.3	1.2	2.6	4.1

Source: Eurostat, as at 3 November 2016.

6. In 2015, the real GDP growth was smaller than expected. In summer 2014, the Ministry of Finance predicted the growth rate to be 2.5%, then 2% in spring 2015 and then 1.7% in summer 2015. Despite such underperformance, the National Treasury collected a bit more tax revenue in 2015 than was envisaged in the state budget.

Salary growth supported the collection of tax revenue but with productivity being modest it could pose a risk for the economy

7. In 2015, the state collected 7.1 billion euros in tax revenue that exceeded the original amount envisaged in the state budget by 160 million euros. In particular, the collection of corporate income tax exceeded the target level (see Table 2). Also, the targets were exceeded for social tax and personal income tax - due to an increase in the employment rate and salary growth - as well as for fuel excise duty. Alcohol excise duty, value-added tax and tobacco excise duty fell short of their target values.

Table 2. Estimated and actual state budget revenue in 2015 (in EUR million)

Type of revenue	2015 budget estimate	2015 actual	Difference
Total state budget revenue, incl.	8,447	7,980	-467
total tax revenue, incl.	6,968	7,128	+160
▪ personal income tax	309	330	+21
▪ corporate income tax	321	424	+103
▪ social tax	2,370	2,393	+23

▪ heavy goods vehicles tax	4	5	+1
▪ value-added tax	1,865	1,858	-7
▪ gambling tax	23	23	0
▪ customs duties	30	34	+4
▪ alcohol excise duty	240	222	-18
▪ tobacco excise duty	185	183	-2
▪ fuel excise duty	424	432	+8
▪ excise duty on packaging	0.3	1.2	+0.9
▪ electricity excise duty	33	34	+1
▪ transferable taxes	1,164	1,187	+23
non-tax revenue, incl.	1,479	852	-627
▪ sale of goods and services	140	163	+23
▪ grants received	1,007	384	-623
▪ other revenues	148	148	0
▪ financial revenue	185	158	-27

Source: Explanatory memorandum to the 2015 State Budget and its implementation report, http://www.fin.ee/riigieelarve-2015

8. In 2015, the employment growth of 2.6% and the average salary growth of 6% helped attain the Treasury's targets but in the long run such rapid salary growth will jeopardise Estonia's future economic development because labour productivity has dropped meanwhile. According to the Ministry of Finance, labour productivity dropped by 1.1% per employed person which, in the opinion of the Bank of Estonia and the Ministry, compromises Estonia's competitiveness.[2]

In 2015, the total state budget revenue was smaller than predicted because more than one half of the planned EU support was not received

9. However, in 2015, the total state budget revenue was smaller than expected - nearly 8 billion euros were collected instead of the predicted amount of approx. 8.4 billion. The main reason was that more than one half of the planned EU support was not received: the amount actually collected was less the 400 million euros as compared to the expected one billion. Because the European Commission allocates aid for financing the incurred expenses retroactively, on the basis of the request filed by Estonia, the poor collection of aid amounts indicates that the implementation of aid amounts was slower than expected. In 2015, the state budget expenditure amounted to approx. 8.3 billion euros.

10. The collection of tax revenue beyond the target levels improved the budget balance of the central government and local governments. In 2015, the government sector budget showed a surplus of 0.1% of GDP, i.e. 27 million euros, which resulted from the excess income tax revenue as well as the surplus of the Unemployment Insurance Fund because active labour market measures cost less than estimated.

[2] Ministry of Finance, explanatory notes to the summer 2016 economic forecast, http://www.fin.ee/majandusprognoosid; 2015 Annual Report of the Bank of Estonia, http://www.eestipank.ee/publikatsioon/aastaaruanne/2016/eesti-panga-2015-aasta-aruanne.

Estonia has maintained a conservative budget policy as opposed to the rest of Europe

11. Despite Estonia's slower economic growth compared to the EU average, Estonia outperformed many others in keeping costs under control in 2015. The average government sector budget position for EU-28 was -2.4%. Both the Latvian and Lithuanian government sector ended the financial year in deficit (see Table 3).

Net budget position of general government – difference between the total revenue and total expenditure of central government entities, local government entities and social insurance funds (Health Insurance Fund and Unemployment Insurance Fund) included in the government sector. The budget position is recognised in accrual-based accounting which - in simpler terms - means that expenses are recognised as soon as the commitment is established and not when money is actually disbursed (as opposed to cash-based accounting).

Table 3. Net budget position of general government in Estonia and some EU Member States in 2010-2015 (% of GDP)

	2010	2011	2012	2013	2014	2015
Estonia	0.2	1.2	-0.3	-0.2	0.7	0.1
Average for EU-28	-6.4	-4.6	-4.3	-3.3	-3.0	-2.4
Latvia	-8.5	-3.4	-0.8	-0.9	-1.6	-1.3
Lithuania	-6.9	-8.9	-3.1	-2.6	-0.7	-0.2
Finland	-2.6	-1.0	-2.2	-2.6	-3.2	-2.8
Sweden	-0.1	-0.2	-1.0	-1.4	-1.6	0.2

Source: Eurostat, as at 3 November 2016.

12. Other EU Member States that enjoyed a government sector budget surplus included Germany (0.7%), Luxembourg (1.6%) and Sweden (0.2%).

Estonia's economic growth perspectives for 2016 and the following years have suffered from a cutback as compared to previous forecasts

13. In summer 2015, the Ministry of Finance (MF) expected the export of goods and services, and investments to grow notably in 2016 and the economic growth to jump to 2.6%. According to the forecast, the state budget and the consolidated budget of government sector were to enjoy a surplus again in 2017 after a period of deficit, and by 2019 the debt burden was to decrease and the reserves were to start growing again.

In 2016, exports and investments will grow less than estimated

14. In its summer 2016 forecast, the Ministry of Finance saw the near future of public finances and of the economy in darker shades. Due to the continued modest growth perspectives of Estonia's essential trading partners, this year's exports of Estonian goods and services will grow only by 2.7% instead of the 3.5% as predicted a year ago. The domestic demand forecast has been cut back likewise.

15. Investments will grow a lot less than predicted: 1.2% instead of 4% (see Table 4). The slow investment activity and exports affect Estonia's economic growth as a whole: the MF expects the economy to grow by 1.3% in 2016 which is only half of the 2.6% as predicted earlier.

Table 4. Economic and financial indicators in 2016 as forecast by the Ministry of Finance

	2016 (summer 2015 forecast)	2016 (summer 2016 forecast)	Change
Real GDP growth (%)	2.6	1.3	-1.3
Growth of exports of goods and services (%)	3.5	2.7	-0.8
Growth of investments (%)	4.0	1.2	-2.8
Government sector budget position (% of GDP)	-0.2	0.4	+0.6
general government debt (% of GDP)	9.7	9.4	-0.3
Government sector reserves (% of GDP)	8.5	8.2	-0.3

Source: Summer 2015 and summer 2016 economic forecasts by the Ministry of Finance

16. Compared to the estimate from a year ago, the 2016 forecast for government sector budget position has improved - amounting to a 0.4% surplus of GDP - but according to the MF, this is mostly due to the postponement of investments on central as well as local government level. For the same reason, the general government debt forecast for 2016 has improved. In 2017-2019, the government sector budget, debt and reserves are expected to make a downturn.

17. The economic growth perspectives for the next few years have been adjusted in the fresh, September 2016 forecast by the MF. In 2017-2019, economic growth should remain between 2.5% and 3% whereas the last summer's forecast predicted growth in the range of 3-3.4%.

18. In its summer 2015 forecast, the MF expected the government sector budget surplus to be 352 million euros in 2019, but the summer 2016 forecast expects it to be 37 million euros (see Table 5).

Table 5. Forecast of the general government budget position for 2016-2020 (in EUR million)

	2016	2017	2018	2019	2020
Net budget position of general government (EUR million), incl.	80	-175	-80	37	145
▪ state budget	70	-48	-134	59	149
▪ other central government	-25	-73	70	-4	20
▪ Health Insurance Fund and Unemployment Insurance Fund	0	26	29	32	31
▪ local governments	36	-80	-45	-51	-56
Structurally adjusted general government budget position (% of GDP)	1.2	0.0	0.0	0.3	0.4

Source: Summer 2016 economic forecast by the Ministry of Finance

19. To keep the budget deficits of EU Member States under control, the rules concerning the general government budget balance have been adopted on an international level, but these are not based on structural budget position rather than the net budget position addressed above in this overview.

The structural budget position of general government is determined by removing from the net position the effects of the economic cycle and all one-off and temporary factors which could distort the budget position.

20. According to the State Budget Act in force since the beginning of 2014, the structural budget of the government sector must be either balanced or in surplus. In other words, once the one-off or temporary factors affecting the government sector's budget as well as the impact of the economic cycle are removed, the total expenditure of the government sector should not exceed its total revenue.

21. According to the Ministry of Finance, the structural budget position of general government enjoyed a surplus of 0.9% in 2015 and the expected surplus for 2016 is 1.2% of GDP. Thereafter, the budget will attain a structural balance according to the forecast (also, see Table 5).

Available funds are still scarce in the state budget and investment capacity depends on foreign aid

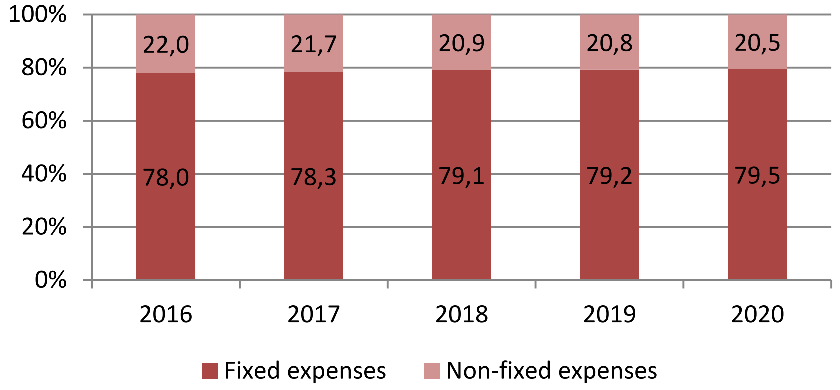
The state budget is growing but most of it is used for predetermined expenses

22. The Ministry predicts that over the next four years the state budget revenue will increase by an average of approx. 5% per year throughout the period covered by the forecast, and exceed EUR 10 billion in 2019. During the forecast period, the share of tax revenue will amount to approx. 85% of total state budget revenue, and in 2018-2019, the share of non-tax revenue will increase because more EU aid will be put into use. According to the forecast, the state budget expenditure will also grow by an average of approx. 5% per year.

In 2020, approx. 80% of state budget expenditure will be appropriated in advance

23. The majority of state budget expenses is predetermined by legislation or otherwise. In 2016, according to the MF, such fixed expenses make up 78% of the state budget. According to the forecast, the amount of money that can be flexibly used for promoting the country's development will shrink proportionally even further - in 2020, predetermined expenses make up nearly 80% of the state budget (see Figure 2). Although the Ministry of Finance has, for years, indicated that the large share of fixed expenses is a problem, the government has failed to make the use of the state budget more flexible.

Figure 2. Breakdown of state budget expenditure by fixed and non-fixed expenses in 2016-2020 (% of state budget)*



Source: Ministry of Finance

Social protection and healthcare expenses leave little room for maneuvering

24. Financing of social protection accounts for the largest share of state budget expenditure. According to the Ministry of Finance, social protection and healthcare expenses form 47% of total state budget expenditure in 2016. The Ministry estimates that, by 2020, their share will increase to 50%.

25. The estimated breakdown of expenses between the spheres of activity of the state is set out in the Ministry's summer 2016 economic forecast but it should be noted that these are government sector expenses rather than state budget expenditure. The data indicates that, compared to 2016, only social protection and healthcare spheres might receive additional funding calculated as a percentage of GDP. Another priority is the financing of national defence. (See Table 6.)

Table 6. Government sector expenses by spheres of activity in 2016 and forecast for 2020 (% of GDP)

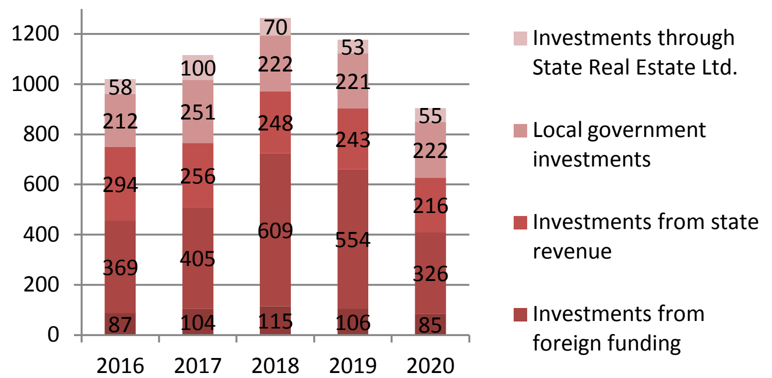
Sphere of activity	2016	2020	Change
General services of government sector	4.1	4.1	0.0
National defence	2.0	2.0	0.0
Public order and security	1.9	1.6	-0.3
Economy	4.8	4.2	-0.6
Environmental protection	0.3	0.3	0.0
Housing and utilities	0.4	0.4	0.0
Healthcare	5.5	5.6	+0.1
Recreation, culture and religion	2.0	1.6	-0.4
Education	5.0	5.0	0.0
Social protection	13.7	14.1	+0.4
Total government sector expenditure	39.7	39.0	-0.7

Source: Summer 2016 economic forecast by the Ministry of Finance

A large portion of investments rely on foreign funding

26. According to the forecast, foreign aid will cover 8.4-11.3% of state budget expenditure in 2016-2020. The State Budget Strategy 2017-2020 envisaged approx. one billion euros for government sector investments in 2016 whereof 36% or 369 million euros is made up by foreign funding. In 2017-2019, the share of EU aid in investment financing will increase even further due to the higher rate of implementation of such aid.

Figure 3. Government sector investments in 2016-2020 (in EUR million)



Source: State Budget Strategy 2017-2020

27. The government sector investment plans reveal that the state's own revenue is predominantly spent on covering fixed expenses and that the investments in long-term development of the country still depend largely on foreign funding.

The forecast states that public debt will grow by more than 600 million euros in three years

28. As at the end of 2015, the general government debt amounted to about 2 billion euros or 9.8% of the GDP. The Ministry of Finance has predicted that the debt will attain 11.2% of the GDP by 2018 which, in absolute figures, means a growth of more than 600 million euros (see Table 7). Thereafter, the debt should start shrinking. Estonia's public debt is still the smallest in the EU. The average general government debt for EU-28 is 85%.

Table 7. General government debt in 2015 and forecast for 2016-2020 (in EUR million)

	2015	2016	2017	2018	2019	2020
Total debt, incl.	1,993	1,970	2,253	2,606	2,604	2,583
central government, incl.	1,264	1,277	1,480	1,789	1,736	1,659
▪ impact of EFSF*	455	461	467	473	480	486
▪ central government without EFSF	810	817	1,013	1,315	1,256	1,173
local governments	729	693	773	817	868	924
Total debt (% of GDP)	9.8	9.4	10.3	11.2	10.6	10.0

* EFSF - European Financial Stability Facility

Source: Summer 2016 economic forecast by the Ministry of Finance

29. As at the end of 2015, the liquid financial assets of government sector almost equalled its debt which still exceeded the liquid financial assets by EUR 93 million. The Ministry of Finance has predicted that the liquid financial assets of the government sector will shrink to approx. 1.6 billion euros by the end of 2017. Thereafter, the government reserves should start growing again, according to the Ministry (see Table 8).

Table 8. Liquid financial assets of government sector in 2015 and forecast for 2016-2020 (in EUR million)

	2015	2016	2017	2018	2019	2020
Total reserves, incl.	1,900	1,719	1,626	1,674	1,858	2,083
central government*	782	608	490	508	660	853
local governments	298	298	298	298	298	298
social insurance funds	820	813	839	868	900	931
Total financial assets (% of GDP)	9.4	8.2	7.4	7.2	7.6	8.0

* In this context, central government includes, according to the rules on international statistics, agencies financed from the state budget as well as public institutions, and central government foundations and companies.

Source: Summer 2016 economic forecast by the Ministry of Finance

Read more

From the NAO audit report Accuracy of Annual Accounts 2015 and regularity of transactions of the state

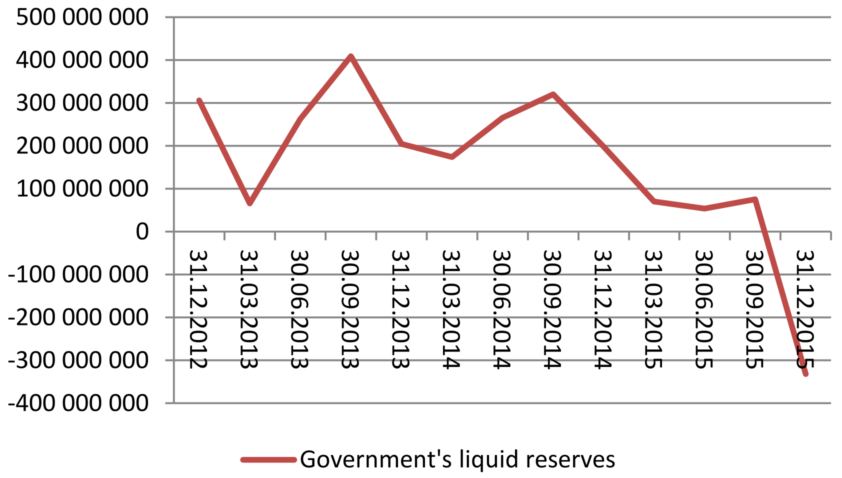
30. It should be noted that the central government's liquid assets do not indicate the amount of reserves at the government's disposal that could be used as necessary to cover state budget expenses or meet other commitments because, according to the methodology applicable across the EU, central government includes the liquid assets of public institutions and similar entities.

31. The government's own liquid reserves were depleted in autumn 2015 and, as at year end, the government had used towards its expenses and commitments a little more than 300 million euros of money belonging to the Estonian Unemployment Insurance Fund and the Estonian Health Insurance Fund that is held by the National Treasury since 2012 (see Figure 4).

32. As from the beginning of 2016, the State Treasury modified the form of the monthly statement concerning the reserves so that the statement of reserves no longer features the information on the amount of money in the Liquidity Reserve broken down by entities. Since 2016, the statement shows such information only in the form of a graph, whereas before that the statement featured detailed information for each entity in the form of a table. The diagram in the September 2016 statement of reserves shows that the balance of the central government's liquid assets in the Liquidity Reserve was nearly 190 million euros on the negative side.

33. The government can, in exceptional cases and with the Riigikogu's permission, make use of the Stabilisation Reserve Fund which is not included in liquid assets and amounted to approx. 400 million euros as of September 2016.

Figure 4. Amount of government's liquid reserves in 2012-2015 (in EUR)



Source: Ministry of Finance

Bank of Estonia on productivity and competitiveness: Estonian economy at the crossroad

34. The small and open Estonian economy is influenced by international tensions and the lethargic financial markets. Due to problems with their own economy, our trading partners are not eager enough to purchase our goods or services. However, Estonia should admit that we lack the skills to develop products and services for which customers in other countries are willing to pay (a high price).

35. Modest productivity is one of the major problems faced by the Estonian economy. Compared to the average for EU-28, the productivity of Estonian labour is on the same level as five years ago. And if productivity growth will linger over the next years, Estonia's quest to catch up with the Nordic countries in terms of development will become highly questionable. The Bank of Estonia has highlighted this in its 2015 Annual Report noting that productivity - its essential growth factor - has failed to grow for quite a while.[3] The businesses have already exploited the simpler means of enhancing productivity hence threatening Estonia's competitiveness.

36. Estonia is facing stagnation unless our businesses invest in growth and the government implements reforms that foster economic growth. Estonia's demographic situation further complicates the attainment of development goals and sets more rigorous demands to government members who need to come up with constructive approaches.

State accountancy is solid but this implies merely that accounting rules have been respected and does not necessarily indicate the expedient use of state assets

The state holds assets worth nearly 30 billion euros and the way of using these assets greatly affects Estonia's development

37. In common language, state assets often refer to taxes collected from individuals, the aid amounts received by the National Treasury, and other revenue that the Government of the Republic can use in the framework of the annual budget to advance life in Estonia. For instance, in 2016, the Riigikogu placed 8.9 billion euros at the government's disposal for improving the population's living standard, ensuring their safety and national defence, and otherwise contributing to the development of the community. The well-being of Estonia and its citizens depends directly on the ability of the Riigikogu and the government to use in a well-considered manner the scarce resources provided for by the state budget.

Other major asset groups of the state, besides tax revenue, include real estate and holdings in companies

38. State assets are not limited only to state budget revenue. Besides tax and non-tax revenue, the state has a number of other assets used for the government's routine functioning, provision of services, and earning of additional income.

39. As of the end of 2015, the state owned assets totalling approx. 28.5 billion euros. In a year, the assets had grown by about 830 million euros. Such assets include, for example, state forests worth approx. 3.2 billion euros. The decisions relating to their management affect the long-term income of the state and its citizens as well as the living environment. Further, state assets include companies and foundations owned by the central and local government which are worth billions of euros and whose operations controlled by the government affect the availability, price and/or quality of many services (e.g. public transport, electricity and healthcare).

By using the state assets efficiently the government can reduce the operating expenses of the state and increase revenue

40. A notable share of state assets is made up by real estate, incl. state-owned buildings, roads and other structures, and undeveloped land other than forest land. The way how the central and local government authorities use their real estate affects the country's economic development and the state's operating expenses. Efficient land use and infrastructure development by the state helps boost the economy, create

[3] 2015 Annual Report of the Bank of Estonia, http://www.eestipank.ee/publikatsioon/aastaaruanne/2016/eesti-panga-2015-aasta-aruanne.

jobs and support regional development. Economical use of the floor area of buildings for performing the state's functions and dispensing with unnecessary property helps cut the state's expenses and boost revenue.

41. The methods for making and the quality of decisions of the Riigikogu and the Government of the Republic determine whether assets are used in the best possible way to support Estonia's sustainable development, unreasonable expenses are avoided, the set development targets are attained, and the income of the entire population increases. The state and its citizens have a lot to gain or lose depending on whether state assets are used wisely.

NAO audits indicate that state accountancy is solid whereas state assets could be used more expediently

Annual accounts of the state include ministries, the Government Office, constitutional institutions, state-controlled companies and foundations and the state commercial body State Forest Management Centre.

42. As a result of financial audits, the NAO can provide assurance that the state's annual accounts 2015 provide, in all material respects, a true and fair view of the state's financial position as well as its financial performance and cash flows over the completed accounting period. Further, the NAO finds that the accounting of state agencies, state-controlled foundations and state-owned companies is well managed and the annual accounts are largely free from material errors.

43. In forming its opinion, the NAO took into account the work conducted by the certified auditors of private audit firms because, unlike for state agencies where the NAO itself carries out the audit operations, the foundations, companies and commercial bodies are audited by such certified auditors on the basis of guidelines provided by the NAO.

44. In the opinion of the NAO, in 2015, the state agencies effected economic transactions in accordance with the State Budget Act and the 2015 state budget in all material respects. This means that the NAO did not find any significant errors in respecting the State Budget Act.

Even inexpedient transactions involving state assets might be correctly recognised in the state's accounts because accounting rules require transactions to be recognised according to their substance, thereby neglecting expediency

45. On the other hand, the NAO audits have revealed that the use of state assets and the relevant decision-making suffer from shortcomings and that the addressing of such shortcomings would allow reducing state expenditure and/or increasing revenue. The use of state assets are characterised by hastily launched as well as incomplete reforms, decisions made on the basis of inadequate information, and the failure to decide despite the availability of necessary information.

Government reform should lead to more efficient and profitable use of state assets

To ensure the country's development it is necessary to revise the operation of the government sector and the state's functions - successful implementation changes requires adequate information, courage to make decisions, and willingness to take responsibility

46. Estonia's public finances are sound compared to the majority of Europe but our shrinking and ageing population, growing social expenditure, and the resulting pressure on state budget and local

government revenue raise serious concerns about the state being able to perform its functions in the current manner and scope.

47. Despite the small public debt, nearly balanced budget and the availability of reserves, the growing social expenditure makes it difficult to finance the state's other spheres of activity in the required extent. The government's ability to make investments depends largely on foreign funding.

48. Estonia' reality is that, in the longer run, the central and local government will have increasing difficulties in performing their functions and meeting their targets. We are facing a challenge: how can the economy generate enough revenue for the community and the Treasury when the working age population is shrinking? At the same time, the pressure to increase social expenditure keeps building up. NAO audits and various studies have indicated that, given these circumstances, the Estonian pension and healthcare system will no longer be sustainable.

49. The country's sustainable development requires a broad discussion and open decision-making as to what kind of government sector we want and are able to maintain. In the longer perspective, which services should be provided to citizens, who should provide them, and to what extent? We need to reach a new agreement on list, amount, and target groups of public benefits that the central and local government should provide.

50. Mainly in the light of Estonia's demographic perspectives, the Riigikogu and the Government of the Republic have, following years of discussions, launched the administrative reform to enhance the capacity of local authorities, and the government reform to revise the entire operation of the government sector. According to the government, the aim of the government reform is to make governance simpler, and more open, innovative and flexible. Detailed objectives include improving the accessibility of public services, simplifying administrative procedures for citizens, and enhancing the effectiveness of state agencies.

51. Revising the functions and organisation of the state is most welcome and needs to be an ongoing process. The government reform action plan addresses a number of appropriate issues and spheres of activity of the state that call for revision and new decisions. On the other hand, the NAO has witnessed the launching and/or implementation of reforms on the basis of inadequate information or in a hurry, and the delaying of necessary decisions.

52. There are many theories and approaches concerning the management of change. One way is to approach the preconditions for any successful reform as follows:

- willingness and capacity to initiate and implement changes;
- availability of adequate and high-quality information for choosing the most appropriate solution for the country and making decisions, and making use of that information;
- besides economic expediency, the availability of substantive information, and the consideration of which public services and to what extent should the government provide, and how the

performance of government functions changes following the reform;

- transparent decision-making to enable the public understand which options the government had and why it opted for the particular decision, and to subsequently evaluate the outcomes of the reform;
- implementation of the principle that the authority to make decisions must entail responsibility.

Below, the NAO has addressed the issue of improving the quality and transparency of decisions and using state assets more efficiently

53. In this annual overview, the NAO has focused on improving the efficiency of government functions and enhancing the preparation and implementation of reforms concerning the operation of the government sector, enhancing the quality and transparency of decisions related to state assets, and using the state's and taxpayers' money more efficiently and profitably.

Performance of government functions always entails the use of state assets where unreasoned decisions and violation of the State Assets Act are not acceptable

54. The state operates and performs its functions by using state assets. The taxpayers' money and public sector revenue are used directly to ensure the provision public services like availability of medical attention or supporting social coping, and to maintain the body of officials needed for organising the provision of such services, and their working environment.

55. The administration of state assets is governed first and foremost by the State Assets Act, the State Budget Act and their implementing provisions. Further, Estonia is committed to respecting the guidelines and good practices developed by internationally recognised organisations (e.g. OECD, IMF).

Government authorities should thoroughly consider decisions concerning state assets, provide explanations, and verify their legitimacy

56. According to the State Assets Act that governs the use and management of state assets, such assets should be administered purposefully, expediently, economically, legitimately, transparently and verifiably. The administrator of assets must conduct any operations or transactions involving state assets subject to the requirement to increase gains and avoid any loss that the state might incur due to such activities.

57. The State Budget Act, the State Assets Act and other relevant legislation and internationally recognised good practices set the following criteria for the use of state assets:

- state budget expenses are necessary for the performance of government functions;
- state budget expenses are the most expedient and economical (and, for investments in state-controlled companies, profitable) instrument for achieving the performance of government functions, and development objectives;

- state budget expenses are determined transparently, and the considered alternatives and the justification of the decision are explained;
- state budget expenses are made in accordance with the applicable legislation and can be verified retrospectively;
- the effectiveness (i.e. the impact on the attainment or development objectives) of expenses and investments made by the state is determined and disclosed;
- state assets are assessed on an ongoing basis to determine whether they are necessary for the state and whether they are used profitably so that the state incurs minimum expenses;
- the entities responsible and their scope of responsibility for the inexpedient use of state assets are clearly identified, and they are actually held liable.

58. Hence, implementing the State Asset Act's principle to use state assets purposefully, expediently and economically, thereby avoiding loss and maximising gains, calls for the decisions concerning state assets to be made on the basis of adequate information and for the substantive analysis of options.

59. For the Government of the Republic this means that information for making decisions is prepared and submitted to it in advance as prescribed by the rules of the Government of the Republic, and that such information allows analysing whether the decision is necessary for performing government functions and whether, according to the available knowledge, it is the most purposeful, expedient and economical way of performing such functions. Further, such information must provide the government with assurance that the decision is legitimate and the choice is clear for the public, i.e. transparent. In other words, the government needs to make sure that the decision complies with the principles of the State Assets Act, and require the author of the legislative draft to furnish information that allows making a decision.

60. The reform of any government functions and government sector maintenance, incl. aspects related to state assets, must rely on analyses and studies and be conducted in a manner the is clear for everyone. Reform implementation must not be guided only by cost savings, and connections with the performance of government functions should be analysed too.

One of the NAO's duties is to help the public understand how the government executives have handled state assets

61. It is the NAO's duty to help the public understand how the government executives have performed their tasks, incl. launched and implemented reforms and respected the applicable requirements and good practices in using state assets.

62. NAO publications in 2016 - audits „Activities of the state in the centralisation of state real estate management“, „Activities of government in the development of national airlines“, „Course and effectiveness of the establishment of the Police and Border Guard Board“, „Economic viability of managing cars of ministries“, plus the analyses on state budget drafting and implementation of public procurement, and the overview of real estate owned by local governments – demonstrate that state assets are not always used profitably or efficiently.

Shortcomings in making decisions concerning state assets entail unnecessary costs and forfeiture of revenue

State real estate reform - 15 years of failure to identify the most efficient solution for real estate management

Read more

From the NAO audit report „Activities of the state in the centralisation of state real estate management“

63. State real estate is one of the state asset groups that the state uses to perform public functions. When using real estate - just like when using tax revenue or biological resources or controlling companies - the government must always analyse whether it uses the assets in the best possible way. The government needs to assess how much real estate it needs to perform its functions and identify the most efficient solution for maintaining such property. Hence, changes in the management of state real estate could be analysed as an example of how the state has used a specific asset group - real estate - for performing its functions and which solutions it has implemented for using the assets more efficiently.

64. The government began to discuss the need for fundamental changes in the management of state real estate at the end of the 1990s and the start of the 2000s when it became clear that real estate management is essentially not included in the state's core functions. The state does not necessarily need to own real estate, and the required premises and maintenance services can be outsourced from the private sector or otherwise.

Essentially, the government did not consider other alternatives when establishing State Real Estate Ltd

65. Following a proposal from the Ministry of Finance, the government concluded that the management of state real estate would become more efficient if a single entity administered all the real estate. In 2001, the government established the state-owned company Riigi Kinnisvara AS ("State Real Estate Ltd" - "SRE") to this end. According to the original reform plan, state agencies were supposed to transfer all developed real estate to SRE by 2003, and lease the premises necessary for performing their functions from SRE on market conditions.

66. In brief, the purpose of the reform was to ensure that state agencies continue to use only buildings which are necessary for their functions and which the SRE has renovated by means of borrowed funds and rental payments. The premises were to be used optimally to achieve more efficient use of state budget funds.

67. The first expected outcome of the reform was that the developed properties of the state are renovated by SRE which borrows funds to this end so as not to affect public debt or budget balance because SRE was excluded from the government sector upon establishment. The second expected outcome was increased expertise in real estate management and cost optimisation because SRE was supposed to assume central responsibility for property maintenance. It was hoped that the major public tenders announced by SRE would optimise the cost of maintaining property that the state agencies used to maintain by themselves.

68. The third expected outcome was more efficient use of premises. It was presumed that, if all real estate is transferred to SRE, the agencies would start leasing only the premises that they need. The limited nature of budgeted expenses and rental cost comparable to market prices was supposed to motivate the state agencies to critically review their need for space and optimise the use of premises. According to the new real estate management scheme, the state agencies were to become so-called smart customers - decide which premises and maintenance services they need for their activities and choose the optimal solution by comparing the SRE's offer with other alternatives. Being the central contracting entity SRE was supposed to become a competitive partner for state agencies.

The expected outcomes and objectives of the state real estate reform have proven illusive - property expenses went up and little thought was given to optimising the use of premises

69. As of 2016, the reform is still pending and the objectives have not been attained. The state agencies have agreed to transfer nearly all of their unnecessary property to SRE but declined to transfer the property they need. As at the end of 2015, state agencies still own 68% of all developed property. Premises leased from SRE make up 25% of premises used by state agencies.

The Ministry of Finance has failed to convince other ministries that the SRE model is the most expedient solution for real estate management

70. Due to, but not limited to, the fact that the Ministry of Finance has failed to convince other ministries that it is reasonable to manage state real estate centrally through a state-owned company, the reform has lingered and progressed uncontrollably. The NAO audit concerning the use and development of state real estate revealed that the management of developed properties of the state is fragmented and that these are used inefficiently which entails an unnecessary financial burden for the state.

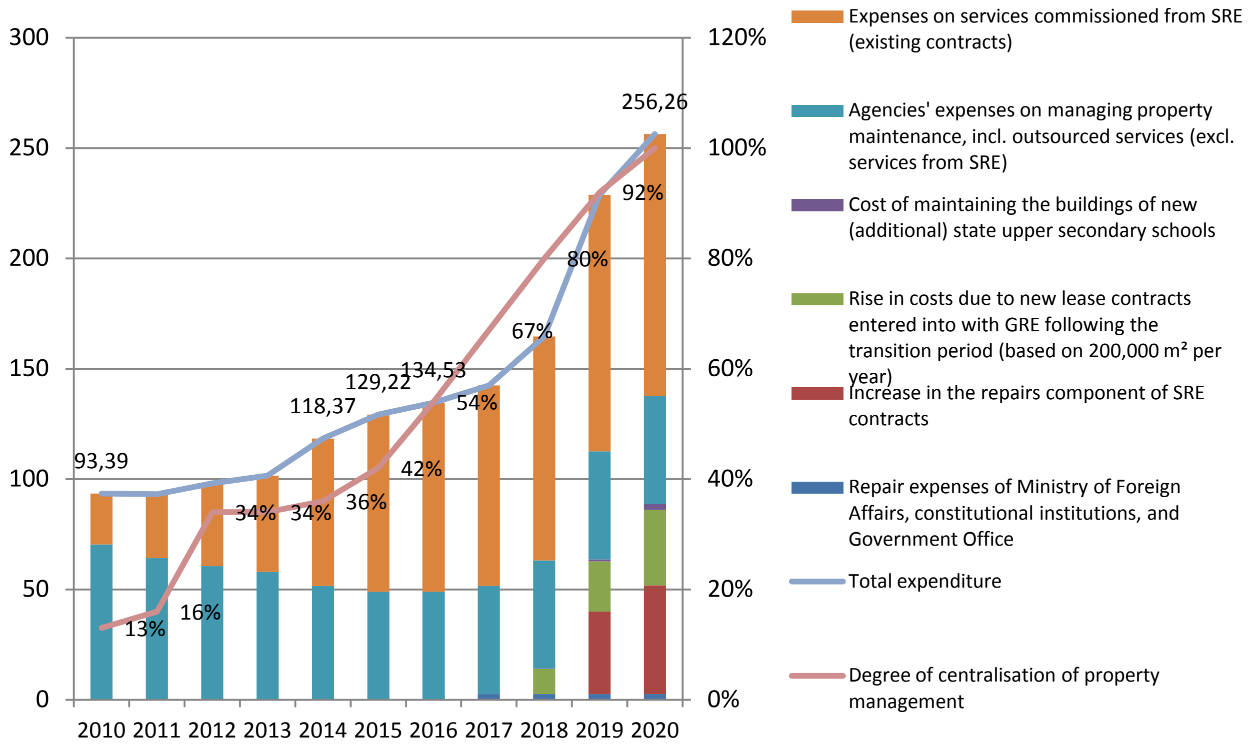
71. The main reason here is the government's failure to agree on a uniform nationwide real estate policy over the 15-year period and select the optimal solution for real estate management given the available knowledge. State agencies have not been subjected to clear objectives for using premises more efficiently or keeping property expenses under control.

72. Hence, the efficient use of premises in the country has not been comprehensively analysed and we still don't know how much and what kind of real estate the government needs to perform its functions (in the longer run) or how to finance the renovation of buildings.

According to the forecast, the state's property expenses will nearly double in five years

73. The state's property expenses have risen notably and, according to the forecast by the Ministry of Finance, will double over the next five years (see Figure 5). In 2016, the property expenses of state agencies total about 134 million euros, but in 2020 approx. 256 million. For buildings transferred to SRE, the property expenses have grown primarily due to the transition to market based rental rates as envisaged by the state real estate reform. Another factor behind the growth in expenses is the general rise of market prices for property maintenance services. In some cases, further factors include the change in the scope or amount of services, and expenses have grown by amounts not previously budgeted as property expenses on permanent basis.

Figure 5. Property expenses of state agencies in 2010-2020 (in EUR million)*



* Maintenance costs of plots, buildings and premises, and finance lease interest payable to State Real Estate Ltd, including VAT, but excluding payments of principal of finance lease, investments, and personnel expenses of state agencies related to property maintenance (labour costs of administrative and maintenance workers).

Source: Ministry of Finance (documents of the Cabinet of Ministers, 21 April 2016)

For buildings analysed by the NAO, the average growth of agencies' budgeted expenses was 2.5 times after leasing their former premises from State Real Estate Ltd

74. Despite the increase in property expenses, there is no assurance that the condition of buildings will improve. The purpose of using the SRE solution was to eliminate arrears relating to the repair of buildings, but according to the Ministry of Finance, the repair fund contributions paid to SRE are not enough to keep the buildings in good condition. The Ministry estimates that the repair funds for state real estate are approx. 500 million euros short.

75. And finding any additional funding from the state budget is complicated. In 2008, SRE's legal status was revised and it was included in the government sector. Hence, the government does not permit SRE to use available and/or borrowed funds for the renovation of buildings because that would have a negative effect on the budget balance of the state. The inclusion of SRE in the government sector quashed one of the main arguments in favour of centralising the management of state real estate through SRE that started in 2001.

76. The NAO finds that SRE's operations are legitimate and its accounts are in accordance with the generally accepted accounting principles. The procurement regulations of SRE are thorough and the public tenders announced during the audited period (2013-2014) are compatible with the Public Procurement Act. SRE is merely the implementing unit and does not design the government's real estate policy - this is done by the Government of the Republic and the Ministry of Finance. Unlike the rest, SRE has a clear overview of the expenses of buildings transferred to it.

The government lacks a long-term plan - it has no idea how much and what kind of real estate it needs to perform its functions and how to finance the renovation of such properties

77. For managing the state's real estate, it is essential to have relevant information, in particular, information on the floor area and quality of buildings, exploitation costs, and future needs. To decide on any changes, provide guidelines and plan the financing of real estate, it is essential for the government to identify how much and what kind of real estate it needs to perform its functions. This has not been done over these 15 years.

78. Due to the lack of required information on real estate, it is impossible to provide an evidence-based assessment as to whether the lingering adjustment of real estate management launched in 2001 was reasonable and expedient for the state and whether we should continue using the SRE solution. The state's property expenses have gone up and, according to the forecasts, will continue to do so. Efficient use of premises is neglected and there is uncertainty about improving the condition of buildings.

79. The state real estate reform is an example of problems in every phase: start, implementation and completion. The problem with starting was that other options were not thoroughly considered when opting for the centralised management of state real estate, plus there was not enough information to determine whether that was the most expedient solution.

80. Due to the lack of consensus on the government level, the state real estate reform has evolved uncontrollably whereby the ministries' approaches and practices related to using state real estate vary. Except for the buildings of the Ministry of Finance and the Ministry of Justice that were swiftly transferred to SRE following a political agreement, a large portion of the 25% in question has been transferred thanks to budget policy measures implemented by the Ministry of Finance, i.e. for property transferred to SRE, the rise in property expenses is reimbursed from the budget. Problems with state real estate have been known for a long time but there still is no agreement as to how these should be solved.

Real estate of local governments - the concentration of population in cities has left many local authorities in possession of useless and degrading buildings

Read more

From the NAO's report, published in 2016, on „Overview of developed properties of local governments and their management“

81. The management of real estate owned by local governments is not free from problems either. Due to the shrinking population, most local governments need less nurseries, schools, and the like. In a number of regions, local authorities have difficulties with finding uses for their real estate.

82. Most of the unused buildings are located in places where the collective farms in operation before the restoration of independence had erected large educational and cultural facilities for their staff but following economic restructuring and population shrinking these facilities were no longer in such demand. Local governments are worried about buildings that were owned by the state and no longer have any use (e.g. former children's homes, special care homes, vocational schools).

Did you know that

- As at the end of 2015, local governments and their companies possessed a total of 5,386 buildings recognised as fixed assets.
- In the opinion of local authorities, the condition of one half of these buildings is either good or very good, and for a bit more than one-tenth, either poor or very poor.
- The local authorities find that they need 81% of their buildings in full and 8% in part, incl. over the next five years, and that the renovation of these buildings would cost a total of 838 million euros.

  For comparison: in 2011-2015, local governments and their companies invested a total of 1.15 billion euros in fixed assets.
- The local authorities would like to demolish 18% of the unnecessary buildings and, according to their estimates, demolition would cost nearly 3.5 million euros.

The land reform commenced after the Republic of Estonia regained independence to transform the legal framework based on national ownership of land into a system of private ownership.

Source: Land Reform Act, § 2

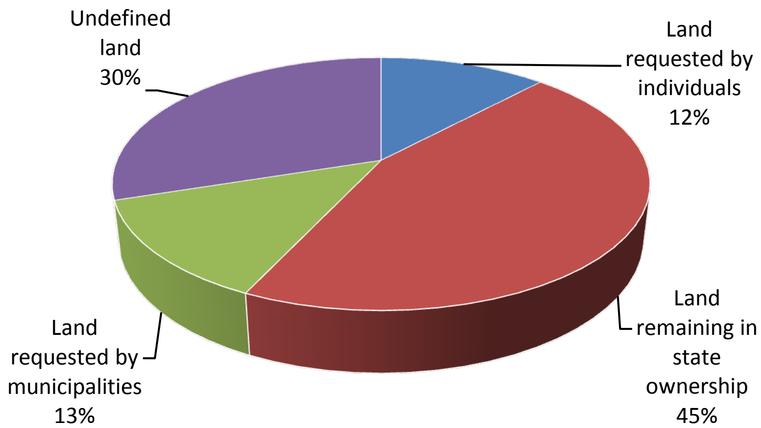
83. In a number of cases, the central government has persuaded the local authorities to assume ownership of such buildings that have no perspective buyers in order to prevent their degradation but finding any use for them has proven difficult. Further, buildings owned by private entities often become useless, keep degrading, and may become hazardous. The implementation of the administrative reform and the merger of municipalities generate additional pressure to optimise the use of premises, and the amount of unnecessary properties possessed by local governments will increase even further.

Land - the government's land needs are still not identified and the land reform is pending

84. Similarly to developed properties, the central government should own land only as much as it might need now or in the future for performing its functions, and see to it that the land not required by the central or local government is put into civilian use as quickly as possible.

85. The land reform that started in 1991 as part of the ownership reform has been going on for 25 years and resulted in the registration of 4.35 million hectares of land or 97.4% of the country's total area. According to Land Board, 70% of the remainder (2.6%) serves the interests of private individuals, local governments or the central government, and for 30% there are no interested parties or they have not declared their interest (see "undefined land" on Figure 6).

Figure 6. Unreformed land as at 1 April 2016



Source: Land Board

86. Only 2.6% of the country's total area is not registered land but that 2.6% represents the more complicated cases. In 2008, the Government of the Republic decided that any land that has remained available during the land reform should be recognised as the state land reserve. Unfortunately, the identification of the land reserve required for performing the government sector or public functions has lingered, and as of 2016, the situation is still not clear.

87. Although the legislator has repeatedly extended the time limits for completing the land reform operations, the successful completion of the reform depends on the capability of central and local authorities rather than the granting of extensions. Specifically, according to the State Assets Act, all land units owned by the state must be entered in the land register by 31 December 2019 but the Land Board argues that this is not actually feasible.

State-controlled companies - engaging in business ventures must be necessary for performing government functions, profitable, and legitimate

88. State-controlled companies are another major asset group besides state real estate that lacks clarity and transparency.

The performance of state-controlled companies has a considerable impact on the country's economy, development and competitiveness

89. As of October 2016, the state holds shares in 33 companies whereof 27 are completely owned by the state. As of 31 December 2015, state-controlled companies account for a little over 6 billion euros or 21% of public sector assets, and annually invest hundreds of millions of euros and employ thousands of individuals. Decisions concerning those companies made by the Government of the Republic, the Minister in control of the shareholding, and the companies' supervisory and management boards determine whether the government and citizens gain or lose from engaging in business.

NAO in 2007: governance and owner supervision of companies is insufficient; NAO in 2013: no improvement

90. Over the last ten years, the NAO has audited the operations of individual state-controlled companies and the management of shareholdings in a broader sense. In the report published in 2007 on „Owner supervision in public undertakings and foundations", the NAO argued that there is no assurance that the governance and supervision of state-controlled companies is expedient and effective. The report published in autumn 2013 revealed that the situation had not improved.

91. Likewise, the audit in 2013 contained the conclusion that the state still lacks a policy on managing shareholdings, and that the ministries abstain from justifying the need for individual state-controlled companies. The ministries as the entities controlling the shareholdings must annually report to the Government of the Republic as to whether and why owning a certain company is still necessary but the reasoning is superficial and terse and repeats itself year after year. The members of management and supervisory boards of audited companies are not convinced or lack consensus that the state necessarily needs to own these companies.

The Minister of Finance and the Minister of Economic Affairs and Infrastructure would both like to change the way that state-controlled companies are managed but the compatibility of their plans is not clear

92. Following the NAO's audits, the Ministry of Finance drafted the Green Paper on Government Shareholding Policy where it reached the same conclusions: the principles of government shareholding in companies are obscure, more specific goals should bet set for companies and their attainment monitored, the practices of staffing the supervisory boards of companies should be revised, and their responsibilities detailed.

93. The Government of the Republic approved the Green Paper in July 2015 whereafter the Ministry of Finance began to draft the White Paper on Shareholding Policy which suggests solutions to problems relating to companies. In summer 2016, the Cabinet of Ministers approved the White Paper but the ensuing specific changes, incl. in legislation, are yet to be identified. The Ministry of Economic Affairs and Communications has developed proposals for managing the state-controlled companies that it governs. Therefore, at the time of drawing up this annual report, it was not quite clear yet whether and how the Government of the Republic would alter the management of state-controlled companies.

Financing of AS Estonian Air - the government could have avoided the loss of approx. 85 million euros

94. The management of state-controlled relates directly to the performance of the state's functions, the operation of companies of strategic importance, and earning revenue for the state. The government engages in business ventures, receives dividends from its companies, and provides additional capital.

95. Just like with using state real estate, the government must manage its holdings in state-controlled companies in compliance with the principle of maximising gains and minimising losses. When the owner of state-controlled companies decides to award dividends, it must see to it that the amounts payable as dividends are not excessive - i.e. do not compromise the company's business. However, when granting additional capital to companies the owner - the government - must be assured that the granted funds are not lost and earn revenue. Similarly to the State Assets Act, the government reform action plan provides that the objective of state-controlled companies is to earn revenue.

Government has granted funding to state-controlled companies or facilitated investments in the light of inadequate information

96. In addition to economic considerations, the government must carefully analyse - especially when providing capital to its companies - whether such provision is compatible with the EU single market rules, i.e. the state aid rules directly applicable to Estonia. If the European Commission finds that a company has received funding in violation of the rules, the company must return such funding to the government which might cause the company's bankruptcy. This risk become reality for AS Estonian Air - in November 2015, the Commission declared that the 84.9 million euros injected in the airline constitutes state aid which resulted in the termination of the airline operator.

Read more

From the NAO audit report, published in 2016, on „Activities of government in the development of national airlines“

97. The NAO analysed the government's activities related to granting funds and loans to AS Estonian Air and concluded that the government adopted those decisions in view of the position that Estonia needs an airline based in Tallinn without essentially giving any thought to other options for ensuring air transport. Further, the government did not require AS Estonian Air to provide a business plan accompanied by an opinion of an independent expert as to the possibilities of turning the airline into a viable undertaking. This means that when granting funds to AS Estonian Air the government could not possible have assurance that it acts like a rational investor who seeks return on his investment and intends to avoid losses.

98. Likewise, the government lacked such assurance when it established the two new national airlines - current Nordica and OÜ Transpordi Varahaldus - and granted them a total of 72.7 million euros. Business plans were submitted to the government for both new airlines but the independent reviews that declared the business plans feasible were finalised after the government's decision.

Granting funds to AS Estonian Air is an example of illegitimate handling of state assets

99. At the time, the government was not fully assured about the legitimacy of granting funds to AS Estonian Air. The European Commission's conclusion that the government's decisions were incompatible with EU regulations could have been avoided, if the government had, at the time of allocating funds to AS Estonian Air, obtained assurance that doing so is in accordance with the EU rules directly applicable to Estonia The government failed to do so. When granting funds, the government lacked the necessary legal analysis to confirm that its decisions are compatible with the EU rules on state aid.

100. The government paid enough attention to the state aid risk years after it had made the decisions considered relevant by the European Commission. In 2010 and in 2011-2012, when the government decided to allocated 17.9 and 30 million euros, respectively, towards the share capital of AS Estonian Air, the Ministry of Economic Affairs and Communications argued, in the explanatory memorandum of the decision, that granting funds is compatible with state aid rules but there was no underlying analysis. The Ministry of Finance did not provide its opinion, and both ministries advised that the European Commission was neither notified nor consulted about the decision. The Ministry of Economic Affairs and Communications requested the first legal opinions at the beginning of 2013 when the Commission had already launched an investigation.

Over the period 2010-2015, government addressed issues related to AS Estonian Air in an expedited manner

101. In most cases, decisions concerning AS Estonian Air were adopted hastily. In 2010-2015, the government addressed issues related to AS Estonian Air 25 times, and on none of those occasions were documents submitted to the government in accordance with the procedure set out in the rules of the Government of the Republic (7 calendar days before the session). Usually, documents were made available to the members of the Cabinet of Ministers on the day of the session or cabinet meeting. In the opinion of the NAO, in nearly all instances, the circumstances referred to in the documents were such that the entity filing the draft should have been aware of these for longer than a couple of days.

102. The entities who prepared documents for the government argued that the reason for communicating the documents at the last minute was the concern that information intended for internal use or only for the eyes of the ministers might leak to the public prior to making the decision. The NAO argues that the lack of trust within the government or the authorities makes it difficult for the government to hold reasoned discussions or make reasoned decisions.

103. The NAO finds that, if the government had employed different decision-making practices, it could have avoided the staid aid proceedings by the European Commission, the ensuing negative decision, and the company's bankruptcy, and consequently the loss of approx. 85 million euros.

104. The government adopted decision concerning AS Estonian Air with an undue haste and using superficial information even in situation where it had the opportunity and time to conduct the necessary analysis and request expert opinions in issues that the officials are not competent to analyse in all respects. In preparing the draft decisions, due diligence was neglected by the relevant minister with regard to his staff, or the Prime Minister with regard to the relevant minister.

105. The case of AS Estonian Air is an example of how the government ignored, over the years, the principles of the State Assets Act when granting funds and loans to the state-controlled company. This led to the loss of tens of millions of euros. The government continued to grant funding to the company even after the Ministry of Finance had written off previous loans and had shared the opinion of the Ministry of Economic Affairs and Communications that the successful salvaging of the company is unlikely.

106. The Riigikogu, the Government of the Republic, public officials, and everyone else who deals with state assets and makes decisions must respect the principles of the applicable legislation. And if legislation obstructs reasonable decisions, it should be amended rather than ignored.

State-established foundations - often, there is no analysis as to whether this legal form is the most appropriate for performing public functions

When the state establishes foundations, it often fails to analyse the expediency of such legal form

107. It is not clear whether the centralised management of state real estate through the state-controlled company State Real Estate Ltd is the most expedient solution, and likewise, the state increasingly uses another legal form - foundations - to perform its functions and often fails to analyse whether this is the most appropriate solution.

108. As at 31 October 2015, the state controlled 76 foundations whose assets totalled approx. 1.3 billion euros. In its audits, the NAO has repeatedly highlighted that, when establishing foundations, alternative legal forms and the advantages and disadvantages of a foundation are not adequately analysed. The analysis of appropriateness of legal form has been conducted for 15 out of the 76 state-established foundations. For instance, for theatres, concert organisations, healthcare institutions, sports centres, development centres and churches, the legal form analysis has been omitted.

109. The NAO has recommended that the Minister of Finance, in cooperation with the Minister of Justice, analyse which public services should be provided through foundations, and explain whether and to what extent the established foundations perform the said duties. To the NAO's knowledge, such analysis had not been conducted at the time of drawing up this report.

Government's vehicle fleet - state agencies buy or lease vehicles without proper analysis that would identify the most economical solution

Read more

From the NAO audit report, published in 2016, on „Economic viability of managing cars of ministries“

110. One manifestation of efficient use of state assets is the ability to maintain the government's vehicle fleet efficiently. In the 2016, the NAO published an audit report on "Economic viability of managing cars of ministries" which analysed the management of the vehicle fleet in state agencies to determine whether resources are used optimally.

111. The audit revealed that the state agencies fail to conduct proper analysis that would identify the most economical solution (either lease or buy). They buy or lease vehicles without adequate reasoning as to whether they actually need them or use them intensively enough.

State agencies make material errors in planning the intensity of use of vehicles

112. The NAO compared the actual average annual mileage of leased regular vehicles with the maximum mileage set out in the lease contracts. The auditors learned that the use of about 70% of audited vehicles remains below the planned level. In other words, vehicles are leased even if there is actually little use for them, or lease payments cover a greater mileage than actually used.

Vehicles are lease on terms that are disadvantageous for the government

113. Although state agencies consider the economically useful life of vehicle to be 10 years, they change vehicles often (mostly every 3-5 years) and therefore spend more money than if they used the vehicles for a longer period. Further, the technical descriptions of vehicles to be acquired by the state agencies range significantly in their level of detail - from about twenty requirements to nearly one hundred - this is justified by the need to take into account the specifics of the agency but such reasoning is not always founded. Plus, joint procurement was very rarely used. Furthermore, the vehicles are often leased on terms that are disadvantageous for the government - this applies mainly to provisions related to premature termination.

Public procurement - transparent and well-considered joint public tenders with clear responsibility yield savings

Public procurement is not always legitimate or transparent

114. Each year, the public sector uses increasing amounts of taxpayers' money to purchase goods and services mostly from private businesses as are necessary for the functioning of the state and the provision of services to its citizens. In 2015, state agencies, local authorities and state-controlled foundations and companies, and the State Forest Management Centre spent a total of more than 1.2 billion euros on public procurement aimed, among other things, at constructing and renewing roads, ensuring the availability of healthcare services, enhancing national defence, and improving the supply of electricity.

115. The objective of announcing public tenders is to boost the economic by supporting fair competition between businesses and, at the same time, acquire goods and services necessary for the functioning of the state as favourably as possible. The NAO underlines that the best price is not necessarily the cheapest price.

116. The NAO finds that - although the required internal controls for procurement in state agencies are in place and generally solid, i.e. in most cases, sufficiently thorough procurement rules have been developed and procurement plans are up to date - the unlawful omission of public invitations to tender continues to be an increasingly prevalent a problem.

Errors in the implementation of public procurement make the transparent, expedient and economical use of state budget funds questionable

117. Year after year, more and more money is used for acquisitions that have been effected in violation of the legal requirements and omitting the required procurement procedures (see Table 9). Hence, the objective of public procurement is not met here - the transparent, expedient and economical use of state budget funds, equal treatment of entities, and the effective exploitation of the prevalent competitive environment for purchasing goods and services and contracting for construction work has not been ensured.

Table 9. Total value of procurement procedures omitted in state agencies in 2013-2015 as identified by the NAO

	Total value of omitted procurement procedures (in EUR million)		
	2013	2014	2015
Total purchases outside public procurement, incl.	**2.4**	**5.7**	**8.0**
▪ without implementing a procurement procedure	1.3	3.9	6.0
▪ without implementing a simplified procedure	1.1	1.8	2.0

Source: NAO audit reports and memoranda

Violations of the Public Procurement Act indicate that control over procurement planning, preparation and implementation is weak

118. The number of cases not compatible with the rules of the Public Procurement Act has not dropped, which means that the planning, preparation and monitoring of public procurement is still weak. The major shortcomings in managing public procurement result from the varying interpretations and implementation of the legislation and the lack of sufficient experience or capability, especially in smaller agencies who announce public tenders infrequently.. The NAO finds that smaller agencies lack the sufficient competencies and experience for public procurement, and therefore, centralised management of the agencies' public procurement by the ministry or a competency centre should be contemplated for each government area.

The procurement activities of state-controlled companies and foundations, and local authorities are monitored less than in state agencies although the value of public tenders is comparable

119. Over the recent years, the number and value of public tenders announced by state-controlled companies have increased, whereas state-controlled foundations have a notable presence as well. According to the Public Procurement Register, in state-controlled companies and foundations, and the State Forest Management Centre (SFMC) have carried out a total of 1,294 public tenders totalling 544 million euros in 2013, 1,490 tenders totalling 471.9 million euros in 2014, and 1,502 tenders totalling 527.2 million euros in 2015.

120. This tendency implies, among other things, that the state is increasingly performing its functions through entities which have different legal forms. Doing so does not conflict with the legislation but reduces the transparency of the functioning of the government.

121. Further, state-controlled companies and foundations, and the state-owned commercial body are subject to less monitoring and control measures than state agencies. The conformity of the procurement activities of state agencies with the Public Procurement Act is audited annually whereas for the procurement activities of state-controlled companies and foundations, and the SFMC there are no such auditing arrangements yet. Likewise, local authorities are audited less, despite announcing about the same number of public tenders as state agencies.

Public procurement could yield even greater economy

122. Public procurement procedures are omitted in cases where they should be applied, the actual need for acquiring goods and services is not thoroughly considered, and the documentation is not in order. All this means that the acquisition of state assets and the management of public procurement could be more efficient, and that use has not been made of all possibilities for ensuring the economical, expedient and transparent use of taxpayers' money or the effective exploitation of the competitive environment in purchasing goods and contracting for services.

123. The practice of joint and centralised procurement has demonstrated that it can yield economy but state agencies coordinate their procurement activities very little and the local authorities have become even more passive. For example, in 2014-2015, the state agencies announced more than 3,500 public tenders whereof 350 were either joint or centralised.

124. Practice has shown that joint and centralised procurement can yield remarkable savings in acquiring electricity, fuel, and ICT equipment. For instance, according to the Centre of Registers and Information Systems, savings amount to as much as 30% of the retail prices have been achieved by joint procurement of standard ICT products.

State budget - more efficient use of state revenue calls for more transparent budget drafting and more substantive reporting

125. The decision-making process on central government level can be deemed transparent, if the adopted decision, the other available options and the justification of the decision are clear for the public. To assess and compare the effects of the decision, the public must be able to understand earlier choices, and compare situations and circumstances. If the decision concerns the use of state assets or taxpayers' money, it must be subsequently be made clear to the public whether the intended goals were attained.

Often, state budget decisions are still non-transparent, and the budget information is difficult to compare in time

126. One of the major decisions adopted annually by the Riigikogu and the government is the drafting and adoption of the state budget. It its audits and previous annual overviews, the NAO has pointed out that the state budget and its explanatory memorandum are difficult to interpret - to identify the items on which the government spends money subject to the Riigikogu's authorisation. Further, the information in the state budget documents is not consistent which limits the possibilities of comprehending and comparing in time the financial position of the state, the state budget choices, and budget information.

127. In 2016, the Special Parliamentary Committee for State Budget Audit published an overview on „Potential paradigm shift in fiscal policy within the parliamentary system of Estonia“, which reveals that the problem still persists and that the state budget is difficult to understand even for the Members of the Riigikogu. Understanding the substantive aspects of the state budget requires thorough knowledge of accounting, financial and economic terminology, and a lot of time to analyse the various materials in combination with one another. The optimal use of public money for advancing Estonia's development requires the general public as well as the Riigikogu, who needs to approve the envisaged expenses as submitted by the government, to understand how much public money is spent and for on what and why.

The effects of using the tax and non-tax revenue of the state on Estonia's development are not sufficiently clear

128. Further, sustainable state budget decisions that advance life in Estonia call for the understanding and knowledge of results yielded by the past activities and money use. The government's yearly management report included in the consolidated annual report of the state must provide an overview of the government's activities and the achieved outcomes. The NAO finds that over the recent years the government's management report has become more balanced - addressing successful steps as well as omissions - but there is still room for improvement in terms of more analytical presentation of links between the government's activities and Estonia's development indicators.

129. Another issue is whether and how the effects of government's past activities are taken into account in making new decisions and drafting of future state budgets. In 2012, the NAO published an audit report on "Activities of the Government of the Republic in assessing the impact of its work and in reporting of the results of its work" showed that performance indicators are rarely used in state budget drafting.

Audits referred to in this annual overview

26 October 2016 - **Overview of developed properties of local governments and their management**

18 October 2016 - **Activities of the state in the centralisation of state real estate management**

29 August 2016 - **Accuracy of Annual Accounts 2015 and regularity of transactions of the state**

26 August 2016 - **Economic viability of managing cars of ministries**

23 May 2016 - **Activities of government in the development of national airlines**

19 April 2016 - **Course and effectiveness of the establishment of the Police and Border Guard Board**

11 September 2013 -**Organisation of management of public undertakings**

18 September 2012 - **Activities of the Government of the Republic in assessing the impact of its work and in reporting of the results of its work**

5 April 2007 - **Owner supervision in public undertakings and foundations**