

Overview of the use and preservation of state assets in 2016–2017

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

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Foreword

For years, Estonian state and society have been able to use non-returnable foreign aid, foremost European Union funds, to finance their development, functions and investments. This is money entrusted to us by the taxpayers of other states on the principle of European solidarity in order for us to make one-time expenditures on permanently improving our standard of living. Therefore, we cannot and must not endlessly keep looking to more prosperous member states of the Union with a somewhat demanding expectation, considering such aid to be a natural and irrefutable part of our life and income and thinking that it's someone else's duty to give us money. For different reasons, now is the time when foreign aid granted to Estonia is starting to shrink.

A few months ago, on 26 September, it was 30 years from the day when the newspaper *Edasi* published an SSE, i.e. self-sufficient Estonia programme, which has become one of the important symbolic markers on the road to restoring Estonia's independence. And although times and the whole of Estonia have changed by now, the message from back then is timely now, too – Estonia should be able to be self-sufficient. In order for us to not become dependent on foreign aid, in particular in the area of various investments, this year's annual overview of the National Audit Office is focusing on foreign aid funds.

A viable and lasting state has to build its function on the funds that we ourselves are capable of earning with our own hands and brains. I don't doubt that Estonia can do that; we have never been as prosperous as we are now. However, we can direct and improve the development and prosperity of our society better and more efficiently when we prepare for life without foreign aid early enough and thoughtfully.

The current good times should also be used for preparing for times that aren't quite so good, accumulating reserves and implementing reforms to curb the growth of expenses and facilitate the generating of new profits. As such, it is important for the government to support activities that have proven to be profitable over time: promoting education and favouring entrepreneurship, creativity, innovation and ingenuity. The need to organise the state reasonably has also proven itself over time. Implementing various reforms, we could be asking ourselves, rather we should be asking ourselves, which of these create added value in the economy, all the while not forgetting the integration of society and reducing inequality.

It's not redundant to once again remind ourselves of the repeatedly talked about need to critically consider everything that the state is currently working on and to think about what is actually necessary. This should be done irrespective of whether the flow of foreign aid continues as it has been or decreases. A simple question – would we do this or that and in the same way we are doing now if we had to cover all the expenses accompanying the respective decision ourselves – helps us make our choices. And before we answer that, we should take a moment to think about it. Now is the right time for such exercises of the mind.

A handwritten signature in black ink, appearing to read 'Alar Karis', with a long, sweeping stroke extending upwards and to the left.

Alar Karis
Auditor General

On 6 November 2017

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State accountancy continues to be well-organised, but changes in financial management require comprehensive rethinking

Over the year, state assets have increased by slightly more than 200 million euros to nearly 29 billion euros

1. When talking about state assets, we often think of the taxes collected from Estonian residents that the Government of the Republic is using for improving life in Estonia with the permission of the Riigikogu.

According to state budget of 2018, i.e. the state revenue and expenditure plan, more than 10 billion euros is planned to be directed to the operation and development of the state of Estonia over one year for the first time. Slightly more than one billion of this is made up of foreign financial aid, mostly from the European Union. The government has emphasised that these expenses have to support the growth of Estonian population, security, social welfare and economy. True, the draft budget is yet to be approved by the Riigikogu.

2. In addition to revenue accrued by the State Treasury, the Estonian public sector has plenty of other assets that are used for carrying out daily activities of the state and ensuring public services. For example, the state has forest, land, constructions works, roads and civil engineering works worth billions of euros. The state is also the owner of dozens of companies, and the activity of many of them is associated with offering services to Estonian residents.

3. As at the end of 2016, the public sector had assets in a total value of approx. 28.7 billion euros. Assessing the legality and productivity of using these assets is the task of the National Audit Office according to the powers given to it. The National Audit Office gives an assessment of using the funds of the state on the whole and funds of all the ministries every year.

The state's annual accounts of 2016 are accurate to a substantial extent

4. As a result of completed financial audits, the National Audit Office concluded that to a substantial extent, the state's **annual accounts** of 2016 accurately and fairly reflect the state's financial status, financial performance and cash flows of the concluded accounting period. The National Audit Office also believes that the accounting of foundations under the dominant influence of the state as well as state companies is well-organised and the annual accounts are mostly without significant errors.

Report on the implementation of the state budget is reliable, although the understandability of state budget is decreasing

5. The National Audit Office believes that in 2016, state authorities carried out financial transactions in accordance with the State Budget Act and state budget of 2016 to a substantial extent. This means that the National Audit Office did not find any significant errors in the compliance with the state budget laws.

In addition to using tax revenue, Estonian development is also affected by the state's ability to manage land and forest, construction works and civil engineering works

State's annual accounts covers ministries, the Government Office, constitutional institutions, state companies and foundations, and the profit-making state agency State Forest Management Centre.

Financing transactions are transactions with financial assets (e.g. securities) or financial liabilities (e.g. loans).

Informativeness of expenditure prescribed with the State Budget Act decreases

Explanatory note of state budget could be made more meaningful

6. In the opinion of the National Audit Office, the report on the implementation of the state budget of 2016, which specifies budget revenue to be 8.58 billion, expenditure to be 8.25 billion, investments to be 299.34 million and **financing transactions** to be 26.49 million euros, provides reliable information on the revenue (incl. accrued aid) accumulated, expenses made, investments and financial transactions carried out by the state.

7. While the comparability of state budget with the report on the implementation of the state budget has gradually decreased over the years, the overview of what the amounts prescribed in the state budget can be used for has decreased in the opinion of the National Audit Office. Informativeness of presenting expenditure has been decreased in the State Budget Act: while in the state budget laws of previous years the expenditure was differentiated by their intended purpose (e.g. the budget specified the content and recipient of aid), this has been abandoned over the years and the information is now only provided for individual expenses.

8. Although the Government of the Republic sees this to be an opportunity to use the budgetary funds flexibly, it also reduces the ability of the Riigikogu and the public to observe budgetary decisions and have a say in making thereof. According to the State Budget Act Amendment Act adopted in June 2017, the informativeness of expenditure prescribed with the annual budget act will decrease even further. The Riigikogu no longer confirms the economic purpose of the expenditure, as this will be decided by a minister responsible for each area.

9. Balance is important with regard to the roles of executive power and legislative power. This means that in addition to other supervisory mechanisms, the Riigikogu and the public must have enough information to assess the activity of the Government of the Republic. One prerequisite for this is the State Budget Act with an appropriate degree of specificity and a meaningful explanatory note of uniform quality.

10. By analysing the explanatory note of state budget, the National Audit Office concluded that the explanatory note of state budget of 2016 had an uneven quality. It included unexplained expenses, several unspecified important changes to revenue and expenditure as well as excessive information that did not help understand the budget. For example, it was not explained with regard to the Ministry of Economic Affairs and Communications which financial assets were planned to be acquired for the 32.65 million euros allocated with the State Budget Act.

11. The explanatory note also failed to explain several significant changes to the budget amounts in comparison with the previous year. At the same time, it provided explanations to amounts that were unimportant in the area of government of several ministries. For example, in the budget of the Ministry of the Interior, revenues have been explained in the amounts 140, 1,600 and 2,128 euros. In the budget of the Ministry of Justice, revenue from the sale of inventories and fixed assets in the amount 300 euros was explained.

12. Changes adopted with the State Budget Act Amendment Act of June 2017 significantly increase the role of the explanatory note of state

budget in the budgetary procedure, because more detailed information about funding activities is subsequently presented only there.

13. Therefore, the explanatory note of state budget drawn up by the Ministry of Finance is an extremely important document, which has to contain sufficient information about the content of financed activities and support the adoption of considered budgetary decisions. Information has to be reliable, adequate and unambiguous. Explanatory note also has to reveal who is responsible for the legal and productive use of specific budgetary funds.

Transition to activity-based budgeting has to be thought through, and the positive and negative aspects of the reform have to be considered.

14. The Government of the Republic has decided to start drawing up an activity-based budget as of 2020, i.e. determine the revenue and expenditure of different results areas of the state and abolish or reduce the detailed nature of the economic content (e.g. operational expenditure, appropriations) of the state budget.

15. In the opinion of the Ministry of Finance, this change should give an overview of how much money the state contributes to achieving certain objectives established in different areas. Transition to an activity-based budget should, in the opinion of the Ministry, create prerequisites for a more efficient cooperation of areas of government in order to better bind objectives, activities and resources.

16. The National Audit Office finds that to a certain extent, implementing activity-based cost accounting may establish prerequisites for a more efficient use of budgetary funds, but drawing up an activity-based state budget might not be the only or the most effective way to achieve this objective. This is indicated by the experience of the pilot project of the Ministry of Education and Research: Ministry drew up the 2016 budget for the area of government as an activity-based budget.

17. The objective of the Ministry of Education and Research was an improved association of funds, activities and results as well as improving the quality of management information in order to thereby make policymaking and adopting decisions more efficient. In the opinion of the National Audit Office, these objectives have not been achieved to date. According to the Ministry, the transition was labour-intensive and burdensome. The National Audit Office has no certainty that the information created as a result thereof can be used for making management decisions, and it is even more difficult to assess the productivity of using the funds planned in this manner.

18. The Ministry of Finance does not share the opinion of the National Audit Office. In the opinion of the Ministry, the risks highlighted by the National Audit Office do not realise; the Ministry assures that an activity-based budget provides a more transparent and better understandable overview of the expenditure of the state and results of using public funds. Because this is a prediction of the Ministry of Finance and the comprehensive solution how exactly budgeting will take place in the future has not been explained to the National Audit Office, the National Audit Office cannot confirm the expediency of activity-based budgeting.

For your information

there are several budgeting methods: cash-based, accrual-based, results-based, activity-based, cost-based, zero-based, etc. It is also possible to use so-called hybrid methods, i.e. mixtures of different methods. Cash-based and cost-based budgeting are generally considered to be the most resource-efficient.

Changes to the establishment of the state budget should help to make more considered cost decisions

19. Activity-based budgeting may reduce the options available to the Riigikogu to direct budgetary decisions. Upon activity-based budgeting, the state budget is established by results areas and programmes, the list of which is determined by the Government of the Republic. The government is able to change the content of results areas and programmes at its own discretion and with desired regularity.

20. Presently, the format and the degree of detail of explaining (in the explanatory note of state budget) the content of results areas and programmes is not known, i.e. based on which information the Riigikogu will make a decision on how much money to allocate to this or that results area or programme. It is also not clear how comparability with the use of the budget in previous years is ensured, which is also necessary information upon making new budgetary decisions.

21. If the division of state budget by programmes is changed frequently and not enough information is given about the content of the programmes and the Riigikogu itself will not monitor the use of funds allocated with the budget more closely than currently, the ability of the Riigikogu to understand the formation of the budget and have a real say in the establishment thereof will significantly decrease.

22. The overview *Potential Changes in Fiscal Policy Paradigm in the Estonian Parliamentary System* drawn up and published in 2016 by the State Budget Control Select Committee of the Riigikogu¹ also reveals that the problem continues to be topical and even the members of the Riigikogu find the state budget difficult to understand. In order to substantively understand the state budget, it is important to have deep knowledge of accounting, financial and economic terms and to find a lot of time to analyse different materials in conjunction with one another. The prerequisite for using public funds in the manner best suited for the development of Estonia, however, is that both the public and the Riigikogu, who has to approve the expenditure plan submitted by the government, understand why, on what and how much public funds are spent.

The growth period of national economy and revenue gives the opportunity to increase reserves

Estonian economy has grown faster than expected; construction and domestic consumption played an important role in it

23. One of the main objectives of Estonian parliament and government over the years has been to increase the prosperity of residents and the state and to improve social integration. The development of states is commonly compared with the help of hundreds of indicators, and the most common gauge of economic success is considered to be the state's gross domestic product (GDP).

24. In 2016, Estonian GDP increased by 2.1%, which is slightly more than the average in 28 Member States of the European Union. At the

¹ <https://www.riigikogu.ee/tegevus/dokumendiregister/dokument/82253fbb-8c75-4d87-89e9-85369b7b4030>

same time, the GDP of 28 EU states increased by 1.9%. Gross domestic product of neighbouring countries Latvia and Lithuania increased by 2.2% and 2.3%, respectively. After years of decrease, Finnish economy also saw an upward trend, increasing by 1.9% in 2016. One of Estonia's main trade partners Sweden exhibited continuously good growth (see table 1). In the EU Member States, Malta's economy grew the fastest (5.5%) in the previous year.

Table 1. Real GDP growth in Estonia and in some of the EU Member States in 2012–2016 (%)

	2012	2013	2014	2015	2016
Estonia	4.3	1.9	2.9	1.7	2.1
EU 28 average	-0.4	0.3	1.8	2.3	1.9
Latvia	4.0	2.4	1.9	2.8	2.2
Lithuania	3.8	3.5	3.5	1.8	2.3
Finland	-1.4	-0.8	-0.6	0.0	1.9
Sweden	-0.3	1.2	2.6	4.5	3.3

Source: Eurostat, as at 27 October 2017

The Ministry of Finance is currently more optimistic about the near future of Estonian economy than in the spring of this year

25. The remarkable growth of security that European economy has seen as of the second half of 2016 has continued to date, and the better than expected economic results of close neighbours have had a positive effect on Estonian GDP as well. In the first half of 2017, Estonian economy grew 5.2%.

26. The faster than expected economic growth has encouraged the Ministry of Finance to view the prospects of the near future as better than previously predicted. In the new economic forecast published in September 2017, the Ministry has changed growth expectations to be better to the extent of the entire forecast period. If in April, the Ministry expected the growth of this year to be 2.4%, it now expects it to be 4.3%. The GDP forecast for 2018 and 2019 has been increased by 0.2% to 3.3% and 3%, respectively. The expectations of coming years with regard to, for example, employment, wage increase and investments have also become more optimistic.

27. However, the Ministry of Finance itself², the Bank of Estonia³ as well as financial analysts have indicated several risks to the global and Estonian economy, which should be taken into consideration with regard to the current quick growth of GDP in 2017.

28. The Ministry of Finance outlines in its forecast that optimism in the European economy may, however, prove to be short-lived and fragile and that it is still not certain which direction the global economy will take in the coming years. Economic sentiment indicator published by the European Commission, which increased to its highest level in the last seven years in Estonia in June, fell once more in July-August. The fall is due to the deteriorated ratings of entrepreneurs on the overall condition of economy and market conditions, particularly in industry and service. That positive messages and development should last longer in order to ensure a

Security of Estonian entrepreneurs and consumers has decreased slightly over the last few months

² <https://www.rahandusministeerium.ee/et/riigieelarve-ja-majandus/majandusprognoosid>

³ <https://www.eestipank.ee/press/majandus-seilab-parituules-21092017>

continuous increase in the security of people is also indicated by the fact that savings of companies and households are higher than ever before.

Construction sector cannot be the main carrier of economic growth for the long-term

29. It deserves attention that in addition to the preserved export capability, the quick economic growth of the first half of 2017 was contributed to the most by the construction sector and mostly the service branches directed at domestic consumption such as commerce, information and communication as well as professional and technical activity, which ensured more than half of the total growth of value added.

30. The contribution of the industrial sector to economic growth has increased over the last half-year, and although according to the forecast of the Ministry of Finance the growth of export industry and service area will also accelerate over the coming years, economic growth will in the opinion of the Ministry continue to be carried by the construction sector and service directed at domestic consumption.

31. In addition to the establishment of apartment buildings that accelerated in the first half of 2017, Estonian construction market has been affected the most by an increase in the state's orders, which was expressed in the 42% growth of establishing civil engineering works. The growth is significantly carried by construction and reconstruction work on infrastructure objects, which are financed foremost with European Union funds.

32. However, on the one hand, economic growth relying on domestic consumption and the construction sector is not sustainable, while on the other hand, there is risk to the economy overheating (short-term) if the state forcefully directs funds to the economy through investments and other expenditure at a time when the economy is growing more rapidly than could be presumed considering the available production resources.

If the economy is doing well, it would be reasonable to use well-accruing revenue for increasing the state's reserves

33. The global financial and trust crisis that commenced in 2008 showed that economic growth that reached nearly 10% in 2005–2007 wasn't actually feasible for Estonia. This means that the fast GDP growth wasn't the result of the growth of our competitiveness, but rather caused foremost by the availability of cheap loan funds in very large quantities. Objectively, considering the resources at Estonia's disposal, continued economic growth would have been significantly more modest.

We can be happy about fast economic growth, but continued growth has to rely foremost on Estonia's competitiveness

34. Although in Estonia, we can't talk about a return of the boom, particularly of a boom that would cover the areas of activity of economy broadly, the newly-released economic forecast of the Ministry of Finance indicates that next year, Estonia's economy will grow slightly faster than could be presumed considering the resources available to Estonia.

35. Economy can exceed the speed of continuous development only for a short time, because demand exceeding productivity causes price increase, increase in the pressure of labour costs and decrease in competitiveness already in the medium term. In Estonia, we have been able to detect the increase in both consumer as well as production prices for some time now.

36. The carrier here is the construction sector, which receives large orders from the state, companies as well as private persons alike. In 2020–2021, Estonian economic growth should even out with the level of potential, i.e. sustainable, economic growth, according to the forecast of the Ministry of Finance. On the other hand, the Government of the Republic is planning to further stimulate economy through large-scale investment projects, and establishing Rail Baltic will also have an effect on the construction sector.

37. These investments give a further boost to the construction sector and activities associated with thereof, but their contribution to the growth of the potential of Estonian economy is questionable. At the same time, expenditure in research and development remains below the EU average, at 1.5% of GDP. In comparison with the objective established with the Estonian competitiveness plan *Estonia 2020* (3% of GDP), expenditures in research and development has seen a decline over the last few years. But research and development are important components in increasing the complexity of products/services as well as the economic potential.

The state should direct additional funds to the economy when companies are having difficulties again

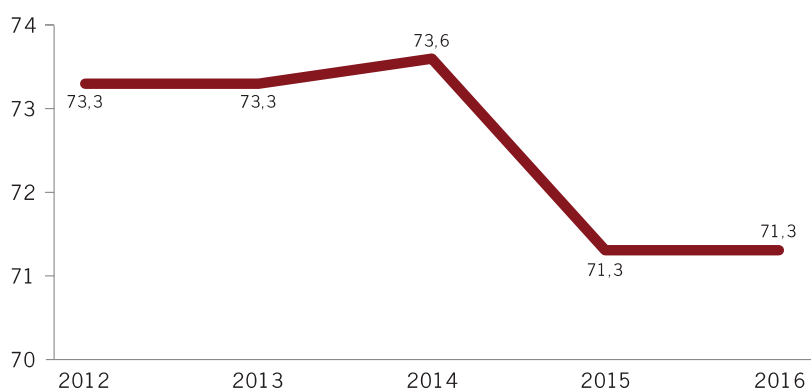
38. A state budget revenue forecast made more optimistic in light of an increased economic growth and Estonia's national debt that continues to be the smallest in Europe seems to enable state's investments in terms of funds. On the other hand, the boom could also reach other sectors should the construction sector overheat. This would cause a negative wage and labour market pressure, and the public sector could start to compete with the private sector for investment ability – as a result of increasing prices, the execution of public sector orders would also suffer in the end.

One of the most acutest challenges of Estonian economy continues to be the increase of productivity

Productivity of Estonian labour in comparison with the EU average is lower than five years ago

39. The Bank of Estonia has emphasised that although companies have been able to once again increase their profits in the conditions of increasing labour costs, the growth of prosperity of undertakings, contractors and the state is not possible in the long-term if the growth of the productivity of Estonian companies does not precede that of our neighbours. The stunted growth of productivity, however, is one of the most acutest problems and challenges of Estonian economy.

40. The data of the European Union statistical office Eurostat reveals that the productivity of Estonian labour in comparison with the average of the European Union has essentially remained at the same level for six years and has rather seen a downturn over the last couple of years. As at the end of 2016, productivity comprised 71.3% of the average of the 28 EU Member States, which is less than in 2012–2014 (see figure 1).

Figure 1. Productivity of Estonian labour per worker in comparison with the European Union average in 2012–2016 (EU 28 = 100%)

Source: Eurostat, as at 27 October 2017

For your information

on the one hand, unit labour cost indicates the labour cost of creating one unit of GDP and, on the other hand, it expresses the ratio of labour costs used in creating GDP to labour productivity.

41. At the same time, Estonian labour costs have increased faster than productivity. One indicator illustrating the international competitiveness of economy is unit labour cost, which in 2016 was 23% higher than in 2010. This means that the products manufactured in Estonia require nearly a quarter more labour costs. Unit labour cost in Finland and Sweden has increased by 11% during the same period. Although unit labour cost in Estonia decreased in the first half of 2017, i.e. productivity increased faster than wages, the Bank of Estonia warns that without additional investments in improving productivity and due to the continued wage pressure on the labour market, this growth may be temporary.

42. One of the objectives of *Estonia 2020*, development plan addressing Estonian competitiveness, approved by the Government of the Republic, is increasing productivity faster than labour costs. Achieving this objective continues to be problematic. When the National Audit Office dealt with the indicators of *Estonia 2020*, incl. the indicators of economic development, in 2014, the situation of labour costs was better than it was in 2016 (see table 2).⁴

Table 2. Change in the indicators of productivity and labour costs of Estonian competitiveness plan *Estonia 2020*

Objective and indicator	2014	2016	Objective 2020	Change in the situation of 2016 vs. 2014
Increase productivity per employee in comparison with the EU average <i>Productivity rate per employee in comparison with the EU average</i>	73.6%	71.3%	80%	Has deteriorated
Increase in labour costs does not exceed the growth rate of productivity <i>Change in the real indicator of unit labour cost</i>	1.7%	4.3%	0%	Has deteriorated

Sources: *Competitiveness plan Estonia 2020* of 27 April 2017 of the Government Office, background information [home page of Government Office EE2020](#) and Eurostat

⁴ Overview of the use and preservation of state assets in 2013–2014. National Audit Office, 2014, pp 22–23.
<http://www.riigikontroll.ee/Riigikontrollipublikatsioonid/Riigikontrolliaastaruanneparlamendile/tabid/110/language/et-EE/Default.aspx>.

43. One of the prerequisites for the growth of productivity is the desire and ability of companies to invest. Such investments are not always connected to construction activity, but if the state's excessively active investment policy proves to be an obstacle for the required private sector investments (because the state and private sector are competing for the same employees when building, commissioning software solutions or outsourcing other services), this may also hinder the growth of productivity.

44. It is therefore important for the state to monitor the economic environment and use additional funds to stimulate economy again when the private sector is doing poorly. To do this, however, these funds have to be accumulated and borrowing capacity has to be maintained.

According to the forecasts, state budget revenue will increase by 2 billion euros by 2021, but reserves will not increase

45. Although the forecast of tax revenue for 2017 has been decreased slightly for reasons arising from tax changes⁵ and border trade, taxes will accrue as expected in 2017 in the amount of approximately 6.7 billion euros, i.e. approximately 376 million euros more than in 2016.⁶

46. According to the forecast of the Ministry of Finance, the total state revenue budget will increase in 2017–2021 on average by 5.6% per year, i.e. 9.3 billion euros to 11.3 billion euros by 2021 (see also table 2). Of this, taxes and social security contributions will increase by 6.7 billion to 8.6 billion euros during the same period, income not subject to income tax will decrease by approx. 300 million euros to 1 billion euros due to gradually using up European Union support, and **transferable revenue** will increase to slightly more than 1.7 billion euros.

47. On the other hand, the summer forecast of the Ministry of Finance reveals that the increasing opportunities of the state budget are used for running costs and no actions are taken to increase the reserves or reduce the debt amount. According to the forecast, the budget position, i.e. revenue and expenditure, of the general government sector is hoped to be maintained near a balance, and the forecast has been improved in anticipation of the accelerated growth of GDP in comparison with the spring, but the state's reserves will remain at the same level that they are now (see table 3).

Increase in the state budget revenue is used for covering running costs

Transferable revenue – taxes, fees, fines and other encumbrances prescribed in the legislation that the tax collector is obligated to transfer to the recipient specified in the legislation, for example a local authority

⁵ For example, increasing overall basic exemption, increasing the increased basic exemption in event of pension

⁶ Without transferable revenue. As of the economic forecast of summer 2017, the Ministry of Finance submits the forecast of state budget revenue as accrual-based.

Table 3. Selected indicators of the economic forecast of summer 2017 of the Ministry of Finance for 2016–2021

	2016	2017	2018	2019	2020	2021
Total state budget revenue (million euros), incl.	8,634	9,356	10,312	10,832	11,142	11,295
taxes and social security contributions	6,319	6,695	7,280	7,669	8,027	8,601
income not subject to income tax	1,051	1,299	1,592	1,632	1,495	968
transferable revenue	1,265	1,360	1,439	1,531	1,620	1,707
Liquid financial assets of the general government sector (million euros)	2,044	1,955	1,835	1,798	1,837	1,934
General government sector debt (million euros)	1,984	2,067	2,101	2,225	2,107	2,018
Nominal budget position of the general government sector (% of GDP), incl.	0.3	0.0	-0.2	-0.3	0.2	0.6
central government	0.1	0.1	-0.3	-0.3	0.2	0.8
health insurance fund and unemployment insurance fund	0.03	0.1	0.1	0.1	0.1	0.1
local authorities	0.2	-0.2	-0.1	-0.1	-0.1	-0.3
Structurally adjusted budget position of the general government sector (% of GDP)	0.8	0.2	-0.4	-0.3	0.2	0.6

Source: Economic forecast of summer 2017 of the Ministry of Finance

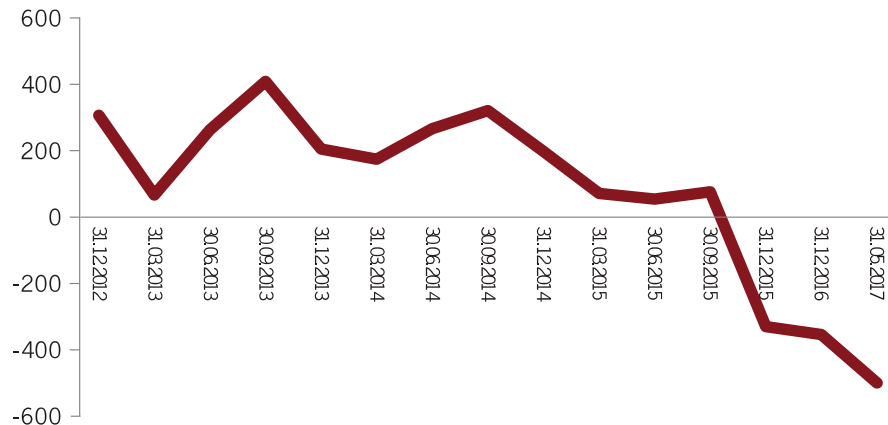
Nominal budget position of the general government sector – balance of total revenue and total expenditure of the central government, local authorities and social insurance funds (health insurance fund and unemployment insurance fund) in the general government sector. Budget position is reflected in accrual-based accounting, which in a simplified manner means that expenditure is registered the moment the liability arises, not at the moment of paying out funds (as done in cash-based accounting).

48. When talking about the state's reserves, it would be a good idea to take notice of the fact that liquid financial assets of the general government sector are not only the government's so-called own funds that the government can use freely in full if necessary, for example to cover state budget expenditure or perform other obligations, because the reserves also reflect the liquid assets of local authorities, public law agencies and other persons.

49. The government's share of liquid reserves ran out in autumn 2015. As at the end of May 2017, the government had used nearly 500 million euros of the funds of the Estonian Unemployment Insurance Fund and the Estonian Health Insurance Fund, which are kept in the State Treasury as of 2012 and which the government has to be able to provide at any time

for ensuring the work of social insurance funds, to cover its expenditure and obligations (see figure 2).⁷

Figure 2. Size of the government's liquid reserves in 2012–2017 (in million euros)



Source: Ministry of Finance

Using the reserves of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund for financing daily expenditure of the state requires legal clarity

Read more

In the audit report of the National Audit Office [“Accuracy of Financial Statements 2016 and regularity of transactions of the state”](#)

50. In the opinion of the National Audit Office, joining the funds and reserves of social insurance funds with the so-called government funds has created a situation where the funds of the health insurance fund and the unemployment insurance fund have been used in conflict with both the Estonian Health Insurance Fund Act and the Unemployment Insurance Act. According to these acts, the funds of the health insurance fund and the unemployment insurance fund cannot be used for anything else other than for performing the tasks provided in the respective acts.

51. Despite this, the Ministry of Finance has used the funds for making the state's payments, referring to the State Budget Act. Because the Ministry of Finance and the National Audit Office are of different opinions when it comes to using the funds of the health insurance fund and the unemployment insurance fund, the National Audit Office has asked for the opinion of the Chancellor of Justice in this matter. The Chancellor of Justice came to the same conclusion as the National Audit Office and responded that the wording of the State Budget Act does not take account of the objectives of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund as well as several restrictions imposed on legal persons governed by public law upon using the assets thereof and is not in accordance with the Estonian Health Insurance Fund Act and the Unemployment Insurance Act, which only specify keeping funds in the State Treasury.

52. Therefore, the Chancellor of Justice is also of the opinion that the State Budget Act is in conflict with the Estonian Health Insurance Fund Act and the Unemployment Insurance Act, and if the Riigikogu wishes to permit such use of funds, this has to be clearly provided for in the laws and legislations have to be coordinated.

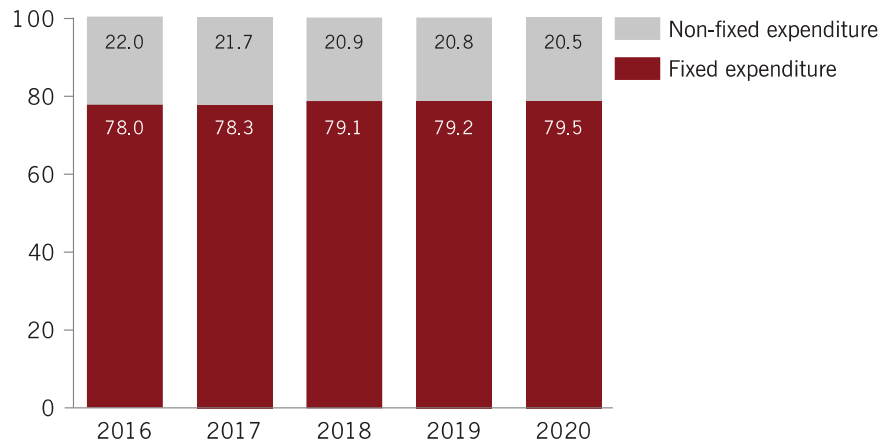
⁷ The government is also able to use the Stabilisation Reserve Fund, the size of which as at September 2017 was 413 million euros, but only extraordinarily and with the permission of the Riigikogu.

In 2020, approx. 80% of the state budget expenditure is reserved in advance

The share of fixed state budget expenditure continues to grow; half of the state budget is allocated to social and health care expenditure

53. The majority of state budget expenditure is prescribed with laws or otherwise. According to the data of the Ministry of Finance, such fixed expenditure comprised 78% of the state budget in 2016 and, according to the forecast, expenditure prescribed in advance will comprise nearly 80% of the state budget in 2020 (see figure 3).

Figure 3. Division of state budget expenditure into fixed and non-fixed expenditure in 2016–2020 (% of the stage budget)*



* The Ministry of Finance has not updated the forecast of fixed expenditure in 2017 due to developing a new accounting methodology. Therefore, unlike other figures containing forecasts, this figure does not provide a forecast for 2021.

Source: Data of the Ministry of the Finance to the National Audit Office in autumn 2016

54. Increase in the share of fixed expenditure means that the state budget revenue and expenditure are increasing, but the amount of available funds used flexibly for directing the development of the state is decreasing proportionally. Even though the Ministry of Finance has deemed the large proportion of fixed expenditure to be problematic for years, the flexibility of using the state budget has not been increased.

Social and health care expenditure comprise half of the state budget

55. Among the areas of activity of the state, the funds of the state budget are used the most for financing social protection. While in 2016, according to the data of the Ministry of the Finance, social and health care expenditure comprised 47% of the total expenditure of the state budget, the share will increase to 50% by 2020 in the opinion of the Ministry.

56. The forecast of the division of expenditure by areas of activity of the state has been provided in the economic forecast of summer 2017 of the Ministry of Finance, but it has to be kept in mind that it's not a state budget but rather expenditure of the general government sector (see table 4 and definition of the general government sector next to table 3).

Table 4. Expenditure of the general government sector by areas of activity in 2016 and 2017, and forecast for 2021 (% of GDP)

Area of activity	2016	2017	2021	Change in 2021 vs. 2017
General services of the general government sector	4.0	4.4	4.4	0.0
National defence	2.0	2.0	2.0	0.0
Law and order and security	1.6	1.6	1.4	-0.2
Economy	4.6	4.9	4.0	-0.9
Environmental protection	0.5	0.5	0.5	0.0
Housing and utilities	0.3	0.3	0.3	0.0
Health care	5.7	5.6	5.6	0.0
Leisure, culture and religion	1.7	1.8	1.7	-0.1
Education	6.2	5.9	5.2	-0.7
Social protection	13.4	13.0	12.9	-0.1
Total general government sector expenditure	40.1	40.0	37.9	-2.1

Source: Economic forecast of summer 2017 of the Ministry of Finance

57. The data reveals that in comparison with 2017, the ratio of financing various areas of activity of the state to the GDP remains approximately on the same level.

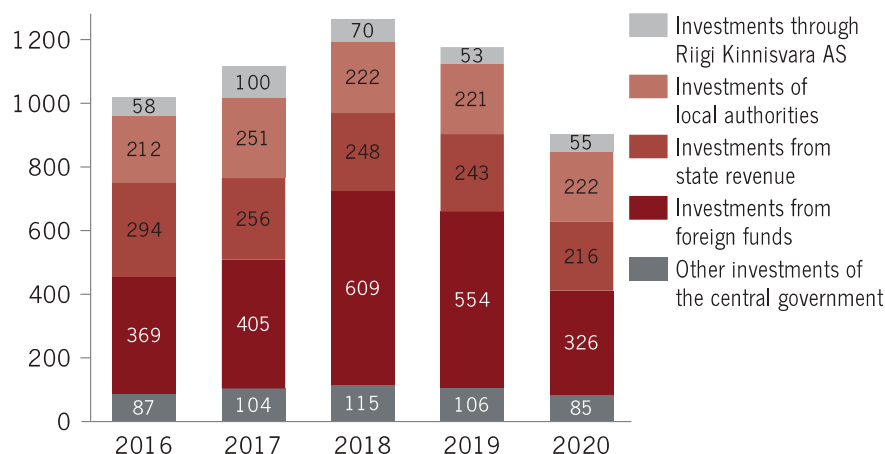
A significant proportion of the state's investments are made with the help of foreign support

58. From the restoration of the independence of Estonia to date, the state budget revenue has not in any year been smaller than the previous year. Foreign support, foremost aid from the European Union, which Estonia has been able to use to the extent of billions of euros has played a significant role in it.

59. The share of foreign support in covering the total state budget expenditure was the highest in 2012 when slightly more than 13% of expenditure were carried out at the expense of various foreign support. The share decreased slightly with the exhaustion of the use of European Union budgetary funds for 2007–2013, but is once more increasing to 10% of the state budget this year.

60. According to the forecast, the share of foreign support in the stage budget expenditure will fall to the range 8.2–10.1% in 2018–2020. According to the state budget strategy 2017–2020, approx. 1.1 billion euros were planned for investments of the general government sector in 2017, 405 million, i.e. 37%, of which comes from foreign support (see figure 4).

Nearly half of the investments are made with help from foreign funds

Figure 4. Investments of the general government sector in 2016–2020 (in million euros)*

* In the newest budget strategy for 2018–2021, the Ministry of Finance has not provided the data of investments of the general government sector by sources in the format provided in the figure. Therefore, the figure does not include a forecast for 2021.

Source: State Budget Strategy for 2017–2020

61. Investment plans of the general government sector indicate that the state's own revenue is predominantly spent on covering fixed expenditure, and investments on long-term development of the state largely come from foreign financing.

62. During the European Union budgetary period commencing in 2021, Estonia has significantly much less support available to it. Therefore, in the context of this year's annual overview, the National Audit Office undertook the task of analysing and paying separate attention to the question whether the state has made preparations for a significant decrease in the European Union support in order to ensure the performance of public functions also when support declines. The main conclusions and observations of the National Audit Office are addressed in the following chapter based on the audit "Financing public functions from the European Union funds" to be published in November 2017.

European Union support to be allocated to Estonia will decrease after 2020 and this requires attention already now⁸

Estonia has received billions of euros in foreign support

63. Since the restoration of independence, the state of Estonia has received billions of euros of non-refundable foreign support,

⁸ Together with preparing an annual overview to be submitted to the Riigikogu, the National Audit Office drew up the audit "Financing public functions from the European Union funds", which addresses the topic by areas. The National Audit Office planned to publish the audit report together with an overview of the use and preservation of state assets in 2016–2017. In September 2017, the National Audit Office submitted the preliminary draft of the audit to the relevant ministries and asked for their opinion. Only the Ministry of Finance submitted substantial comments to the draft, and these have mostly been taken into consideration in the report. The draft report was completed on 13 October 2017 and was sent for official opinions to the Ministry of Finance, Ministry of Economic Affairs and Communications, Ministry of Education and Research, Ministry of the Environment, Ministry of Social Affairs, Ministry of the Interior, and the Ministry of Culture. Responses were requested by 27 October 2017 at the latest so that the National Audit Office could

predominantly from the European Union. During the budgetary period 2014–2020, European Union supports Estonia with 4.4 billion euros from structural and investment funds. Approx. 3.5 billion of this is used as cohesion policy funds for supporting the development of, for example, the area of education, entrepreneurship, transport, information society and environment, and approximately 900 million euros is used for supporting the area of agriculture and fisheries⁹.

Nearly half of the state's investments and one-tenth of the state's total expenditure is carried out with support from the European Union

64. Over the last ten years, on average approximately half of the general government sector investments (see figure 5) and slightly over one-tenth of the state budget expenditure have been financed with support from the European Union.

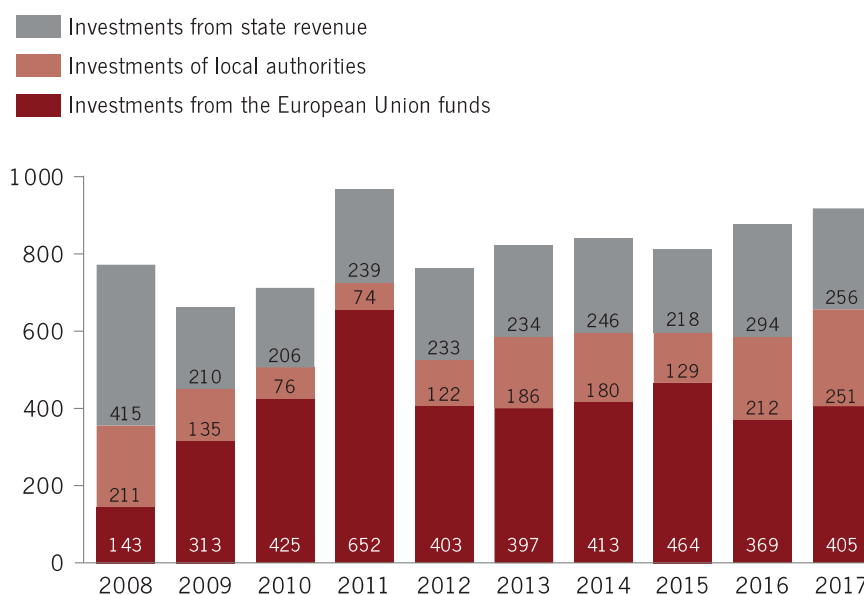
65. Although the initial magnitude is expected to be determined in 2019, Estonia is likely to have significantly less grant money available to it during the next European Union budgetary period commencing in 2021. Without considering the effect of the United Kingdom leaving the European Union, the grant money will decrease up to 40%, i.e. by approx. 1.5 billion euros, in comparison with the current budgetary period, according to the initial assessment of the Ministry of Finance.

66. European Union funds have helped to develop the state of Estonia, perform public functions and ensure the provision of public services for nearly 15 years already. The investments and expenditure in the living environment of the Estonian taxpayer made in the last decade have, to a significant extent, been possible thanks to the European Union grant money, which is now starting to rapidly decrease. The state's preparedness and decisions determine whether there's a way to support the course of Estonia and the fate of its residents also in conditions where much less foreign aid is available.

submit the report to the Riigikogu together with the annual overview. By the time of completing the annual overview of the National Audit Office on 3 November 2017, the Ministry of Finance, Ministry of Economic Affairs and Communications, Ministry of Social Affairs and the Ministry of the Interior had not submitted their official opinion with regard to the audit report. Due to the aforementioned, the National Audit Office is unable to publish the final report of the audit "Financing public functions from the European Union funds" by the time of publishing its annual overview to the Riigikogu – 6 November 2017. The National Audit Office shall publish the report, which provides a detailed approach to this overview chapter, at the first opportunity after receiving the official responses from the audited.

⁹ In 2014–2020, the European Union allocated funds to Estonia mostly through five funds. Due to the varying planning principles of the funds, support directed at the development of agriculture and fisheries (European Agricultural Fund for Rural Development, European Maritime and Fisheries Fund) is distinguished from the support for other areas (European Regional Development Fund, European Social Fund, Cohesion Fund). See more about the funds and areas of activity being financed with them <http://www.struktuurifondid.ee/et>.

Figure 5. General government sector investments from European Union funds, state's own revenue and the budget of local authorities in 2008–2017 (in million euros)



Source: Ministry of Finance, state budget strategies and explanatory notes to state budgets

67. The National Audit Office carried out the audit “Financing public functions from the European Union funds” in order to determine whether the state has made preparations to ensure the performance of public functions also when European Union support significantly decreases.

68. In order to achieve the objective of the audit, the National Audit Office prepared a survey covering the activities and investment measures currently financed with European Union funds and asked the area of government (implementing agency) responsible for implementing the activity to submit the following written assessments:

- which activities currently financed with the support from the European Union should continue during the next European Union budgetary period;
- how much money are these activities expected to require;
- how is financing the activities planned when less grant money is available;
- what is the expected impact on the achievement of the area-specific objectives of the area of government and/or ensuring public services when the necessary activity should be ceased or funding for it should be reduced.

69. The audit covered activities financed with funds from the European Regional Development Fund, European Social Fund, and the Cohesion Fund. The report does not address support for agriculture and fisheries, because these are generated on other, foremost political, grounds and are not based on the gross domestic product or gross national income indicators of the Member State. The list of activities was based on appendix “List of structural support measures for the period 2014–2020” to the Government of the Republic order no. 325 of 29 September 2016.

Support from the European Union is also used for financing activities necessary in the long-term for the performance of public functions

70. Assessments and forecasts provided by the ministries and available financial information indicate that in addition to single investments, support from the European Union is also used for financing activities that are important in terms of the development of the state and that have to continue during the next EU budgetary period as well. Some areas of activity of the state/public functions are, to a great extent, financed with foreign support (e.g. construction and renovation of roads, environmental protection, supporting entrepreneurship and regional development).

71. The audit revealed that the ministries deem it necessary to continue with nearly all the activities that are currently carried out with the help of grant money during the following EU budgetary period. In the opinion of the areas of government, 90% of these activities continue to be necessary after 2020.

72. The assessments of the ministries do not mean that the daily expenditure of the state is financed with EU funds to the extent of 90%. On the other hand, the opinions of the ministries show that some activities are necessary long-term and are not easy to give up when support decreases.

In the current period, the European Union is financing activities that should continue during the next budgetary period in the opinion of the ministries to the extent of 3 billion euros

73. The National Audit Office asked the areas of government for their opinion on how much money is presumably needed in order to continue with the activities that are currently carried out with the EU funds after 2020.

74. All the areas of government did not provide a numerical evaluation of the need for financing, which is why it is not possible to make generalisations nor determine on the whole what the need for financing for activities currently financed with support from the EU will presumably be after 2020. The answers of the ministries can be analysed with a degree of accuracy, which determines whether the need for financing for the activity increases, does not change, decreases, or ceases.

75. The total budget for EU support in 2014–2020 is approx. 3.2 billion euros¹⁰. In the current period, activities that should continue during the next EU budgetary period in the opinion of the ministries are financed to the extent of approx. 3 billion euros.

76. In the current period, there is approx. 600 million euros for the activities whose funding should increase during the next EU budgetary period in the opinion of the ministries. Slightly more than 1 billion euros is currently spent on activities whose need for financing is expected to continue to be the same in the opinion of the ministries. In the current period, approx. 960 million euros of EU funds is used for financing activities whose need for financing may decrease but continuing with

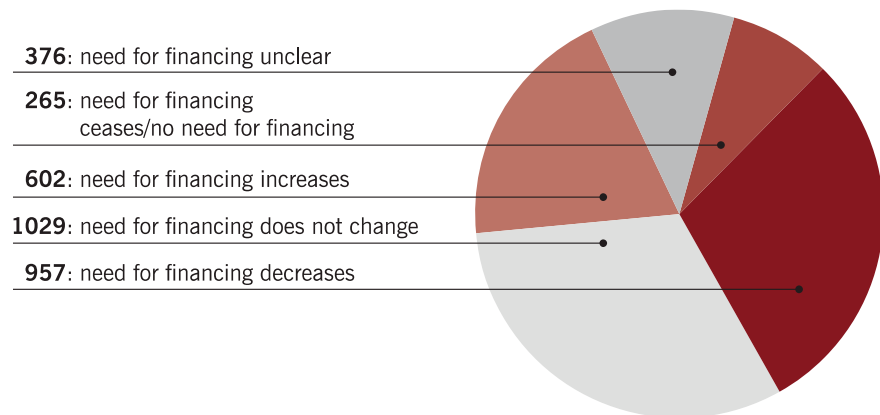
90% of activities financed with the support from the European Union continue to be necessary after 2020 in the opinion of the ministries

Activities currently financed by the European Union and that can cease in the opinion of the ministries cost 265 million euros

¹⁰ Together with the performance reserve and technical support measures, the budget is approx. 3.5 billion euros.

which continues to be important in the opinion of the ministries. Approximately 265 million euros is intended for activities which can/should be ceased during the next budgetary period in the opinion of the ministries (see figure 6 and regional subreports for more details).

Figure 6. Budget for activities financed with support from the European Union in 2014-2020 pursuant to the assessments of implementing agencies (in million euros)*



* Budgets provided in the figure include only European Union support, i.e. do not include national co-financing nor potential monetary contribution of a beneficiary.

Source: National Audit Office on the basis of assessments of implementing agencies

In the event of a decrease in support from the European Union, the ministries are hoping to implement necessary activities with other state revenue

Ministries are hoping to find necessary funds from other state revenue should support decrease

77. With regard to slightly more than half of the activities that the ministries consider necessary to continue, there is no clarify which sources the activity would be financed from should the EU funds decrease. However, the state budget own revenue is relied on to a great extent. With regard to slightly more than half of the activities deemed necessary, the ministry is continuing to consider the budget of the area of government to be a source of financing.

Compensating the decrease of the European Union support with state (tax) revenue may prove to be difficult due to the decreasing and aging of the population

78. Compensating the decrease of the EU support with tax revenue, however, may prove to be difficult due to the decreasing and aging population of Estonia. The prospects of Estonian economy and accrual of state revenue for the coming years have improved and the finance of the state of Estonia is in good order in comparison with the rest of Europe according to the newest financial forecast of the Ministry of Finance published in the summer, but changes in the population and the fragile stability of global economy put risks and pressure on state budget both in terms of revenue and expenditure.

79. Although state revenue will grow rapidly in the coming years according to the forecast of the Ministry of Finance, approx. 80% of state budget expenditure is reserved and the increase in revenue will mostly be used for financing the area of social protection and health care.

80. If the EU support decreases in the next budgetary period and the ministries are relying on the state budget when financing the necessary activities, it may be difficult to find the missing funds from the state's own revenue, considering the expenditure and revenue structure of the budget and the demographic development of the state. But if the financing of necessary activities were significantly cut down on, it would

have a negative impact on the performance of public functions in the opinion of the ministries.

Potential decrease of the European Union support would affect many public functions and objectives

Reducing financing would negatively affect many activities and objectives of the state

81. In addition to predicting the need for financing and sources of financing, the National Audit Office also requested the ministries to provide their assessment on how the performance of public functions and/or availability/quality of public services would be affected if the activities currently financed with support from the EU that should continue during the next budgetary period as well were financed less or not at all.

82. The ministries did not generally outline in their assessments any specific or quantified effect on the availability or quality of public services or on Estonia's development objectives. However, the areas of government did provide a generalised description of what a significant decrease or cessation of financing could bring about.

83. For example in the social sector, the volume of welfare services for the elderly or people with special needs may decrease in the opinion of the Ministry of Social Affairs if no additional EU support or additional funds from the state budget are not available in the next EU budgetary period. The Ministry of Social Affairs also specified that if the EU support decreases in the next period but there is a need for additional investments in the area of health care or special welfare, these investments have to be made from own funds of service providers. However, no particular options for increasing the sources of income are foreseen for major hospitals and providers of special welfare service.

84. Among others, the Ministry of Economic Affairs and Communications outlined that if financing the transport sector should decrease after 2020, this would bring about a deterioration of the quality of the roads and railway network. Excessively small investments in the railway may bring about the deterioration of passenger train service. If the IT sector is left without necessary financing, this may cause, inter alia, the quality of e-services to decline and services that decrease administrative burden will no longer be developed in the current volume, according to the opinion of the Ministry of Economic Affairs and Communications.

85. Many support activities for business are currently dependent on the European Union funds to the extent of 90–100%. In the opinion of the Ministry of Economic Affairs and Communications, an important decrease in the EU funds would negatively impact the development objectives of Estonia, for example research and development, innovation and export capacity of companies.

86. According to the current assessments of the representatives of the Ministry of Education and Research, the main problem of decreasing financing is the deterioration of education on all levels of education, i.e. general education, vocational education and higher education. The deterioration of quality has the most extensive impact on research and higher education. Sustainability of research is an important factor in achieving economic growth and welfare. If the problem of the

sustainability of research will not continue to be addressed, the number of young people commencing studies in the field of natural and exact science may decrease according to the assessments.

87. Cessation or decrease of financing would also have a negative impact on the development of lifelong learning in the opinion of the officials of the Ministry of Education and Research. Return to adult education would decrease, and participation in education could no longer be supported. Availability of high quality and relevant refresher training and retraining would decrease, which would further decrease the rate of employment.

88. Experts of the Ministry of the Environment find that if Estonia does not receive additional grant money for continuing the current activities and enough funds are not found within the state to cover the expenditure in the next EU budgetary period, this may cause a delay in the achievement of several environmental objectives established in EU directives such as improving the condition of bodies of water and stopping biodiversity loss. In the worst case, the environmental status could also degrade due to excessive environmental pressure and inadequate alleviation measures.

89. The Ministry of the Interior outlined that decreasing investments (from EU support) may mean a setback by way of increasing anti-pollution capability.

90. The Ministry of Finance as an implementing agency of regional development aid outlined that not receiving necessary financing would, inter alia, reduce the competitiveness of (rural) areas and the establishment of jobs and that emigration to centres would accelerate even further.

In the opinion of the Ministry of Finance, potential issues arising from the decrease in the European Union support are resolved foremost in the course of preparing state budget strategies

91. As an agency organising the use of European Union support, the Ministry of Finance initiated a process in 2013, the objective of which was to draw up a comprehensive strategy on how to cope with less EU grant money in the future. The Ministry of Finance requested similar information as the National Audit Office from the areas of government: opinion of the relevant ministry regarding which activities financed with support from the EU in 2014–2020 should continue after 2020, how much money is needed for that, and where should this money come from.

92. According to the Ministry of Finance, information and forecasts received from the ministries were inadequate and had uneven quality, which is why it was not considered to be expedient to draw up a separate action plan on how to prepare for the decrease of foreign support. According to the Ministry, preparations for the potential decrease of EU support are taking place in the course of other financial management processes of the state.

93. The Ministry also highlighted that a transition to accrual-based budgeting will take place in 2017, and activity-based budgeting will be implemented in 2020. In the opinion of the Ministry of Finance, upgrades serve as an important development in the management of the state. These

Attempts to prepare a strategy for coping with the decrease of the European Union support were already made in 2013

upgrades help achieve a more detailed overview of the use of public funds and serve as a prerequisite for making better management decisions. According to the Ministry, reforms help to identify services that are unnecessary or ineffective and to decide which resources would be best for offering this or that service.

94. The Ministry also finds that there is no need to prepare a separate strategy for avoiding negative effects arising from the decrease of grant money, because analyses and decisions concerning the state's options and needs have to take place in the context of drawing up state budget strategies and state budgets, looking at both foreign support and other state revenue. The Ministry of Finance therefore expects the potential problems associated with decreasing the EU support to arise in the course of state budget strategy discussions. Preparations for 2021+ should thus take place flexibly and as needed.

Decrease of the European Union support should be prepared for one way or another

95. In the opinion of the National Audit Office, the statements of case and forecasts provided by the ministries as well as the financial information available in the state indicate that the likely significant decrease of the European Union support after 2020 is a prospect which should definitely be given attention to one way or another.

96. The results of the audit reveal that although the state's information systems do not enable accurate data, European Union support is used, in addition to single investments, for financing public functions and activities necessary in the long-term, the financing of which may prove to be difficult when support decreases and the state's economic situation deteriorates.

97. Because Estonian population is decreasing and aging, state budget expenditure is predominantly reserved in advance and the growth of state revenue is used mostly for financing increasing social and health care costs, financing state development in the conditions of decreasing European Union support after 2020 requires analysis and attention already now.

Riigikogu should also be involved in planning the next budgetary period of the European Union

98. The National Audit Office agrees that the format of preparing for the decreasing of the European Union support is not fundamental, rather is making sure that it's done substantively, thoughtfully and transparently. For this reason, the National Audit Office is expecting the Ministry of Finance to submit in the composition of the next state budget strategy concerning the years 2019–2022 a detailed explanation as well as schedule and action plan on how and in the context of which processes the likely decrease of the European Union support is being prepared for.

99. In the opinion of the National Audit Office, the information to be submitted should include, inter alia, information on which areas of activity and functions of the state and to which extent depend on the European Union support and how the financing of necessary activities in the future is planned.

100. Needs, opportunities and alternative cost options of the state in the event of decreasing foreign support have to be analysed and addressed comprehensively and understandably. Outlining this information and decision points in the state budget strategy and other financial management processes of the state is even more important because the

transition to an activity-based budgeting and changes to the State Budget Act and the explanatory note may decrease the opportunities of the public and the Riigikogu to understand and direct state budget expenditure.

101. In order to establish more broad-based priorities, it would be important to also involve Riigikogu in planning the next budgetary period of the European Union. If, according to the confirmation of the Ministry of Finance, a decrease of the European Union support is prepared for, inter alia, in the course of drawing up state budget strategies, the National Audit Office is of the opinion that the state budget strategies should also be taken to the Riigikogu.