Overview of the Use and Preservation of State Assets in 2005

Foreword

This overview summarises a part of the work of the National Audit Office (“NAO”) in auditing the state assets in 2005. Presentation of the Overview is a constitutional obligation of the NAO in order to inform the Parliament and the public, whether state assets have been used efficiently and in accordance with the law. When preparing the Overview on the Use and Preservation of State Assets (OUPSA), the NAO has been guided by the principle that the primary responsibility for reporting on state budget implementation, use of state assets and results of actions lies with the Government of the Republic.

The task of the NAO is to assess the sufficiency and reliability of the information provided by the government to the Parliament, specifying the details if necessary, pointing out any discovered problems, and making proposals to enable the Parliament to use more efficiently its powers in making budgeting decisions and exercising parliamentary control over the activities of the government.

This Overview presents a selection of problems associated with state assets and their management, which in the opinion of the NAO require special attention of the Parliament and the public. Specific information on the implementation of the 2005 budget, government accounting procedures and reporting can be obtained from the consolidated annual report of the state and the evaluation of this report by the NAO.

The Overview is not restricted to describing the problems but attempts also to propose solutions. The highlighted problems and proposals have been discussed in cabinet meetings. OUPSA has been prepared in cooperation with the government and government’s response to the proposals of the NAO has been appended to the end of the Overview.

The examples provided in the Overview are presented to illustrate the problems. The report of the NAO includes only a small part of the observations made during the audits and the ministries should not use this as a comparison base in managing state assets.

The aim of the NAO is to help the state to be a good manager. The independent information provided by the NAO helps the Parliament to enhance the efficiency of the parliamentary control. The need for parliamentary control has been also emphasised by the Parliament through the formation of a separate committee for cooperation with the NAO and the Government of the Republic.

In September 2005, the top experts from SIGMA (Support for Improvement in Governance and Management), an organisation operating at the joint initiative of the European Union and the Organisation for Economic Cooperation and Development (OECD), prepared a report on the Estonian NAO, emphasising the crucial importance of the parliament’s support and efficient response to the audit reports submitted by the highest auditing institution. This helps to strengthen government’s responsibility for the rational use of the budget resources allocated for policy implementation.

According to SIGMA experts, the current special committee should be reformed into a permanent committee in order to supply the audit committee of the Parliament with the necessary degree of power and reliability in improving the accountability and management of the public sector. SIGMA also found that the Parliament committee and the NAO should review the ‘life cycle’ of the audit report, from strategic planning and selection of issues to the type of approach adopted. This requires more hours from the members of the committee than would be available if the work continues in the form of a special committee.

Since 1992, the main efforts of the Parliament have been directed towards legislative development – creation of the basic state structure. This structure is now, for the most part, complete. Therefore, this would be the time to start discussions on possible new focal points of the parliamentary work. The time and energy that become available as a result of decreased amount of legislative work could be increasingly used to inquire how the public funds have been used and whether these funds have produced the desired results.

Increasing the significance of the work of the audit committee of the Parliament would help to demonstrate to the public the actual work of the parliament and reduce the number of people who are sceptical about the parliament. It is a specific opportunity available to the audit committee to become the main driving force in the actual protection of the taxpayers' interests by the Parliament.

In order to provide the parliament with exactly the sort of information that would be helpful in decision-making, the NAO considers as its highest priority the audits to check whether the funds allocated to certain programmes have led to the results that were expected at the time of allocation of the funds.

In other words – the NAO focuses foremost on performance audits to provide a valuable service to the state and create added value for the parliament. Further, our plans include creation of overviews and audits concentrating on dissemination of best practices.

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1. Financial Situation of the State in 2005

The financial situation of the state is good and has been improving continuously. The state has sufficient funds to cover all existing liabilities. The revenue has improved and expenses are within the planned scope. These conclusions would be impossible without the consolidated annual report 2005 of the state, which deserves some recognition. Despite some critical comments of the NAO on this report, one could say that the consolidated annual report 2005 submitted by the government is more comprehensive and informative than in any previous financial year.

Much money is kept on bank accounts and in securities

As on 31 December 2005, the state[1] and the foundations and companies under direct government control held 9.1 billion kroons on the bank accounts, and 20.2 billion kroons together with short-term notes and bonds. This is more than a third of the last year's state budget. The public sector as a whole (incl. the Bank of Estonia, local governments and legal persons in public law) held 52.1 billion kroons in liquid funds.

The funds on the state bank accounts are divided mainly between State Treasury (4.5bn), foundations (1.2bn) and companies (3.3bn). Compared with the last year, the liquid funds of the state have increased by 4 billion kroons. The increase is largest on the bank accounts of the companies with state participation (1.6bn), but state-established foundations also have by 300 million more disposable funds. The average interest rate on the funds kept on bank accounts is 1.6 %. Short-term investments in shares and bonds earn an average annual interest of 2.6 %.

Liabilities of the state have increased moderately

Liabilities of the state payable in 2006 amount to 14 billion kroons. Compared with 2004, short-term liabilities have increased by 3 billion kroons. Liabilities where payment starts in 2007 amount to 23 billion kroons, and they also increased by 3 billion during the year. The funds kept on bank accounts and in securities outbalance the total amount of liabilities for 2006.

The major liabilities of the state include appropriations and loans. The largest portion of the balance item 'Appropriations' (10bn) is made up of the appropriation for future special pensions payable, e.g., to the members of the Parliament, police officers, members of the Defence Forces, etc. The total pension liability has grown by 1.5 billion kroons, to 7.9 billion kroons. By the end of 2005, the state had contracted 11.7 billion kroons worth of loans, including 3.1 billions by the government and 8.6 billions by companies with state participation. Liabilities of the state constitute a quarter of the state assets. Despite small loan burden and the fact that all liabilities only amount to a quarter of the total state assets, it would be sensible to continue the conservative loan policy. The NAO believes that before contracting any new loans, the size of the public monetary reserves should be thoroughly analysed, as well as any options for increasing the amount of dividends from the companies with state participation and reducing allocations to foundations who have been unable to use the funds received from the state earlier.

Value of tangible assets has increased

The total value of tangible assets (immovable property, buildings, machinery and equipment, etc.) is 68 billion kroons, constituting a half of the total state assets. In 2005, the state revaluated its fixed assets: it turned out that the actual value of the fixed assets was 17.2 billion kroons higher than accounted before. In addition, the amount of state investments in the fixed assets (7.2 billion) outbalances the amount of annual depreciation (4.3 billion).

Revenue has increased

[1] The analysis is based on the consolidated balance sheet and receipts report from the consolidated annual report of the state.

Public revenues exceeded the expenses in 2005 by 4.4 billion. Compared with 2004, public tax revenues have increased by 7 billion kroons. 3 billions of this growth comes from the value-added tax, 3 billions from the social tax and the rest from excise duties and income tax. Increased tax revenue has not been accompanied by the increase in ‘bad’ or uncollectible tax claims, which has remained at the level of 4.7 billions. The amount of tax arrears showed now significant growth compared with the last year, indicating that the payment discipline of the taxpayers has not deteriorated.

State expenditures conform to plans

Public operating expenses in 2005 amounted to 70 billion kroons. 15.3 billion kroons of tax revenue, incl. social tax, individual income tax, land tax, etc., were transferred to the local governments and other bodies of the government sector. More than a half of state expenditures is paid as support (53%), while labour costs make up one fifth (20%), as do the economic and other costs (21%), with depreciation at the level of 6%. In addition, the state has made investments worth 7.4 billion kroons.

2. Accounting and Financial Reports

In the public sector, budget and financial reports are the pillars of good management practice. A good budget does not only allocate more funds to the public authorities in each year, but rather provides a simple and unambiguous overview of the benefits created by these funds, explaining how the expenditures of taxpayers' money help to improve the situation in the state. Financial reports, in turn, enable the Parliament and the public to see whether taxpayers' money has been used reasonably and purposefully, or whether the promises were delivered. The financial reports also provide an answer to the question, whether the financial situation has improved or worsened in comparison with the previous year.

During the last decade, Estonia has made good progress in improving the quality of budgeting and reporting. Budgeting has become increasingly strategic and financial reports are created on the basis of international good practices. Naturally, there is further room for development in both fields.

2.1. Accounting

Quality of financial reports has improved

The year 2005 could be regarded as significant in view of the annual report, because the completed report is at a good quality level. The financial year 2005 was the second year in which the state continued the implementation of the new reporting system. The state has created an information system for financial reporting (so-called account balance data system) where all bodies[2] submit their financial reports in an electronic format. The submitted data is used to create the consolidated annual report of the state, which provides information on the state, local governments and the public sector as a whole. In 2005, the companies in which the state has dominant influence also joined this information system. Additionally, the reports of the information system were made available on the Internet in 2005. This enables all interested parties to receive quick overview of the financial indicators of the local government or public authorities.

This completed the transfer to electronic collection of consolidated financial data for the state accounting: a month after the end of each quarter, the state should have a complete picture of its financial situation and results. Implementation of the unified information system has already had a strong impact on the quality of the financial accounting and reporting both in public authorities and local governments. The unified system has enabled to create more accurate and comprehensive reports; however, the system needs further improvements.

Financial reports should be created and submitted earlier

The reports of the authorities were completed late in 2006. Despite the deadline being March 31, they were finished only in April and the Ministry of Finance finalised the numeric indicators for the consolidated annual report by the end of June. In the assessment of the NAO, the accounting information systems and procedures need further development so that the consolidated report of the state could be completed by March 31 and the audited consolidated annual report could be submitted to the Parliament for review by May 31. So far, the report has been reviewed in October when the information is almost one year old and has lost some of its value. Earlier creation of reports and review would make it more useful for drafting new budgets.

The Ministry of Finance is of the opinion that earlier deadlines are necessary, but not accomplishable at the current stage. The main reason is that the deadlines of annual reports of the companies, foundations and legal persons in public law, to be included in the consolidated report, are April 30 and

[2] Nearly 1900 bodies, incl. persons in which the state has dominant influence

June 30, respectively. Consequently, shortening of the deadlines would depend on whether the process of auditing and approval of the reports of these bodies could be accelerated.

Centralisation of accounting would increase efficiency

Management and processing of submitted information generates a high workload due to the large number of independent accounting entities submitting their reports (see Table 1). The consolidated annual report of the state includes indicators from approximately 1700 entities. Independent accounting is often maintained at the level of school, nursery school, etc. In the assessment of the NAO, the limited scope of accounting in most entities should lead to serious consideration whether it would be more efficient (economical) to concentrate accounting into larger units. The organisation of accounting in Great Britain could serve as an example, with less than 1300 accounting entities being consolidated into the annual report of the state. Another good example is Scotland (similar in size to Estonia) where there are only about two hundred accounting entities.

Table 1. The number of entities consolidated into the annual report of the state as on 31.12.2005.

	State	Local governments	Legal persons in public law	**Total**
Agencies/entities	382	765	41	**1 188**
Foundations	56	155	11	**222**
Companies (subsidiaries)	43	253	8	**304**
Total	**481**	**1 173**	**60**	**1 714**

There are many good examples of centralised organisation of accounting at both the state and local government level (such as the accounting in the courts of the Ministry of Justice and the cities of Tartu and Pärnu). Compared with the last year, the state has been able to reduce the number of accounting entities. In addition, several ministries have started to implement centralised accounting software in their areas of government, which could lead to a decrease in the number of entities, savings on administration costs, as well as acceleration of data transfer speeds and improved reliability.

However, a solution for the local governments is also required in order to achieve significant improvements in the quality of data and transfer speeds. 70% of the accounting entities included in the report submitted to the Parliament come from the local governments. A clear opportunity for more economic use of resources presents itself from the comparison of the volume of funds (transactions) and the number of accounting entities (see Figure 2). Centralisation of the accounting of the local governments would significantly improve the use of resources and create a more efficient reporting model.

Figure 2. Ratio between the funds and accounting entities

Total financial volume of assets	State sector 73%	LG 22%	PPL 5%
Total financial volume of budget	State sector 74%	LG 15%	PPL 11%
Number of accounting entities	State sector 26%	LG 70%	PPL 4%

LG – local government PPL – person in public law

Most local governments should have access to state support in the organisation of accounting

A problem for smaller local government units is their inability to ensure the required standard of administrative functions due to budget restrictions. Previous accounting audits of the smaller local government units by the NAO have shown that their accounting clearly lags behind other units in the public sector (the ministries, larger local governments, etc.). Insufficient standards of accounting in these units and the resulting errors in the reports submitted to the state make the creation of consolidated reports of the state more complicated and labour-intensive. The problems of financial accounting in the local governments are discussed separately in Chapter 7.

In the assessment of the NAO, the Ministry of Finance should in cooperation with the Ministry of the Interior and county governments demonstrate more initiative, because low quality level of accounting and reporting may inhibit the development of the state as a whole. The Ministry of Finance should support with knowledge, guidelines and finished solutions the local governments intending to centralise their accounting, replace accounting software and reorganise accounting procedures. The county governments could serve as centres that are able to provide accounting and reporting services to the smaller local governments if needed.

2.2. Consolidated Annual Report of the State

The NAO gave a qualified opinion on the consolidated annual report 2005 of the state

The NAO audited the accuracy of the consolidated annual report of the state and the legality of transactions, and prepared a corresponding separate audit report. The Minister of Finance appended this report to the consolidated annual report of the state, which was approved by the Government of the Republic.

The NAO gave a qualified opinion on the accuracy of the consolidated annual report 2005 of the state and the legality of transactions. In addition to comments on the consolidated annual report 2005 of the state and the legality of transactions, the audit report of the NAO points out the most common mistakes in accountancy and main violations regarding the legality of transactions.

Given as comments are the observations on the accuracy of the annual accounts and legality of economic transactions that the NAO finds relevant. Regarded as relevant are observations, which will probably affect the user of the financial report, and in the case of legality of economic transactions, such violations of the requirements of legislation that can cause significant damage. Relevancy depends on the financial volume[3] and contents of the observation and it is assessed on the basis of surrounding conditions. The NAO made the following comments:

- The NAO did not give an assessment to the consolidated annual report 2004 of the state. The balances compiled as of 31 December 2004 may include mistakes that affect the annual accounts of the state compiled as of 31 December 2005. The NAO does not give an assessment to opening balances compiled as of 1 January 2005 or to the influence of the potential mistakes in them on the financial situation and cash-flow of the state's financial year ending in 31 December 2005.

- The claims and liabilities of the Agricultural Registers and Information Board had not been examined as required in the area of government of the Ministry of Agriculture, which is why the NAO was not confident enough regarding the accuracy of the claims and liabilities recorded in the annual accounts of the state. The ministry completed additional procedures to verify the accuracy of the balances in July 2006, but the NAO has not evaluated the reliability of these procedures.

- Several state authorities have assumed long-term liabilities at the expense of future periods although the State Budget Act[4] prohibits the taking of loans, use of financial lease and assume

[3] According to the standards of INTOSAI, the materiality threshold is 0.5–2% of the financial indicator, which records the audited entity's economic activities in the most adequate way.
[4] State Budget Act, § 29 (3)

other such liabilities. For example, the City of Jõhvi (owner of the registered immovable), FKSM AS[5] (superficiary) and the Ministry of Culture (usufructuary) have concluded a tripartite agreement on the right of superficies, right of pre-emption, usufruct and establishment of real right regarding the registered immovable located at 40 Pargi St. in Jõhvi. Said agreement established the right of superficies of the registered immovable located at 40 Pargi St. in Jõhvi for the reconstruction of Jõhvi Concert Hall for the benefit of FKSM AS. It was also agreed that the superficiary should conclude an agreement with the usufructuary establishing usufruct until the expiry of the right of superficies (i.e. until 30 September 2025). For the right of usufruct a fee of 285 million kroons shall have to be paid to the superficiary in the period of 21 years. Contract of usufruct puts all economic risks on the usufructuary. In the assessment of the NAO, it is a contract concluded in the terms of financial lease, assuming liabilities prohibited by the State Budget Act of 285 million kroons. Thus, the Ministry of Culture has violated the State Budget Act.

In other respects, in the assessment of the NAO, the annual accounts 2005 of the state according to which the state's consolidated balance was 135.4 billion kroons as of 31 December 2005 and the consolidated net surplus of the accounting period 4.4 billion kroons, account accurately and in compliance with the generally accepted accounting principles the financial situation of the state as of 31 December 2005 as well as the net surplus and cash-flow of the financial year ending on the said date. According to the NAO, the economic transactions included in the sample were carried out in compliance with the State Budget Act, 2005 State Budget Act and 2005 Supplementary State Budget Act.

Arrangement of inventory-taking was unsatisfactory

Several state accounting entities have not paid enough attention to the inventory of assets and liabilities. Shortcomings still occur in the course of inventory of assets and liabilities:

- Several state accounting entities had not taken inventory of assets and liabilities or the inventory had not been comprehensive, i.e., annual inventories did not cover all relevant groups of assets and liabilities.

- Persons taking the inventory and proprietarily liable persons had not approved the results of inventories and the results had not been recorded in accountancy.

- The course of the inventory and its results were poorly documented: inventory sheets were missing; inventory sheets were inaccurate; inventory sheets lacked the signatures of persons taking the inventory, which is why it was not possible to confirm afterwards whether the inventories had actually been carried out or not.

- Persons responsible for the assets participated in inventory committees.

The NAO identified the abovementioned shortcomings in the authorities in the area of government of the Ministry of Culture, Ministry of Education and Research, Ministry of Defence, Ministry of Justice, Ministry of Social Affairs and the Ministry of Economic Affairs and Communications. According to the NAO, the shortcomings in inventories can cause mistakes in recording state assets and liabilities comprehensively and in correct value. The NAO drew attention to the fact that state accounting entities do not comply with the assets and liabilities' inventory and assessment procedures established with the general rules of state accountancy also last year.

According to the NAO, there is another circumstance that refers to unreliable arrangement of inventory-taking: several assets were identified in the course of audits that had not been registered (for example, land units and facilities in the use of state accounting entities), it was also found that state

[5] As of 28 February 2005 by the name of AS YIT Ehitus

accounting entities had registered assets that did not actually exist (e.g., equipment, facilities), some assets were double-registered. Mentioned shortcomings were identified in the Ministry of Foreign Affairs and in the authorities in the area of government of the Ministry of Culture, Ministry of Economic Affairs and Communications, Ministry of Education and Research and Ministry of Social Affairs.

Mistakes are made in recording investment properties

Regarded as investment properties is the leasing of land, building or part of a building for the purpose of income or keeping it for the purpose of increasing market value, if the leasing party does not use said assets for his main activity. Pursuant to the good accounting practice, the investment properties must be recorded on a separate line of the balance sheet, but many state authorities have not differentiated the assets regarded as investment properties and record said assets as tangible assets along with the spaces used for their activities. Due to inaccurate recording, the consolidated annual report of the state provides false information to the reader regarding the assets used for the main activities of state authorities. According to the NAO, a total of 418 million kroons of assets should have been classified as investment properties in the authorities in the area of government of the Ministry of Education and Research, Ministry of Social Affairs and Ministry of Culture, whereof approximately 400 million kroons of dormitories of vocational educational institutions and institutions of professional higher education.

Charges for surplus sugar stocks are not recorded

Estonia has to make contributions to the budget of the European Union for the sugar stocks considered as surplus upon accession to the European Union. The NAO submitted a notice to the Ministry of Finance and Ministry of Agriculture as neither ministry has recorded in its annual accounts the liability of 715 million kroons formed because of surplus stock. In the consolidated annual report of the state, the chief accountant of the state has included the said liability in the state balance sheet. According to the NAO, it is unacceptable that the ministries have not been able to agree on the recording of the liability. According to the NAO, the liabilities given in the consolidated report of the state have to be based on the reports of state accounting entities, as the state's assets and liability form on the basis of the economic transactions of state accounting entities.

All off-balance liabilities have not been registered

Pursuant to the instructions[6] compiled on the basis of the general rules of state accountancy, the binding liabilities arising from fixed-term lease contracts not subject to cancellation or from certain lease contracts subject to cancellation in terms of advance notice shall be recorded in an off-balance entry of state accounting entities. An annex compiled for off-balance liabilities provides the reader with information on how high the liabilities could rise if the reporting person should cancel the concluded lease contracts as of the date of the balance sheet.

For example, pursuant to the contract concluded for the purpose of leasing the buildings of Police Board and Northern Police Prefecture located at Pärnu mnt 139, the Police Board and Northern Police Prefecture have to pay contractual penalty in the case of the termination of the lease contract before 11 years has passed from the date of the conclusion of the contract. The contractual penalty shall be equal to the sum of lease payments of 11 years, from which the total sum of lease payments paid by the police authorities by the date of the termination of contract has been deducted. The NAO found that as of 31 December 2005 the Police Board and Northern Police Prefecture failed to record off-balance a liability of *ca* 300 million kroons pursuant to the contract, instead recording off-balance liabilities amounting to 97 million kroons. By now the said police authorities have corrected the off-balance

[6] Instructions compiled by the chief accountant of the state 'Submission of off-balance sheet accounts as of 31 December 2005

sheets as of 31 December 2005, and the off-balance liabilities of police authorities have been recorded accurately in the consolidated annual report of the state.

According to the NAO, state accounting entities have not recorded off-balance liabilities arising from lease contracts pursuant to common principles. Therefore, the consolidated annex on off-balance liabilities does not give an overview of how many binding liabilities arising from lease contracts did the state have as of 31 December 2005

All off-balance assets are not recorded

The annexes to the annual accounts of the state do not disclose information on the amount of protected forests and protection forests belonging to the state. Pursuant to the general rules of state accountancy, biological assets shall be recorded in the balance sheet either by fair value or acquisition cost. If there is no reliable assessment given regarding the fair value of the biological assets or the acquisition cost is not known, the assets must be recorded off-balance.

Keeping accounts of most of protected forests and protection forests owned by the state is the responsibility of the Ministry of the Environment. State Forest Management Centre, belonging to the area of government of the Ministry of the Environment, manages *ca* 164,000 hectares of such protected forests and protection forests that have been given the value 0 and that are not recorded in the annual accounts of the ministry. The balance sheet of the Ministry of the Environment only records by fair value those protected forests and protection forests the state has purchased from private owners or exchanged for commercial forest (or land), in a total amount of 18.1 million kroons. In addition, the balance sheet of the Ministry of the Environment records the protection forests managed by the State Forest Management Centre, with the value decreased by certain coefficients and with the total area of *ca* 107,000 hectares.

As the state fulfils its duties that are assigned to him regarding nature preservation through the possession and management of protected forests and protection forests, the NAO is of the opinion that the annex to the annual accounts must include information on the amount of protected forests and protection forests and an assessment of their possible value.

It is difficult to find links between the state budget and the consolidated annual report of the state

Annually, the Parliament approves the state budget and the Government of the Republic submits a report on the implementation of that budget in the form of the consolidated annual report of the state. However, it is difficult to compare the budget with the report. State budget implementation report is a part of the annual report, but it only shows how much money was received and how much was spent. At the same time, neither the management report nor any other part of the consolidated annual report of the state provides an answer to the question, whether the money of the taxpayer was used in the previous year for the same purposes it was asked for. There is no clear link between the commitments made in the letter of explanation to the draft State Budget Act and the results achieved. However, the NAO believes that such overview is crucial; otherwise, the whole reporting from government to the parliament would lose its main purpose.

For example, an ‘Overview of the ministries and State Chancellery’s performance in 2005’ has been published as part of the consolidated annual report of the state. According to the NAO, it is necessary to give an overview of the performance of the government in the consolidated report, but the weakness of said overview is its poor linkage to the report on the implementation of the state budget. While the report on the implementation of the state budget is very elaborate, the results of the activities have been described very generally. Thus, for example, the reader of the report fails to receive information on how much money has been used in every area of activity. The overview also gives only a description of activities carried out during the year, and it remains unclear whether the objectives of activities set for the accounting year have been met, i.e., there is no overview of the performance.

It is also worth mentioning that while the state budget is structured by individual ministries, the annual report includes reports (balance sheet, income statement, etc., with notes) on the state as a whole, preventing any substantial comparisons between the two. The NAO finds than an opportunity to give the parliament a better overview and control of the use of funds by the ministries would be a discussion of the annual reports and budget implementation of the ministries, as well as review of the audit reports by the NAO in the committees of the Parliament prior to the summer leave.

Proposals to the Government of the Republic

- Develop principles for centralised organisation of accounting in the ministries and reduce the number of accounting entities.

- Offer state support to the smaller rural municipalities and towns for more efficient organisation of accounting.

- Establish earlier deadlines for the drafting and submission of the annual report of the state.

3. Lease of Buildings and Premises to Public Authorities

The public authorities have leased more than 270,000 m^2 of area in buildings and premises, including 60% leased from Riigi Kinnisvara Aktsiaselts (Government Real Estate Ltd – "GRE") and 40% leased from the companies in the private sector.

Upon foundation of GRE,[7] leasing was seen as a beneficial opportunity, because surrender of the administration of buildings enables the public authorities to focus on the performance of their main functions and leasing also enables quick response to the changing room requirements of the authorities. The declared benefits of transition from ownership to leasing the buildings required for the operation of public authorities also included clarity of the expenses on premises. In addition, the transition to leasing was supposed to facilitate efficient use of premises in the public authorities. The ideological basis of the policy favouring lease relations was maximum reduction of the responsibilities of the state, or transfer to the private sector of all responsibilities that the private sector is able to perform.

The analysis of the NAO indicated that the state has concluded with companies lease contracts that include disadvantageous terms and conditions for the state, such as the requirement to pay the amount of lease for several years in the case of early termination of the lease contract, annual automatic increase of the lease amount in the extent exceeding the increase of the consumer price index, or the obligation of the lessee to carry out maintenance repairs in the leased premises.

Assessing the process of conclusion of lease contracts and the preceding financial analyses, the NAO found serious deficiencies in the documentation of the processes. The lack of analysis of different options for meeting the space requirements of an authority, as well as establishment of different or too general tendering criteria for the tenderers, leads to a suspicion that some tenderers have been preferred without a legitimate reason. Many companies would like to lease their buildings to the public authorities on a long-term basis, because it ensures guaranteed income. If an authority has formulated the conditions in a way that complicates the comparison of tenders or access to the tendering procedure is unfoundedly granted to only a few companies, it is difficult to eliminate the suspicion that the person making the decision was not impartial or has concluded a contract disadvantageous to the state. It should be possible to verify the legality and economic justification of the transactions with state budget funds also after the event, but this is not possible if the analysis of options and the procedure have not been documented.

Even though the budgeting policy does not permit the use of loans or financial lease to Estonian public authorities for the purpose of renovation or purchase of premises, several schemes have been attempted to circumvent this prohibition. The NAO concludes that leasing of the premises required by an authority should be avoided if it would be economically more beneficial to renovate the existing premises or purchase new premises.

The NAO has analysed the process of contract conclusion and the terms and conditions of the contracts relating to the lease of premises in the area of government of the ministries on the basis of a sample of contracts.[8] The following main questions were posed in the analysis:

- Was the lease of selected rooms justified in view of the room requirements of the authority and various other options for meeting these requirements?
- Was the contract conclusion process (particularly the comparison of tenders) documented and does it enable subsequent assessment?

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[7] Government of the Republic Order No 461-k of 28 June 2001 and the letter of explanation to the draft Order

[8] The small size of the sample would not permit to extend the results to all contracts for the lease of premises concluded by the public authorities. The examples are provided in the analysis only for illustrative purposes.

- Is there a reasonable balance between the rights and obligations in the contract from the viewpoint of the state?

All ministries do not have an overview of the lease contracts for the premises leased in their area of government

The NAO queried the ministries for data concerning the start dates and terms, users and intended purpose, areas of leased and useful space, investment obligations, lease price and accompanying costs specified in the lease contracts for the premises leased by the ministries and authorities in their area of government (information on the area of leased premises and lease prices is presented in Table 2).

The responses submitted to the NAO indicated that the authorities in the area of government of the ministries do lease premises, but the ministry, being responsible for supervision of all authorities in its government area, is often unaware of the terms and conditions of the contracts and sometimes even of the fact of contract conclusion. If a ministry has not an overview of the lease contracts and the important terms and conditions of these contracts (price, conditions of termination, etc.) in their area of government, it will find it difficult to plan the budget of the area of government and to take responsibility for legal and efficient operation of the authorities in the area of government. Overviews of the important terms and conditions of lease contracts for premises in the area of government were available in the Ministry of Education and Research, Ministry of Justice, Ministry of Social Affairs, Ministry of Finance, and Ministry of Foreign Affairs. The information included in the overviews of the Ministry of Justice, Ministry of Social Affairs and Ministry of Finance was presented according to harmonised criteria.

Table 2. Areas and lease prices of the buildings and premises leased in the areas of government of the ministries*

	Information on the leased area						**Information on lease price**		
	PRIVATE SECTOR		**GRE**		**TOTAL**		**PRIVATE SECTOR**	**GRE**	**TOTAL**
	m^2	**percentage of total area leased from private sector (%)**	**m^2**	**percentage of total area leased from GRE (%)**	**m^2**	**per-centage of total area leased (%)**	**annual lease expenses, EEK**	**annual lease expenses, EEK**	**annual lease expenses, EEK**
Ministry of Education and Research	4 960	5	8 641	5	13 601	5	4 192 709	6 999 210	11 191 919
Ministry of Justice	16 288	15	81 083	50	97 371	36	8 120 930	59 189 359	67 310 289
Ministry of Defence	1 377	1	0	0	1 377	1	1 013 651	0	1 013 651
Ministry of the Environment	6 523	6	138	0	6 660	2	8 884 429	77 937	8 962 365
Ministry of Culture	15 093	14	0	0	15 093	6	13 472 695	0	13 472 695
Ministry of Economic Affairs and Communications	4 830	5	934	1	5 764	2	6 253 344	1 588 734	7 842 078
Ministry of Agriculture	4 700	4	15	0	4 715	2	5 289 433	14 683	5 304 116
Ministry of Finance	13 871	13	33 437	21	47 308	17	14 654 218	31 723 090	46 377 308
Ministry of the Interior	33 810	31	38 533	24	72 344	27	59 405 096	38 785 314	98 190 410
Ministry of Social Affairs	5 981	6	151	0	6 132	2	5 644 144	119 502	5 763 646
TOTAL	**107 433**		**162 932**		**270 365**		**126 930 649**	**138 497 829**	**265 428 478**

* The information consolidated by the ministries and submitted to the NAO may be imprecise, because there is no regular data collection and no current overview of the changes in the contracts. A detailed comparison of lease prices is impossible, because the ministries and authorities in their area of government have used different calculation methods (the calculation may or may not include the value-added tax, utility costs, maintenance costs, etc.). The table does not include data on the Ministry of Foreign Affairs, because it does not lease premises in Estonia; there are also no data on the buildings and premises leased by constitutional institutions and the State Chancellery. The table does not reflect premises leased from one public authority to another.

Room requirements of public authorities are generally unclear

A prerequisite of justified selection of premises for the public authorities is an analysis by the lessee on the term of the contract, size and conditions of the required premises. Rapid decisions on the lease of premises restrict the possibility of a transparent selection procedure and offering a bidding opportunity to all companies.

Decisions to restructure the operations of an authority are often not based on the long-term development plan of that authority. For example, unexpected room requirements were caused by the moving of the Ministry of Education and Research to Tartu, merger of the Ministry of Economic Affairs with the Ministry of Roads and Transport, and foundation of the Southern Police Prefecture. The Ministry of the Interior invited offers from the developers for the new building complex of the Public Service Academy and requested from the Government of the Republic permission for the procurement of new premises before approval of the new development plant of the Public Service Academy. At the time of the call for offers and request for permission (9 January and 4 May 2006, respectively), the development plan had been approved until the year 2006, even though the new development plan of the Public Service Academy may significantly influence the room requirement, depending on the curricula, number of students, etc. In the Ministry of the Environment, a room committee established a room requirement of 4,100 m^2, but the area of leased premises was 6,000 m^2: at first the ministry applied for and received from the government the permission to lease 4,700 m^2, but already before moving into the new premises, it applied for and received the permission to lease additionally 1,300 m^2. Modification of the requirements for the leased premises in the course of the procurement procedure or negotiations or shortly after signing the lease contract indicates poor planning of the actual room requirements.

In such cases, closeness of the new premises to the existing ones may become the primary selection criterion, which restricts the freedom of choice of the state. On 15 July 2002, the Tax Board leased premises in Tallinn at Narva mnt 9A in order to concentrate the entire central office in one location. About a year later, additional premises at Narva mnt 9J (*ca* 2,400 m^2) were leased for ten years from the same owner As a result of merger of the Tax Board with the Customs Board slightly more than six months later, these premises have become too tight for the merged central office and, consequently, the main objective of the additional premises was not achieved. The Ministry of Education and Research and the Agricultural Registers and Information Board have also negotiated expansions of the area of leased premises due to expansion of the office and establishment of new positions.

The requirements for leased premises have been modified also because of stricter security requirements, relocation of positions, closing of open office spaces and other reasons. In the case of modified requirements, the changes to the premises and the associated investments have to be financed from the budget of the respective body. For example, the Ministry of Education and Research, Tax and Customs Board and Police Board have incurred additional expenses in the leased premises from their own funds.

A positive example is the building leased in Kärdla, in the area of government of the Ministry of the Interior, where the officials of the Police, Border Guard and the Citizenship and Migration Board are brought together in one building, which should result in better cooperation in overlapping work areas in addition to savings on administration costs. According to the development plan, concentration of divisions in one building has been also envisaged by the Ministry of Economic Affairs and Communications; and the Ministry of Agriculture has achieved some success in bringing the authorities together on the same premises.

Lease of premises to public authorities may be economically more disadvantageous than renovation or procurement

The room requirements of a public authority could be satisfied by adapting the premises in a state-owned building to the needs of the authority, purchase of property by the state, or the lease of required premises. Both renovation of existing premises and procurement of new ones require investment. It is clear that the annual budgets of the ministries cannot cover the short-term requirements for property investments, while ensuring sufficient funds for labour and other costs. 2006 State Budget Act provisioned amounts for individual ministries that could be used for investment after the sale of surplus real property. The draft of the 2007 State Budget Act gives the ministries an opportunity to sell the real property, which is not used, and to direct two thirds of the proceeds into investments in the area of government. This opportunity facilitates disposal of the buildings not required for principal activities, but does not provide an universal solution for satisfying the need for real property investments.

Therefore, renovation or procurement of necessary premises could be treated as alternatives to leasing if they could be financed from the state budget revenue or existing reserves. Involvement of foreign capital could also be a more economical alternative to leasing.

If a public authority leases premises for its principal operations on a long-term basis, it means long-term financial obligations similar to a loan, particularly if the lease contract specifies a long period for which lease payments have to be made even if the room requirements of the authority change and the authority would like to leave the leased premises or if the termination of the lease contract is expensive and complicated for some other reasons.

Peeter Kreitzberg, Member of the Parliament, submitted on 29 September 2005 to the Auditor General an interpellation regarding possible economic damage caused to the state in connection with the lease contracts for the buildings at Pärnu mnt 139 in Tallinn (so-called 'house of Kalev') and at Riia 132 in Tartu (KEK building). In order to respond to the interpellation, the NAO ordered expert assessments to find out the cost of construction a new building with similar cubage. The expert assessment received did not include expenditures on land purchase and fittings. The lease price of the Tallinn Police Building includes utility costs, fees for furnishing, etc. The following is an argument regarding the economic justification of leasing a building for the Police in Tallinn.

According to OÜ BK Konsultatsioonid, the construction costs of a building with a similar cubage than the building at Pärnu mnt 139 in Tallinn at the moment of entry into the lease contract, i.e., July 2003, would have been between 181.9 and 217.2 million kroons, depending on the materials used. Presuming that the contract between the Police Board, Northern Police Prefecture and OÜ Raldon will not be cancelled and taking into account an estimated annual price increase due to the growth of the consumer price index, the total amount payable over 20-year lease period, including utility and maintenance costs, would be 775.2 million kroons. Normally, utility and maintenance comprise approximately 30% of the lease price. After subtraction of the 30% allocated for utility and maintenance costs and discounting all contractual payments, the present value of the contractual payments would be 270.8 million kroons (price includes the cost of furnishing). The construction price of a new building, excluding the land purchase costs, at the 2003 price level would have been 181.9-217 million kroons.

The performance of police duties can be presumably envisaged in a long term and there are no indications that the room requirements would be reduced in the future. The NAO finds that, even if the acquisition cost had exceeded the present value of total lease payments, it would have been economically more beneficial to procure the building required for the Police Board and the Northern Police Prefecture. If the state leases premises for long-term performance of its duties and the lease period expires, the state will be faced again with the need to lease or procure the premises. The lack of real competition creates a forced-choice situation where the new contract would have to be made with the same lessor.

The NAO cannot agree with giving unjustified preference to leasing of premises required for the public authorities. Economically, leasing of premises could be more disadvantageous to the state than acquisition or renovation. In the assessment of the NAO, each case should be reviewed separately and all options for satisfying the room requirements of an authority should be analysed. The selected option should be best suited for the performance of the duties of the state, i.e., the most economical option that meets the requirements.

In the last few years, some authorities have planned and in some cases used building lease schemes resembling financial lease contracts. A plan that envisaged construction of a study village for the Public Service Academy on the properties at Pärnu mnt 139 and Kohila 4 specified that the state should purchase the land, establish a right of superficies on this land for the benefit of the developer in exchange of a very small fee, and agree on long-term lease of the buildings located or constructed on that land, with an eventual purchase at the end of the lease period. The plan for the construction of the new building complex for the Public Service Academy describes such scheme, adding that this is not a financial lease. Formal assessment of this statement could not exclude the possibility of paying a market-level purchase price, which would mean double repayment of investments. Contracts concluded by the public authorities should not permit even such formal interpretations indicating possible losses to the state. A similar scheme was used for the construction of the Jõhvi Concert Hall of Eesti Kontsert (the contract was concluded by the City of Jõhvi as the owner of the immovable, a right of superficies was established for the benefit of the builder, with the Estonian state being the usufructuary). The NAO condemns a situation where the meaning of the law is disregarded in order to find the most beneficial economic solution – a contract, which in essence stipulates financial lease, is treated as an operating lease contract, or schemes are devised, which conform to the law formally but not in their essence. Adherence to the legislation should be demanded consistently and if adherence is not possible, the legislation has to be amended.

Lease contract conclusion process is insufficiently documented in most cases

The room requirements of an authority, the comparison of different options for satisfying this requirement and decision criteria should be documented even if the poor condition of current premises is generally known and there are few alternatives. Documentation of the selection process is not only necessary to verify the justification behind the decision, but it also protects the interests of the authority and its employees. Firstly, correct documentation enables easy handover of the work if officials are replaced and, secondly, it protects the officials from potential reprimands regarding their bias. One would presume that many undertakings would be interested in leasing premises to the public authorities and giving preferential treatment to some casts doubt on the impartiality of the decision-makers.

The NAO found that the selection procedures are often insufficiently documented and tenders have been invited on the basis of different or too general criteria, which make it impossible to compare different tenders. For example, there are several cases where possible components of the lease payment are not itemised in the tender: fees for the use of floor space and furnishing, property maintenance costs, utility costs, etc.

Even though the Public Procurement Act does not require organisation of a public procurement for the lease of premises, many rooms, including those of the Registration and Land Registry Department of Harju County Court, Tax and Customs Board in Tallinn at Narva mnt 9A, Ministry of Education and Research in Tartu at Munga 18, and ARIB in Tartu at Narva mnt 3 and 9, have been leased by way of a public tendering procedure.

If public authorities start to search for new premises, they generally request an offer from GRE and consider the possibilities of finding the required premises from their own area of government, because there is no unified and easily accessible overview of all unused buildings owned by the state.

The NAO found several shortcomings in the documentation of the lease of larger buildings and premises, even though the amount of lease payments for these buildings is particularly high and would require special attention. For example, there were no clear criteria for selecting the best offer in the procedure of leasing premises for the Ministry of the Environment. The whole selection process used to lease buildings for the Police Board and Northern Police Prefecture was not documented in writing, which is why it is impossible to evaluate the selection after the event. In the procedure for selection of new premises for the Southern Police Prefecture, the location was decided first so that other potential tenderers could not participate, as they were automatically excluded.

In the case of most of these contracts, there were no preceding comparisons between the lease costs and possible acquisition or construction costs. The overwhelming motivation has generally been the need to start using the new premises as soon as possible, so that leasing remained the only viable option. For example, while leasing the new premises for the Southern Police Prefecture, a contract was concluded, specifying that the term of moving in was six months after conclusion of the contract, which essentially eliminated the possibility of constructing a new building.

GRE is usually asked to submit an offer for the lease of premises, but it is foreseeable in many cases that the offer from GRE would be inferior to other offers, because GRE is unable to offer sufficiently large premises. Lease contracts with GRE are usually concluded only if the building, which houses the institution, has been previously transferred to GRE and the institution wishes to continue work in the same premises after they have been renovated.

A positive example is the procurement of the Ministry of Justice to find premises for the Registration Department of Harju County Court, where the ratio between useful area and total area was taken into account as one criterion of the functionality of premises, and the whole decision-making process has been thoroughly documented.

Concluded lease contracts include problematic terms and conditions

The contracts for the lease of premises to public authorities are usually reviewed once a year. The main contractual reasons for increasing the lease payments include increases in the utility service prices and the consumer price index, whereby in the latter case the upper limit is mostly fixed at 3%. There are also some lease contract that specify a certain percentage by which the lease payments are annually increased. As a result, the increase in the lease price has in some cases exceeded the growth of the consumer price index in the last few years. For example, the lease payments increase annually by 5% for the building of the Ministry of Culture, 8% for the Karksi-Nuia Constable’s Office, and 10% for the Vändra Constable’s Division. In itself, the price increase provisioned in the contract does not indicate disproportionate obligations of the lessee, but in the case of long-term contracts, the price on one square meter may increase to an extent, which could not be foreseen at the time of contract conclusion.

The public authorities have concluded contracts stipulating that the lessee is responsible for maintaining the leased premises. At the foundation of GRE, the main stated justification for the lease of buildings and premises to public authorities was that this enables them to focus on their principal activities. The same consideration should apply to the lease of premises from other companies. If the conditions of the contract obligate the lessee to perform maintenance repairs in the leased premises once in every five years, for example, this would not indicate that the public authority wishes to focus on its principal activity. Such conditions can be found, for instance, in the contracts for the lease of premises in Tallinn at Väike-Ameerika 19 to the Data Protection Inspectorate, and at Narva mnt 9A and 9J to the Tax and Customs Board, whereas the Data Protection Inspectorate, being unable to find a better offer, contracted the repairs from the lessor.

Possibility to respond flexibly to the changing room requirements is an important criterion in evaluating the economic justification of the lease of premises to the public authorities. If the lease contract stipulates that lease payments have to be made for a certain extended period even if the authority terminates the contract before expiry, there will be no essential difference between a lease and acquisition through a loan: in both cases a single decision creates a long-term financial obligation.

For example, when leasing the Kalev building to the Police Board and Northern Police Prefecture, the state undertook to pay a contractual penalty if the lease contract is terminated within 11 years from the date of entry into the contract, and the amount of penalty equals the amount of lease payments for 11 years, less the amount of lease paid by the police authorities by the date of contract termination. It means that the police authorities have to pay 11 years worth of lease in any case.[9] At the same time, the contract for the lease of the Staff Building of the Border Guard Administration does not contain a clause of contractual penalty in the case of early termination, even though the Government of the Republic has in principle consented to a 5-year fixed lease period. The Southern Police Prefecture has permission from the Government of the Republic to pay five years worth of lease, irrespective of circumstances.[10] The NAO believes that in future contract negotiations, the state should avoid inclusion of such long-term fixed obligations.

Proposals to the Government of the Republic

- Develop unified real property policy of the state and apply the principles of this policy to select economically most justified methods for satisfying the room requirements of the public authorities. The policy should include decisions on the principles of lease of buildings and premises, and the future role of GRE. Consider changing the current policy that in essence prefers lease relations.

To the ministers heading the ministries

- Identify the precise room requirements on the basis of long-term development plans before making any decisions on the method of satisfying the room requirements of the ministry and the authorities in its area of government.

- Specify tendering criteria and evaluation criteria for submitted tenders to ensure comparability of the tenders.

- Prepare thorough documentation on the analysis of alternatives to the lease of premises, as well as on the process of selecting the best offer and conclusion of the lease contract to enable subsequent clarification of the justification of the decisions and preclude any doubts regarding the bias of the decision-makers.

- Collect current and comparable information, incl. information on contract amendments, on the lease contracts concluded by the authorities in the appropriate area of government.

- Avoid agreeing to contractual penalties equal to the amount of lease for several years. Give serious consideration to renovation or acquisition of premises, if it is highly probable that the room requirements will not change in the next ten years, the functions of the authority are stable and/or it needs rooms adapted for special purposes.

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[9] Lease Contract No PA7-10.18/123 between OÜ Raldon and the Police Board
[10] Lease Contract No PA5-10.18/4 between OÜ Rondam and the Southern Police Prefecture

4. State Investments in Local Governments

A total of 1.34 billion kroons (see Table 3) were allocated to the local governments in 2005 as specific purpose investment support (through article 4502.01 of the State Budget Classification). Compared with 2004, the amount of investment support redoubled in 2005. Significant areas of increase included the European Union environmental investments and support for the local roads. The 2006 State Budget allocates 1.22 billion kroons to the local governments for investment.

The state budget does not provide a comprehensive overview of the amounts allocated to the local governments for investment. Some support is allocated through the programmes not included in article 4502.01 of the state budget, where the local government could be one of the beneficiaries. One of the largest programmes of this type in the reporting period was the Development Programme for Local Physical Living Environment financed from measure 4.6.1 of the EU Structural Funds (based on the LGIS Plan[11]) and managed by Enterprise Estonia. Approximately 320 million kroons of support have been granted to the projects through this programme. Local governments also receive hundreds of millions kroons as a support from the Environmental Investment Centre and measure 4.2 of the EU Structural Funds. In addition, support has been provided to the local governments from the state budget item intended for government agencies and the public authorities managed by them.

Table 3. Specific-purpose allocations for fixed assets acquisitions by the local governments under article 4502.01 of the state budget in 2005 and 2006 (in million EEK)

Ministry	**2005 budget**	**incl. EU assistance (and co-financing)**	**2005 supplementary budget**	**2006 budget**	**incl. EU assistance (and co-financing)**
Ministry of Education and Research	12,7	8,8 (2,2)	81,9	44,3	15,9 (4,0)
Ministry of Defence			2,0		
Ministry of the Environment	806,2	806,2	84,5	796,9	786,9***
Ministry of Culture	84,4		59,3	98,0	
Ministry of Economic Affairs and Communications	125,4	2,9 (1,7)	51,8*	282,1**	
Ministry of Finance	4,3				
Ministry of the Interior			6,0		
Ministry of Social Affairs			23,7	1,6	
Total	**1033**	**821,8**	**309,2**	**1222,9**	**806,8**

* Incl. 17.2 m from the budget of the Road Administration
** Incl. 10.6 m from the budget of the Railway Inspectorate
*** Difference with the 2006 total budget (10 m) was due to the sale of property
Sources: 2005 State Budget Act, 2005 Supplementary State Budget Act, 2006 State Budget Act

Support from the Ministry of Education and Research is divided between allocations to municipal vocational education institutions (11m EEK in 2005 and 19.9m EEK in 2006) and other specific-purpose allocation to the educational institutions of the local governments (84m in 2005 and 24.5m in 2006). The allocation to the vocational education institutions comprises assistance from the European Regional Development Fund, measure 4.3 of the Structural Funds) and the corresponding co-financing. The budget of the Ministry of the Environment forwards to the local governments the assistance for waste and water management projects from the EU Cohesion Fund (CF). Local

[11] LGIS Plan – Local Government Investment Support Plan

government allocations from the Ministry of Culture are designed for the construction and renovation of local sports and culture facilities.

The majority of the allocations from the Ministry of Economic Affairs and Communications comprised assistance for local road maintenance. Pursuant to the Roads Act, the investment support for the local road maintenance amounted to 142.5 million in 2005 and 265 million in 2006. In addition, the local governments have in both years received support from the Phare energy efficiency programme, and support has also been allocated to the Narva transit project. The 2005 supplementary budget included a special allocation of 17.2 million kroons to the Maardu City Government from the budget item of the Road Administration. In 2006, local governments have been allocated 10.6 million kroons from the budget of the Railway Inspectorate in connection with the technical assistance project for the construction of grade-separated railway crossings.

The other ministries have allocated investment support to the local governments in isolated instances and in smaller amounts. The Ministry of Social Affairs has mostly supported care homes, day centres and shelters of the local governments. In 2005, the Ministry of the Interior allocated from the supplementary budget support to nine rural municipalities with small islands (eight of them also receive support from the Equalisation Fund pursuant to the Small Permanently Inhabited Islands Act; the other recipient was Noarootsi Commune). The 2005 budget of the Ministry of Finance allocated 4.27 million kroons to Püssi Town Government for its solvency problems. The Ministry of Defence allocated from the 2005 supplementary budget 1 million kroons to the Tartu City Government as co-financing for the sports ground in Tartu at Riia 25a, and 1 million kroons as co-financing for the renovation of the square in front of the Baltic Defence College in Tartu at Riia 12.

Planning of investments needs improvement at the level of state and local governments

The investment support audits by the NAO have revealed shortcomings in the planning of investments at the level of both the state and the local governments. Even if long-term plans are drafted, they are frequently modified. For example, the Ministry of Culture did not disclose its perennial local government investment plan precisely because the plans could be changed and the ministry did not want to give empty promises to the local governments. Planning problems at the state level also complicate the preparation of local long-term development plans and vice versa – if the local governments have not identified their needs and resources, the central government would find it difficult to make any strategic plans. The insufficient long-term planning at the state and local levels does not provide certainty that investments are directed to the objects where they create most benefit.

The NAO has found on the basis of the results of the 2004 audit on 'The Planning of Public Investments for General Education Schools and the Use of such Funds' that investment support may be allocated to non-sustainable schools, because there is no comprehensive vision of the future school network. The 2004 programme for public investments in 2004-2007 envisaged assistance to 21 schools (i.e., 15% of all schools), where in five years the number of pupils will drop below the minimum level required for opening a school. A survey among the local governments indicated that 80% of the local governments had adopted a school network development plan by 2004. If the Government of the Republic approved in the end of 2004 the list of sustainable schools[12], eligible for renovation funds allocated to GRE, the local governments entered almost all schools into this list. However, it is know that the number of pupils is constantly decreasing. According to the data from the Ministry of Education and Research, already five of the 'sustainable' schools in the government-approved list had been already closed by this year and a couple of schools will be still closed during 2006. The forecasts indicate that in ten years the number of general education schools in Estonia will decrease by 25-40%.[13] However, an investment that has been already made, gives the local government a justification to continue management of a non-sustainable school or even apply for further investments. The local governments manage nearly 90% of the general education schools and

[12] Government of the Republic Order No 911-k of 29 December 2004
[13] PRAXIS Center for Policy Studies survey on 'General Education Schools Network', 2005

they are not interested in closing the non-sustainable schools, because this would mean a loss of an income source for the local budget. However, the state should avoid making public investments in such schools.

The major investment objects in the area of culture and sports were included in the local development plans, but the scope of these plans clearly exceeded the actual building and funding resources of the local governments and the amount of potentially available support. County planning and the associated action plan are used as part of the sources for preparing a ranking order for investments in culture. However, it has not been regulated who should prepare the county development plan and what objectives and principles should be used, i.e., whether this plan should represent the development trends of the local governments or the county government (central government). The analysis of the local government development plans, county plans and the action plan of the Ministry of Culture indicated that a large number of investment objects or objectives were named, but priorities had not been identified. In some cases, the action plans appended to county development plans do not include a list of investment objects.

The state has not set particular goals in allocating funds for local road maintenance and supporting the investments in local roads. Development of local roads is not included in any national development plans and, when allocating support, the state has not specified whether and to what extent the support should improve the condition of local roads. Even tough local roads comprise 38% of all public roads only 10% of the funds allocated for the maintenance of public roads are used for the local roads. In the assessment of the Association of Estonian County Governments, the support allocated for the maintenance of local roads should be increased at least three times. However, there is a lack of information necessary for planning optimal state support, because the state and local governments have not collected systematic data on the condition, usability and maintenance cost of local roads.

The planning of the regional water management projects, coordinated by the Ministry of the Environment, is based on the CF implementation plan with which the government approves the list of major projects to be financed during the entire EU programme period. Most of the projects included in the list are going into actual preparations. The water management projects also conform to the general objectives of the national environmental strategy and environmental action plan, but the investments requirements have not been assessed in detail at the level of local governments. The objects were selected at the time of preparing the CD project application, but the technological choices have to be modified as a result of the poor quality of that application. Establishment of a water management infrastructure should be based on a public water supply and sewerage development plan, but at the time of submission of the application to the CF, half of the 63 local governments audited by the NAO did not have such plan. In addition, in nearly half of the cases, the actions and co-financing obligations of the CF project were not included in the general development plan of the local government. The lack of development plans indicates that the local governments did not always analyse the requirements and opportunities for the establishment of the water management infrastructure. Consequently, there can be no certainty that the decisions made are best suited for the local needs and that the most important works were really financed first.

Allocation of support is sometimes non-transparent

The NAO was unable to clarify in the case of several ministries the reasons for making the decisions and justifications for selecting some and rejecting other objects for support. In addition, it was sometimes impossible to identify, where and by whom the actual decisions were made. Therefore, it is not clear who in the state is responsible for inefficient investment decisions.

There is no unified procedure for allocation of specific-purpose investment support to the local governments from the state budget (article 4502.01). In actual practice, the ministries have used this article of the state budget to support a wide range of relatively liberally selected local government projects. The only criterion is connection with the area of government of the relevant ministry. Due to the absence of clear application and allocation systems, decisions are made randomly and potential recipients of support are treated unequally, because an agreed application procedure has not been established.

An exception is the local roads support allocated by the Ministry of Economic Affairs and Communications, which is allocated pursuant to the Roads Act and the associated implementing provisions. Allocations of environmental investment and educational investment in vocational education institutions have also been regulated, because they deal with the finances from the Cohesion Fund and European Regional Development Fund.

The Ministry of Culture has established a procedure for applying for support and processing of applications by a directive of the minister, which is an internal instrument and cannot impose obligations on local or county governments. The procedure of application and decision-making relating to investment support has not been regulated in the Ministry of Social Affairs, Ministry of the Interior and Ministry of Education and Research (regarding the investments in general education schools and child care institutions). In 2005, the division of investments by objects was approved by a directive of the minister in the Ministry of Social Affairs and Ministry of the Interior. The division of funds allocated for local road maintenance by the Ministry of Economic Affairs and Communications was approved by the Government of the Republic by individual local government units on 7 March 2005. For the Ministry of Culture, Ministry of the Environment and Ministry of Defence, the division of support by objects was approved in 2005 by an order of the Government of the Republic, but it was done only in December. An order of the Government of the Republic was used in 2005 to approve the division of general education school and childcare institution investments by objects. In 2006, the Government of the Republic order was used to approve the division of support by objects for the Ministry of Culture, Ministry of Education and Research, Ministry of Social Affairs, Ministry of the Environment and the Ministry of Economic Affairs and Communications.

In the case of the Ministry of Culture and Ministry of Education and Research, the NAO reached the conclusion that the applications for investment support did not include sufficient information for decision-making. In addition, the applications did not comply with the requirements established by a regulation of the Minister of Finance. In the case of the Ministry of Culture, applications were sometimes not submitted at all.

In the response to the 2004 audit report on the investments in general education schools, the Minister of Education and Research stated that as of 1 January 2005 the funds intended for investment in municipal schools are added to other educational expenditures, i.e., money allocated on the basis of the number of pupils in a school. The plan was to connect all funds allocated to the schools with the number of pupils as of 2006. The system based on the number of pupils was expected to solve the problems of non-transparency, lack of consistency and presence of different sources of financing in the allocation of educational investments. Indeed, as of 2005, the investment support from the state budget to the local governments has been included as ain investment component in the funds-per-capita allocations to the general education schools (1,270 kroons per student). In 2005, the total amount of the investment component of general education schools was 240 million kroons (230m in 2006). As the funds-per-capita allocations do not differentiate between salary and investment components, the local government can decide, which part of the allocation is used for salaries and which for investments.

The 2005 state budget, indeed, did not include any specific-purpose investment support allocations to the general education schools, but the supplementary budget of the same year already allocated more than 80m kroons to the schools as specific-purpose support. According to the explanations given by the Ministry of Education and Research, the initial allocation was decided by the government coalition partners and only after that were applications to the ministry submitted by the local governments selected as recipients of the funds. While the division of investments was decided on the county level before 2005 and the problem was the lack of clear decision criteria, the system has not become more transparent after 2005, contrary to the expectations. The ministry has justified the continued allocation of specific-purpose investment support by claiming that the investment component in the funds-per-capita does not satisfy the needs of the educational institutions and in the case of smaller schools, it is sufficient only for current repairs.

The Ministry of Culture has included in its activity plan some general principles for allocation of investment support to the local governments, but the different principles have not been prioritised. The NAO finds that the procedure for allocation of investment support, established by a directive of the minister, leaves open several important issues. The ministry has requested from the county governments the annual creation of a ranking of required culture and sports investments at the county level, but the order of this ranking has not been followed when allocating support. Additionally, support has been given to objects, which were not included in the ranking or for which the local government has not submitted any official applications to the county government of the Ministry of Culture. Only a quarter of the recipients of support from the 2005 state budget were listed among the three most important objects in the county rankings. Further, a quarter of the objects that received funding were objects for which the county governments and local governments had submitted no applications to the Ministry of Culture in the period 2000-2005. Nearly 6.7 million kroons were allocated to objects without applications in 2005, which comprises 8% of all allocations of the main budget. New objects for investment support from the budget of the Ministry of Culture were added also in the Parliament – these objects do not even require submission of an application or compliance with any other requirements. For example, the Parliament added 38% of the objects receiving support from the 2005 main budget, which comprised 16% of all investment support allocations. Of the 55 supported objects that were added in the Parliament as amendment proposals to the draft State Budget Act only two were identified by name; for the remainder, the division by objects was decided by a letter from the Finance Committee of the Parliament to the Ministry of Culture.

Support for the same purpose is allocated from several sources

Several ministries allocated investment support from the state budget (article 4502.01) or through national programmes to similar objects. Additional to that are foreign assistance projects. Therefore, it is very difficult to get an overview how much support is allocated to the local governments for a specific purpose. There is no central record on how much support an object gets from different sources.

For example, according to data available to the NAO, general education schools received investment support from nine different sources in 2005. Firstly, the investment component has been added to the funds-per-capita allocated to the general education school from the equalisation fund of the state budget. The Ministry of Education and Research allocates specific-purpose investment support through the state budget (article 4501.01) and, further, separately from the programme of pupil homes (the 2005 budget of the programme was 18m kroons). In the period 2004-2006, the general education schools receive approximately 200 million kroons of European Union assistance[14]. Enterprise Estonia manages the regional programme for allocating support to investments relating to children, youth, families, elderly and disabled persons out of the gambling tax, from where the schools received nearly 8.5 million kroons in 2005, as well as the Phare energy efficiency programme for the local governments, from where the municipal schools receive 7.1 million kroons of investment support in 2005-2006. Support for the construction of school gyms and stadiums can be also applied for from the budget of the Ministry of Culture (article 4502.01). Local governments where schools are housed in manor buildings may apply for investment support from the national programme of the manor schools of the Ministry if Culture (the 2005 budget of the programme was 8.6 million), and as of 2006, foreign assistance from the Norway and European Economic Area financial mechanism (Estonia can use an estimated amount of 113.7 million kroons until the year 2009). While the intention of the Ministry of Culture and Research in establishing the system of funds-per-capita was to create a unified coordination system in order to allocated funds to the educational objects through a single channel, it is now clear that this objective has not been achieved.

[14] Structural Funds measure 4.6.1 'The Development of Local Physical Living Environment'

The Ministry of Culture has granted allocations from the state budget (article 4502.1) to playgrounds and sports fields, even though a separate programme for playgrounds and sports fields has been established (the 2005 budget of the programme was 3.4 million kroons), to health centres, even though a programme for regional health centres 2003-2006 has been established, and to churches, even though a national programme for 'Preservation and Development of Sanctums' has been established (16.5 million kroons were allocated in 2005 for the renovation of churches).

There have been instances where the Ministry of Education and Research and the Ministry of Culture have allocated support to the same objects from different sources, but the NAO has not discovered any instance of double funding of the same activities.

With the 2005 supplementary budget the Ministry of Social Affairs allocated from its budget 1.5 million kroons for the renovation of Orisaare Family Health Centre, and 0.55 million kroons for designs of the Vändra Health Centre (designed also for the provision of family medical care), even though family doctors are private entrepreneurs who are financed on the basis of a capitation fee through the health insurance fund and whose expenses on the lease or maintenance of premises have been included in the base funds. The local governments have the right but not obligation to support the family doctors servicing the local residents and many local governments do indeed offer favourable work conditions to the family doctors, but in this case, the family doctors of two local governments will get better working conditions at the expense of the state, while the total number of registered family doctors is more than 900. In 2006, Tallinn received from the budget of the Ministry of Social Affairs 1.1 million kroons of investment support for SA Tallinna Lastehaigla (Children's Hospital), even though hospitals are financed by the health insurance fund on the basis of the price list.

Loan burden of local governments is not sufficiently monitored

The local governments have the opportunity to apply for extensive investment support from both the Estonian state and foreign assistance. However, some amount of co-financing is usually required from the local governments. The local governments must make precise calculations to estimate the amount of support they are able to accept without having problems with cost sharing. The Ministry of Finance collects data on the loan burden recorded in the accounting of the local governments to make sure that liabilities would not exceed the limits established by the Commune and City Budgets Act. The ministry monitors the local governments only with respect to existing debts, not additional future obligations. The audits of the NAO have indicated that even the ministries granting investment support do not verify whether the local government in question is able to comply with the cost sharing requirements. Securing co-financing for a number of support allocations simultaneously may create financial difficulties for the local government in the case of incorrect planning. For example, the Commune of Orissaare had solvency problems in 2005.

In 2005, Orissaare Commune initiated the construction of a new sports building with the assistance of the investment support from the Ministry of Culture. The contractual cost of the building was 26.3 million kroons. By the end of 2005, the Ministry of Culture had invested 5.4 million kroons in the construction of the sports building. At the same time, Orissaare Commune had an outstanding heating loan in the amount of 8.44 million kroons. In addition, the Commune participates in the water management project of the Cohesion Fund, with the amount of co-financing at least 2.4 million kroons, incl. 2.17 million payable in 2006 (or up to 3.5 million depending on the final value of the building procurement). By the end of 2005, the Commune had been able to pay only 5% of the amount required for cost sharing for the sports building. Due to the heating loan obligation and participation in the water management project of the Cohesion Fund, the Commune lacked the resources to continue construction of the sports building and pay the loan taken from the building company (11.2 million), which is why the construction of the sports building was suspended. Suspension of participation in the water management project would have increased the financial obligations of other local governments involved in this project, which would have put the whole project to risk, with the possibility of needing to repay the money received to the European Commission. As a result of its solvency problems, Orissaare Commune approached the Ministry of Finance and asked for a readjustment support. The committee for local governments with solvency problems at the Ministry of Finance decided that Orissaare should have the chance to finish the construction of the sports building. The Government of the Republic allocated by a decision of 1 June 2006 to the Orissaare Commune Government 6.3 million kroons to secure the performance of the obligations assumed by the local government unit. In addition to Orissaare Commune, the government supported by its decision of 1 June 2006 also the town of Võru, which had developed solvency problems as a result of heating loan as well and participates in the Cohesion Fund water management project for Viljandi County for which the funding application is currently being prepared.

As the local governments are unable to build large facilities without loans and their loan burden is restricted by the Commune and City Budgets Act, the local governments are searching for suitable schemes to finance the construction depending on their limit of loan obligations. Several local governments have formed foundations to act as the recipients of the loans. A new possibility for constructing certain objects is a scheme where the local government establishes a right of superficies for the benefit of a private company (building company), the company constructs the building, and the local government uses the building on the basis of usufruct. The clear benefit of this scheme for the local government is the opportunity to postpone the payment of large capital expenses by distributing the cost across the life cycle of the project. However, usufruct contracts create long-term obligations for the local governments, usually with the obligation to purchase. The current regulation enables to exclude such obligations under usufruct contracts from the loan burden restrictions imposed on the local governments. The Ministry of Finance that monitors the loan burden of the local governments has no clear rules for handling the obligations under usufruct in relation to the loan burden.

In the assessment of the NAO, the state has not weighed the risks associated with the transfer of ownership of an investment object to a private law legal person under the right of superficies, usufruct or similar solutions, and has not anticipated potential problems in the contracts for the use of allocations from the state budget. For example, the local government and private undertaking may amend their contracts at any time so that the use of the building for is initial purpose will be discontinued. Purposeful use of public investment support could not be ensured in such cases.

Use of investment support is not always purposeful and supervision sufficient

The NAO has in its audits highlighted several problems related to the use of investment support in the local governments: the local governments make mistakes in organising public procurements, the cost sharing limits are exceeded, and the funds are not used for the intended purpose. The audit of the investments in general education schools indicated that some money was used for operating expenses, as well as procurement of inventory and study aids. When assessing the use of funds allocated for local road maintenance, the NAO found that road maintenance works are often ordered from unlicensed persons and the planning, ordering and maintenance of the road management works do not comply with the Roads Act.

The audits of the Ministry of Education and Research indicated that the concept of investment for a specific purpose is not defined with sufficient clarity. The contracts for the use of allocations from the state budget include the provision that the ministries have the right to reclaim the support in the case of non-purposeful use, but the NAO believes that the use of allocations for the intended purpose is difficult to verify and reclamation in the case of misuse is also complicated if the contracts for the use of allocations do not specify with sufficient level of detail the objects for which the local government is supposed to use the support. The contracts concluded by the Ministry of Culture often only included the name of the receiving authority and an explanation such as ‘renovation works’ or ‘construction’, but not a list of the planned works or a description of the building to be constructed. No local government has yet been requested to repay any allocations to the Ministry of Culture.

Positive examples include the contracts for the use of allocations from the state budget concluded by the Ministry of Social Affairs. The annexes to these contracts provide details both on the planned works and their cost. A positive practice in the contracts of the Ministry of Social Affairs and Ministry of Finance was also the clause that the ministry has the right to conduct general supervision over the use of the allocated funds and to review relevant documents.

In the Ministry of Culture, supervision of the use of investment support has meant payment of invoices on the basis of expense receipts, reviewing the interim and final project reports, and inspecting the finished object. The ministry has not been able to supervise the economy and efficiency of the projects. There was some confusion in defining the supervisory competences. On some occasions, the county governments have supervised the use of support allocated by the Ministry of Culture, even though there is no legal basis for a county government to conduct supervision over state budget allocations to the local governments.

Supervision by the Ministry of Education and Research in the last two years has been limited to the review of reports.

No executive body is responsible for supervising the legality and purposefulness of the support allocated for local road maintenance and the state has no overview of the actual use of these funds. The respective data is not included in the local government reports and submission of additional reports is considered practical by the ministries. The Roads Act that regulates the funding of road maintenance does not require any executive body to supervise the use of funds allocated for investments in local roads and no government agency has the right to reclaim the funds from the local government in the case of a discovered misuse. As of 2005, the State Budget Act provides the opportunity for the state to conclude contracts for the use of allocations from the state budget with each local government, including the provision that the state has the right to supervise the use of allocations. The Ministry of Economic Affairs and Communications opined that conclusion of such contracts with all 227 local governments is impractical, because the ministry has not the resources to supervise these contracts.

During the performance of CF environmental projects, the Ministry of the Environment and the Ministry of Finance perform preliminary verification of the eligibility of procurements and expenditures. However, financial supervision and monitoring by the ministries is carried out only until the final report is submitted to the European Commission. This report is submitted within 6 months after the final term specified in the financing decision. The monitoring of projects does not include an analysis of the efficiency and long-term effects of investments (compared against the improvement of water quality and the condition of water bodies). Both the European Commission and the Member State have the right to initiate project assessments during the project term as well as after the submission of final reports in order to assess the actual impact. However, the Commission has not initiated any assessments (the first ISPA[15] projects were completed within the last two years) and Estonia has demonstrated no respective initiative.

The NAO believes that if the state makes any investments for specific purpose to the local governments in addition to allocations from the equalisation fund, such investments should be prescribed by the development plans for the specific area or by legislation. The bases for allocating support should be established by legislation and they should be public. All target groups should have equal opportunities to apply for support and decisions should be made on equal bases. The rights and obligations of the granter and the user of funds need specific regulation as well.

Proposals to the Government of the Republic

- If support for specific purpose is allocated on the basis of applications, ensure that contracts for the use of allocations are concluded with all beneficiaries, including the following clauses:
  - specific purpose (list of works) for which the support will be used;
  - right of the ministry allocating the funds to carry out supervision and review all relevant documents;

[15] ISPA – Instrument for Structural Policies for Pre-Accession

- the amount of co-financing of the local government and eventual consequences if the local government fails to comply with the agreement;

- condition that if the local government surrenders the ownership of the investment object and provision of the public service within a specific period, the money allocated as investment support should be partially or fully repaid to the state;

- requirement to repay the allocation if the local government purchases things or services and orders construction works without organising a tendering procedure for public procurement. Purchase of things and ordering services and constructions works through public procurement procedures should ensure economic use of the funds.

- If support for specific purpose is allocated on the basis of legislation, the respective legal instrument should specify the precise purpose and conditions of the use of support, as well as requirements for reporting, supervision and refund claims in the case of misuse.

- Create an opportunity for acquiring an overview of the total amount of support allocated to the local governments by the state, and establish a central supervision system for the loan burden and cost sharing abilities of the local governments.

5. Activity of the Public Authorities in the Field of Information Technology

The i2010 document on European information society states that nearly a quarter of the EU gross domestic product and two fifths of productivity increase are the result of information and communication technology applications. Estonia has been internationally recognised as a country with good level of information technology development, compared with other countries in Eastern and Central Europe, but the NAO believes that the state should take important steps to ensure that the current rate of development continues.

Increasing availability of Internet connections in rural areas

According to studies[16], nearly 60% of the population in the age group from 15 to 74 were regular Internet users in spring 2006. Almost all institutions and companies have computers and an Internet connection. However, approximately 40% of the households still find that having a computer and Internet connection at home would be too expensive or impractical.

The availability of Internet connections in rural areas is currently lower than in the cities. The situation should improve significantly after implementation of the 'KülaTee 3' project launched in 2005 to provide Internet connection opportunities for rural population. The state has allocated 29.2 million kroons for that purpose. By the end of the project, direct connection to the Internet should be available in almost all rural areas on the conditions specified by the state.

Public sector is well equipped with information technology

The institutions in the public sector have spent annually more than half billion kroons on the development and maintenance of information technology systems in the last years, which is more than one per cent of the state budget. As of 2005, the resources of the European Regional Development Fund can be used for that purpose as well, and the respective measure 4.5 'Information Society Development' could be used to finance public sector projects with a total value of *ca* 130 million kroons in the course of four years.

At present, most public sector agencies are well equipped with information technology, the state budget provides sufficient resources to ensure the operation of information systems, and funding of important large-scale national development projects is not a problem because of the opportunity to use EU funding. The current main challenges are the use of the existing equipment and the associated information systems as efficiently as possible, establishment of priorities for the funding of new projects, and ensuring the quality of their implementation. Further progress will depend primarily on the possibility to engage sufficient number of competent people, as well as the desire, skill and opportunity of the officials in the field to make these people work towards shared goals.

Coordination continues to be a problem

The NAO has repeatedly emphasised the need to improve significantly the coordination of information technology activities of the public authorities. There have been some positive changes in the last year, for example:

- 'The Estonian IT Interoperability Framework' document that harmonises the principles of information technology activities of the state and local governments and the associated 'Estonian IT Architecture' and 'Estonian Semantic Interoperability Framework'[17] were prepared and made publicly available at the initiative of the Ministry of Economic Affairs and Communications, the

[16] eSeire, TNS Emor, May 2006
[17] See http://www.riso.ee/et/koosvoime/

coordinator of the development of public information systems, and in cooperation between the government agencies, local government authorities, private sector and third sector specialists.

- The development projects co-financed by the European Regional Development Fund are managed under coordination of the Ministry of Economic Affairs and Communications on a project basis.

However, there have been no fundamental changes in the coordination of information technological activities. Preparation of an information society development plan for the coming years and the planning of relevant organisational implementation measures progress slowly.

The Ministry of Economic Affairs and Communications has so far practiced a so-called open (soft) method of coordination, which consists primarily of the following: establishment of the objectives of national information policy; giving suggestions to other public authorities on how to approach these objectives; supporting cooperation between agencies; launching the most important projects for the state as a whole; making proposals to the Ministry of Finance regarding allocation of funds for information technology investments to other ministries.

In the opinion of the NAO, some more forceful administrative measures in addition to the open coordination method could be considered at the current stage of developing a civil information society. For example, the ministries could be made responsible for achieving compliance with the civil information society objectives in the institutions in their area of government, public law persons and foundations founded by them, as well as state-owned companies. In addition to government agencies, the process should involve the local governments and the authorities administered by them, which are most directly engaged in the provision of public services to the people. It could be worth to consider establishment of innovation centres that would develop and implement civil information technology solutions for specific fields and for the institutions that have no such capability.

In the assessment of the NAO, the adoption of the 'Estonian Information Development Plan 2010', which is being prepared by the Ministry of Economic Affairs and Communications, should be accompanied by the adoption of procedures to ensure implementation of the development plan and participation of all related organisations in the development projects.

As the discussion on coordination and financing of this field has been going on for years, an assessment of the current organisation of work in the field could be ordered from independent experts (academic or foreign experts) to receive some recommendations for better administration of the management and financing to create a civil information society.

Public information systems do not yet focus sufficiently on the citizen

Most of the information processed by the public authorities in Estonia is available in digital format and X-tee, a secure data exchange environment, has been created to transmit and use this information. There is a considerable number of e-services, which are often available through the portals managed by the state. An identification system based on the ID card has been created to associate the person with digital information submitted by that person.

All documents dealing with the information technological development of public authorities emphasise the need to shift the focus of the public information systems from the institutions to the persons and services. Everyone agrees that users of public services should not search for the officials and databases they need, and that the authorities should not request from the citizens the data and documents, which are already available in national information systems.

There are some good examples of how this principle is implemented: transfer of the parental benefit and family benefit application procedure into an electronic format released more than 200,000 parents from the obligation to obtain up to seven paper documents from different authorities, while the officials were released from the duty to verify and enter the data from these documents. Unfortunately, these are still exceptional examples. For instance, Tallinn City Government required in late spring this year that city residents wanting to purchase available land next to their immovable property (the applications had to be submitted by 1 June) had to submit their applications on paper, appending a copy of their passport and an excerpt from the land register, even though the data on these documents would have been readily available from the central national databases.

The NAO believes that a list of public services, which should be available to the citizens as e-services, has to be compiled as soon as possible, based on the EU list of priority e-services and the current needs and opportunities in Estonia. At the same time, the work of authorities should be reorganised, taking into account the new possibilities provided by information technology applications. This would enable to organise the information management and exchange of the authorities in such manner that everyone would be able to provide the agreed e-services after a couple of years.

Local governments need support from the state

It is estimated that the local governments provide 70% of the public services to the people. Most local government authorities have been able to acquire modern computers and have a reliable Internet connection. However, it has not always been considered that the information technology solutions should be compliant with the national information systems in order to publish as much of the activities of the local governments through these solutions as possible and that the solutions should enable the citizens to use as many of the services provided by the local governments as possible through the Internet.

Competent specialists for these tasks are not always available. Most local governments operate separately, without coordinating their activities with others. The state has not attempted to coordinate their activities or provide broad support, indicating that the local governments are independent and there are no clear lines of responsibility. At present one should admit that the information technological resources of the local governments are not used with a sufficient degree of efficiency and the provision of e-services by the local governments lags significantly behind similar developments in government agencies.

In the opinion of the NAO, the state should attempt to expand its activities in developing the information society to the whole public sector, trying to integrate the information systems of the state and of the local governments. The needs of the population in general should come first. The information society should be developed in a regionally balanced manner; the task of the state is to implement measures to reduce the digital gap.

Proposals to the Government of the Republic

- Establish a single set of rules for the preparation and implementation of information technology development projects at the national and local government levels.

- Select a body responsible for the development of information systems in the country as a whole, as well as the competence and responsibilities of other ministries.

- Find an efficient form of cooperation between the local governments and the state, and establish measurable targets for overcoming problems associated with the application of information technology in the local governments.

- Identify the services, which should be provided in a digital form by the state and local government authorities.

- Establish a prohibition (effective as of 2008, for example) on the authorities to request from the people data and certificates, which have been already submitted to the state and local government authorities or which they have collected or compiled before.

6. Major Conclusions from the Audits of the NAO

In addition to the problems discussed above in more detail, this chapter also presents some other major conclusions and observations from the audits completed in 2005-2006. The background of the conclusions is given in the form of short explanations, with the detailed discussions being available in respective audit reports. For simplification purposes, the issues that deserve the attention of the Parliament are presented by individual ministries.

6.1. Ministry of Education and Research

Accounting has improved in the ministry but needs further refinement in the area of government

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Education and Research for the purpose of assessment of the consolidated annual report 2005 of the state' indicated that 663 state asset objects of 62 subordinate institutions and biological asset objects of 4 subordinate institutions were revaluated with their fair value as of 31 December 2005 in the course of revaluation of state assets governed by the Ministry of Education and Research. The revaluation increased the fair value of the fixed assets of the ministry by *ca* 3.76 billion kroons.

However, there were some shortcomings in the organisation of the fixed assets revaluation. For example, all fixed asset objects subject to revaluation were not submitted for revaluation; in some cases, the consolidated data approved by the state assets revaluation committee included duplicate data and calculation errors; the committee did not apply the established methodology consistently and did not deduce the value of privatised apartments in a revaluated building from total value of that building.

The internal audit system does not ensure preservation of the assets in several institutions in the area of government. There were some cases where inventories were not taken or accounting data had not been adjusted according to inventory data; some fixed asset items were not recorded in accounting, etc.

The NAO discovered in the course of the audit that some assets subject to registration in the state assets register had not been registered, some written-off or transferred assets were not deleted from the register, and the register did not record the fair value resulting from the revaluation of fixed assets. This did not enable getting reliable information from the state assets register and did not ensure efficient use and monitoring of preservation of the state assets.

In many cases, the institutions in the area of government did not comply with the Public Procurement Act. Sometimes public procurements were not organised to purchase products and services with the value that exceeds the limit established by the Public Procurement Act; in some cases, tenders were not requested from at least three tenderers and contract award notifications were not submitted to the register; in some cases, procurements were organised but the limit value of the procurement contract was exceeded.

In order to eliminate the shortcomings, the NAO recommended the Ministry of Education and Research apply additional measures to ensure recording of the state assets in the area of government of the ministry with their fair value, order the data in the state assets register, provide training on financial management, organisation of accounting, Public Procurement Act, conclusion of contract and other topics to the heads of the institutions in the area of government, and increase the responsibility of the heads of the institutions in the organisation of economic activities.

Updating of building records has started

After the audit of the 'Administration of state-owned buildings by the Ministry of Education and Research', which was completed in August 2005, the Ministry of Education and Research has taken important steps to improve the administration of state assets managed by the ministry. The ministry has adopted principles for the use of state assets managed by the ministry with the respective action plan, and has prepared a list of superfluous assets. By 7 July 2006, 118 buildings (or parts of the building registered separately) managed by the ministry were deleted from the state assets register, incl. 107 buildings transferred, 9 written-off, 1 declared unusable, and 1 transferred to another authority. The process to transfer the apartments at Raadiku Street and Meeri manor complex owned by the ministry has been initiated.

Internal audit system of Tallinn University needs improvement

As a result of the audit of 'Economic Activities of Tallinn University', the NAO reached the conclusion that the accounting management of Tallinn University economic transactions is weak and the internal audit system needs to be improved.

In some cases, no public tender had been organised to find lessees and the concluded rental contracts included unfavourable conditions to the grantor. The University did not have a comprehensive overview of the rental contracts.

In making investments, the internal audit system did not function when accepting performed works and when paying for them. Due to the deficiencies in the internal audit system and management of accounting, it had become possible that there were errors in the documentation of cash transactions and the money from sales was received later than the specified due date; the fuel cards registered to cars were used when the cars were in the University garage; in several cases, the University had paid for works and services without having concluded prior contracts and/or preparing statements of acceptance of work, etc. In some cases, the payment of remuneration was registered as the payment of scholarship to evade paying taxes.

After the audit, the University Senate approved a plan for measures, including the deadlines and persons responsible for the refinement of the internal audit system. The plan envisaged development of a regulation for rental contracts and procedures for contract conclusion, as well as improvement of the public procurement regulations and internal accounting rules. The Rector was required to submit to the Senate an overview of the measures taken to improve the University internal audit system by 1 October 2006.

6.2. Ministry of Justice

Accounting is at good level

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Justice for the purpose of assessment of the consolidated annual report 2005 of the state' was used to examine the records of the annual accounts of the Ministry of Justice, which were important for the consolidated annual report of the state. The audit results indicated that the balances of the examined transaction classes were recorded substantially correctly in the annual accounts. In addition, the transactions included in the sample were performed in compliance with the important legislation governing such transactions. An observation was that some of the liabilities associated with the deposits of prisoners had expired.

6.3. Ministry of Defence

Salary management and accounting of fixed assets needs ordering

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Defence for the purpose of assessment of the consolidated annual report 2005 of the state' indicated that the salary grades specified in the General Staff of the Defence Forces did not comply with the State

Public Servants Official Titles and Salary Scale Act. In the opinion of the NAO, the General Staff of the Defence Forces and other institutions of the Defence Forces should follow the salary grades established by law. If the Defence Forces feel they need different salary grades, they should initiate a relevant procedure to amend the legislation. At the time of the audit, the Commander of Defence Forces submitted a proposal to the Minister of Defence to prepare a draft legislative amendment.

In addition, there were individual cases where public procurements were not organised, some contract award notices had not been submitted, or had been submitted late. The internal procurement procedure was being updated at the time of the audit.

The Ministry of Defence is required to transfer the state assets possessed and used by the Defence League, except for any military weapons, ammunitions and other military equipment, to the ownership of the Defence League by 31 December 2006 at the latest. As on 31 December 2004, the balance sheet of the Defence League recorded assets in the value of 67.2 million kroons (acquisition value) for which the ownership had not been legally transferred from the Ministry of Defence. In the course of revaluation of fixed assets in 2005, the acquisition value of these assets was increased to 70.6 million kroons. In 2005, the Ministry of Defence has transferred no further assets to the Defence League, even though the value of the assets still to be transferred is nearly 20 million kroons. Particularly condemnable in the assessment of the NAO is the fact that the Ministry of Defence has been unable to ensure legal transfer of ownership to the Defence League in 1.5 years.

6.4. Ministry of the Environment

Accounting of forests is a problem in accounting

Pursuant to the general rules of state accountancy, biological assets not subject to development and without a reliable assessment of the fair value shall be recorded off-balance, providing an estimation of the value if possible.

The Ministry of the Environment is responsible for keeping records on most of the state-owned protected and protection forests and the State Forest Management Centre in the area of government of the ministry manages *ca* 164,000 ha of such forest, which has been recorded with zero value. 'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of the Environment for the purpose of assessment of the consolidated annual report 2005 of the state' indicated that the report of the ministry does not reflect the existence of protected and protection forests and does not include the estimation of their value.

The balance sheet of the ministry only records those protected forests and protection forests the state has purchased from private owners or exchanged for commercial forest (or land), in a total amount of 18.1 million kroons. Recording of the value of such forests on the balance sheet of the state is disputable, because the state does not gain any direct economic income from these forests either.

Supervision of hazardous waste operators can be improved

The state is required to take all measures to ensure safe handling (collection, transport, recycling, disposal) of hazardous waste. The audit of 'Hazardous waste handling in intermediate depots and landfills' indicated that the necessary legal regulation has been established at the initiative of the Ministry of the Environment, the organisational structure necessary for implementation has been created, and the state has spent over 150 million kroons on the creation of a hazardous waste handling system.

According to the reports of the waste operators, 636,000 tons of hazardous waste were created in Estonia in 2002-2004 (not including the waste from oil shale processing) and 161,000 tons were recycled. The actual quantity is larger, because the obligation to prepare and submit respective reports only applies to waste operators that handle quantities of waste above a certain limit. There are only estimates regarding the quantities of hazardous waste disposed of by the population together with mixed consumer waste. It is clear that some of hazardous waste is not processed according to the regulations and may, therefore, pose a great risk to the human health and the environment.

Issuance of licenses and permits to waste operators need more specific regulation, and supervision of the waste handling operators should be made significantly more efficient.

6.5. Ministry of Culture

Quality of accounting in the institutions of the area of government is uneven and needs ordering

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Culture for the purpose of assessment of the consolidated annual report 2005 of the state' indicated that 99 state asset objects were revaluated with their fair value as on 31 December 2005 in the course of the revaluation of state assets managed by the Ministry of Culture. The revaluation increased the fair value of the fixed assets on the 2005 consolidate balance sheet of the ministry by 762.7 million kroons.

It was also discovered that the internal audit system does not ensure preservation of the assets in some institutions in the area of government. There were some cases where inventories were not taken or accounting data had not been adjusted according to inventory data; some fixed asset items were not recorded in accounting, etc.

The NAO discovered in the course of the audit that some assets subject to registration in the state assets register had not been registered; some written-off or transferred assets were not deleted from the register. This does not enable getting reliable information from the state assets register and does not ensure efficient use and monitoring of preservation of the state assets. In some cases, financial lease contracts were concluded that conflict with the State Budget Act, and loans were taken under the cover of factoring contracts.

In the assessment of the NAO, the level of accounting in the area of government of the Ministry of Culture has improved in 2005 compared with the preceding year. In order to eliminate the shortcomings, the NAO recommended the Minister of Culture improve the internal audit system and demand adherence to the established procedures to ensure correct accounting of the assets, and order the data in the state assets register.

There were shortcomings associated with the construction of Kumu Art Museum

The objective of the audit of 'Economic activities of the Foundation for Building the Art Museum' was to assess the economic activities of the Foundation in 2001-2005, as well as to establish the cost of building the museum and the reasons for its growth compared to the estimated cost.

The growth in the construction cost of the Art Museum of Estonia when compared to the initially estimated cost was 264 million kroons and 77.7 million kroons after awarding of the contract for services. The final cost of the building was 864 million kroons.[18] The cost of the new building of the Art Museum increased due to the construction of the tunnel, a slight shift in the initially planned location, modifications to the project, additional architectural solutions, additional works, several changes regarding building materials and furniture, and a great number of commissioned expert opinions. The Foundations has commissioned expert opinions on the circumstances of the rise in the cost of the building and the Supervisory Board of the Foundation has accepted the growth. Therefore, the NAO had no reason to doubt that the growth in the cost was unjustified.

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[18] Including all expenses associated with the construction, furnishing and financing (both capitalised and period expenses)

However, the changes in the scope of some works that caused the increased cost were not sufficiently documented and in some cases, the Management Board of the Foundation was not active enough to find opportunities for saving.

In most cases, public procurements were organised in the prescribed manner. At the same time, it became evident that in some cases, public procurements were not organised (e.g., for finding the organiser of asset sales, contracting for additional preparatory works of the construction, etc.).

Although pursuant to its articles of association, the Foundation may use its revenues and assets only to reach the objectives specified in the articles of association, it had incurred the expenses that should have been incurred by the Art Museum several times. The audit identified such expenses in the amount of 2.83 million kroons.

Deficiencies were detected in awarding the contracts for employment and service, and calculating remuneration on the basis of these contracts, as well as registration of assets.

The Minister of Culture notified that the Supervisory Board of the Foundation will take into account the proposals made in the audit report in the future. A member of the Management Board of the Foundation notified that the work on improving the internal audit system has begun.

Rental contracts of Estonian Television should be reviewed and the management of remunerations should be improved

The audit of 'Economic activities of Estonian Television' indicated that Estonian Television (ETV) has not used all the possibilities of earning the maximum income from granting use of their premises. The NAO finds that the rent is low, particularly considering that in most cases it included utility and other costs. Contractual opportunities to increase the rent charged from the lessees have not been used. It was also established that purchasing supplies and outsourcing requires better coordination between the structural units of ETV in order to get an adequate overview of the need for supplies and outsourcing. Thereafter it will be possible to organise open tendering procedures in order to ensure sustainable use of funds.

Another conclusion was that the organisation of remuneration of the employees of ETV needs reviewing in order to ensure justified and transparent use of the money allocated for remuneration. Remuneration rules had been established, but were not followed in some instances.

The action plan prepared by the Broadcasting Council and the Management Board of ETV after the audit requires to amend the rules for possession, usage and disposal of the assets of ETV in order to specify the principles for renting the assets; review the existing rental contracts and implement measures to change these contracts; prepare a procurement plan and establish new remuneration rules.

Major deficiencies were discovered in the internal audit system of the National Library of Estonia

As a result of the audit of 'Economic activities of the National Library of Estonia', the NAO found that the system of income collection and accounting of the Library needs refinement. All the options for maximising the income had not been used, because the lease rates of the premises were low and did not correspond to the market prices for the city centre area; in most cases, the lease rates also included the constantly increasing utility services, power supply, surveillance and cleaning charges.

It was also discovered that the internal audit system for asset accounting included several shortcomings, which is why there were occasions of unregistered fixed assets, while some assets recorded as fixed assets were already out of use and fully depreciated. There is a need to develop and enforce a unified and comprehensive procedure for recording publications, tracking their movement and keeping relevant records in order to ensure the preservation of the publications.

The NAO also noted that the internal audit system for cash and bank transactions was weak and insufficient, generating a risk of accidental or deliberate errors.

The audit report was discussed at a meeting of the Supervisory Council of the National Library. The Director General of the National Library notified the NAO of the measures planned for the refinement of the internal audit system.

6.6. Ministry of Economic Affairs and Communications

Accounting of fixed assets is a problem in accounting

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Economic Affairs and Communications for the purpose of assessment of the consolidated annual report 2005 of the state' revealed several deficiencies in the accounting of fixed assets. There were some assets, which were not recorded as fixed assets and some errors from the previous years were discovered. For example, some low-value assets of the Railway Inspectorate were recorded as fixed assets, and the internal auditors of the ministry highlighted shortcomings in the organisation of annual inventories in several institutions.

It was also discovered that some assets subject to registration in the state assets register had not been registered, some written-off or transferred assets were not deleted from the register, and the register did not record the fair value resulting from the revaluation of fixed assets. This did not enable getting reliable information from the state assets register and did not ensure efficient use and monitoring of preservation of the state assets. Further deficiencies were discovered in the organisation of revaluation of fixed assets. For example, the committees of some institutions administered by the Road Administration did not apply the established methodology consistently, which is why the value of national roads was estimated 33 million kroons lower than the actual value.

Based on the above observation, the NAO recommended the Minister of Economic Affairs and Communications ensure the accuracy of data in the state assets register and impose an obligation on the Road Administration to supervise the organisation and accuracy of accounting in its subordinate institutions.

Funds allocated for road maintenance are not sufficient for maintaining the roads

In the end of 2005, the state owned 16,470 km of roads (i.e., 29% of all Estonian roads), valued at 14.13 billion kroons. The Road Administration responsible for road maintenance spent in 2005 more than 400 million kroons for that purpose. Two thirds of the national roads are maintained by private companies under contracts concluded with the regional road offices, and a third is maintained by the employees of the road offices themselves.

The NAO organised an audit of 'Organisation and maintenance of national roads', auditing also the requirements included in the contracts for the road maintenance services and supervision of compliance with these requirements, and reached the conclusion that the state cannot require from the companies maintaining the roads preservation of the roads in a condition that complies with the requirements for national roads. It was discovered that all roads given to maintenance (particularly secondary roads that comprise three fourths of the roads of the country) cannot be preserved only through maintenance – the roads should at first undergo repairs. However, the funds allocated for that purpose over the years have been insufficient. The government has approved the road maintenance plan for 2006-2009 that provisions significant increase in expenditures on both the repair and maintenance of roads.

Service charges collected by the state are insufficient for making the investments necessary to ensure safe navigation

Pursuant to the Maritime Safety Act, the state is responsible for maintaining the public waterways. For this reason, the ships entering the ports are required to pay lighthouse and navigation dues to the state. The amount of such dues collected by the Maritime Administration in 2005 was 137.3 million kroons. The NAO audit of 'Activities of the Maritime Administration in collecting lighthouse and navigation dues and organising procurements' indicated that the current tariff rates established by law are insufficient to cover the expenditures necessary in the coming years to ensure safety of navigation (incl. procurement of crucial ice breakers for the state). If the state would raise the tariffs, the ports could be forced to reduce the port dues, i.e., their own income, in order to retain their competitiveness. The NAO stated that the state as the shareholder of the company that owns Estonia's largest port has not sufficiently analysed the potential impact of the increase or decrease in port dues on the ports and the economy of the state.

The targeted share of bio-fuels was not achieved and no responsible authority appointed

In the end of 2004, the Parliament set the objective to achieve in 2005 a share of 2% of bio-fuels in vehicle fuels and by 2010 a share of 5.75%. Reducing the share of oil products does not have merely economical or environmental protection implications, but also serves an economic policy objective, as the establishment of a new type of fuel increases the security of supply. Increasing the share of bio-fuels is a priority on the EU level as well.

As a result of the audit of 'Handling of issues related to rape and bio-diesel fuel by the Government', the NAO stated that the objective for 2005 was not achieved with regard to the use of bio-fuels in transportation. None of the filling stations in Estonia was selling bio-fuels in the end of 2005. Bio-fuels have been exempted from excise duty, but this slightly lower cost is for most car owners not a sufficient reason to replace their vehicle with another one suitable for using such fuels, or to modify their vehicles accordingly. Additional state measures are required to persuade government agencies and persons benefiting from government support for transport to prefer vehicles propelled by bio-fuels and carriers using such fuels. None of the ministries has found that it has the responsibility to take respective initiative and start working towards the achievement of the objective set by the Parliament.

6.7. Ministry of Agriculture

Accounting is most problematic in ARIB

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Agriculture for the purpose of assessment of the consolidated annual report 2005 of the state' indicated that claims in the amount of 1,032 million and liabilities in the amount of 616 million kroons of the Agricultural Registers and Information Board (ARIB), recorded in the annual accounts 2005 of the ministry, had not been inventoried as on 31 December 2005. Therefore, the NAO lacked assurance that these balances have been recorded comprehensively and with accurate values in the annual accounts of the ministry. The accounting in ARIB is dissipated between several structural units and the Director General had not appointed a person responsible for the accounting in the institution. The accounting records of the Board were maintained in several non-compliant software applications, creating a potential for errors. The ministry completed additional procedures in July 2006, but the NAO has not evaluated the reliability of these procedures.

Like in previous years, the Ministry of Agriculture and its subordinate institutions permitted the use of state assets under unfavourable conditions and public procurements were not organised on some occasions.

For a second year in a row, the NAO pointed out the fact that the Ministry of Agriculture and the Ministry of Finance have not included in their annual accounts the obligation to pay 715 million kroons to the budget of the European Union. This obligation was created in 2005 when the European Commission required from Estonia the payment of charges for surplus stock located in Estonia at the moment of accession to the European Union.

AS Werol Tehased was brought to the brink of bankruptcy

98% of the shares of AS Werol Tehased were owned by the state and managed by the Ministry of Agriculture. The NAO audit of ‘Handling of issues related to rape and bio-diesel fuel by the Government in 2004’ indicated that when the manager of the company developed and started to implement ambitious expansion plans, the ministry did not request the Supervisory Board of the company to exercise stricter control over the activities of the manager. The Supervisory Board also failed to do so at its own initiative. As a result of management errors, the company ended the financial year 2004/2005 with a loss of 42.4 million kroons. The related financial problems took the company to a situation nearing bankruptcy by the beginning of 2006.

6.8. Ministry of Finance

Accounting has improved

The purpose of the ‘Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Finance for the purpose of assessment of the consolidated annual report 2005 of the state’ was to assess the indicators in the annual accounts of the Ministry of Finance important from the viewpoint of the consolidated annual report of the state and the legality of transactions behind these indicators.

Similarly to the previous year, the NAO commented on the fact that neither the Ministry of Agriculture nor the Ministry of Finance have recorded in their annual accounts the obligation to pay 715 million kroons to the budget of the European Union for surplus stock. The NAO also found that the budget revenue and expenditure statement included in the annual accounts is not comprehensive, because the budget revenue and expenditure statement of the ministry only includes the expenditures arising from the 2005 State Budget and Supplementary State Budget Acts and does not include, for example, the money allocated to the Ministry of Finance from the reserve of the Government of the Republic and the money transferred to the 2005 budget from the year 2004. The NAO found that the audited transactions had been made in compliance with the main legislation regulating them and recorded accurately in accounting.

In his response to the NAO, the Minister of Finance concurred with the proposals of the NAO and described the activities for the implementation of the proposals.

Organisation of tax audits can be improved in various areas

The NAO found in the audit of ‘Organisation of tax audits’ that frequent exceeding of the deadlines of tax audits and audits of single cases and poor performance of the audits indicate that the tax authority does not always organise the procedures with sufficient speed and effectiveness. The major conclusions of the NAO regarding the planning of tax audits were the following:

- General planning of the auditing activities of the tax authority has enabled to set sufficiently good audit objectives for individual projects. In the assessment of the NAO, this has improved the overview of the objectives and results of audits.

- Central auditing samples are designed on the basis of too general criteria, without paying sufficient attention to the specific characteristics of different economic sectors and regions. There are no specific and updated data on the taxable persons (such as differentiation between the core and auxiliary business of a taxable person, determination of the business seat of a person), which would be necessary for the preparation of risk analyses and audit samples. The use and efficiency of created samples is not systematically analysed after auditing. In the assessment of the NAO, these circumstances have prevented a more efficient selection of objects.

- The preliminary analysis of central audit samples in regional information authorities is poorly organised (responsibilities, use of local information, etc.). This is also related to the poor usability of the preliminary information added to the audit sample by the central authority. In the assessment of the NAO, these circumstances have prevented a more efficient use of central samples in auditing.

The major conclusions of the NAO regarding the performance of tax audits were the following:

- The audit files often lack the mandatory additions, incl. the audit plan as the main planning document. In the assessment of the NAO, this is an indication of poor preparation for auditing. The NAO found that an average of at least 71 tax audits and audits of single cases – i.e., 11% of the potential total number – remain uncompleted in each year due to insufficient time planning.

- The documents included in the audit files do not provide an overview of the operating procedures of the tax auditor. In the assessment of the NAO, limited documentation complicates achievement of a uniform quality level of the audits.

As a result of the audit, the NAO made proposals to the Director General of the Tax and Customs Board to ensure better planning and efficiency of tax audits, and implementation of a quality management system. The reply of the Director General of the Board includes an action plan for the implementation of the proposals of the NAO.

Accreditation audits of implementation of the EU assistance have improved

The NAO audit of 'The activity of the Ministry of Finance in accrediting the Intermediate Bodies and Final Beneficiaries' was designed to assess whether the control measure of the Ministry of Finance – accreditation of the internal audit systems of the Intermediate Bodies and Final Beneficiaries – takes into account the requirements specified in the EU legislation and whether the activities themselves have been carried out accurately. During the programme period 2004-2006, a Member State can decide whether to accredit the relevant agencies prior to the implementation of support funds, the evaluation of management and audit systems will be mandatory in the next programme period 2007-2013 according to the Council's draft of the general regulation on the structural assistance.

In the opinion of the NAO, the criteria used as the basis of accreditation comply in principal aspects with the requirements for the management and audit system as specified in the legislation of the EU and the Ministry of Finance has created preconditions for implementation of accreditation as a control measure.

The NAO found that the quality of the accreditation audits of the Ministry of Finance has improved. While the documenting of the accreditation audits before the autumn 2004 did not comply with international audit standards, the audits conducted after autumn 2004, when the Financial Control Department had updated the auditing methodology, were generally compliant with the requirements specified in international audit standards.

The Ministry of Finance has not documented the formation process of accreditation decisions with sufficient degree of thoroughness. In addition to documenting, there were also problems with preservation of accreditation documents and the exchange of information between the parties involved in the accreditation. The NAO considers documentation and preservation of documents important because this enables the ministry justify its decisions subsequently if necessary and prove them with documents. Documentation and exchange of information also play and important role in the elimination of shortcomings discovered during accreditation audits.

The NAO believes that the importance of monitoring the accreditation audits and the elimination of discovered shortcomings is confirmed by the example of the Labour Market Board. During the accreditation audit of the Labour Market Board, the Financial Control Department of the Ministry of Finance pointed out that the document 'Draft procedure for processing ESF [European Social Fund] project applications' includes several vague provisions, such as the procedures for registration of documents and preservation of information, for the assessment of a project, selection of assessors and ensuring their independence. According to the explanations given to the NAO, the Foreign Financing Department of the Ministry of Finance believed that this observation does not affect accreditation and did not consider it necessary to require from the Labour Market Board elimination of deficiencies before the accreditation decision. The Foreign Financing Department has not documented the analysis behind this decision. It was discovered after accreditation of the Labour Market Board that the management and audit system included several deficiencies, the most serious being the generality of the procedures for the processing of structural assistance applications. After discovering these deficiencies, the Ministry of Finance had to suspend the payments to the projects of the Labour Market Board, Ministry of Social Affairs, Public Employment Service and the Unemployment Insurance Fund. By now, the rules have been specified.

6.9. Ministry of the Interior

Accounting has improved in the ministry but needs further refinement in the area of government

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of the Interior for the purpose of assessment of the consolidated annual report 2005 of the state' indicated that the level of accounting of audited transaction classes in the area of government of the Ministry of the Interior has improved compared with the previous year but it remains uneven and needs further improvement. There were also some problems with failure to organise public procurements for the purchase of products and services with the value exceeding the limit specified in the Public Procurement Act. This problem has been solved in 2006 by conducting central procurements.

In 2005, the Ministry of the Interior took important steps to implement the accrual method of accounting for the revenue and claims associated with fines and procedure expenses. In addition, queries are made in all regions to the POLIS software for recording the fines and procedure expenses. Nevertheless, there are still some problems with the estimation of the probability of payment, and the accurate recording of the fines imposed by one prefecture and paid to the bank account of another prefecture.

The audit did not gave the NAO a complete assurance that overtime work in the area of government of the Ministry of Finance is remunerated in compliance with the Wages Act. The working hours tables do not indicate that overtime work has been compensated by time off.

According to the NAO, the institutions in the area of government of the Ministry of the Interior have not recorded off-balance liabilities arising from lease contracts pursuant to common principles. Consequently, the report does not show the amount of potential off-balance liabilities as on 31 December 2005.

The analytical registers for recording the privatisation of land on deferred terms are incapable of issuing the information needed for accounting with sufficient degree of accuracy and reasonable time consumption. Different county governments use different evaluation criteria and methods for the preparation of the annual accounts. The use of different evaluation criteria and methods and different accounting environments may lead to errors in the accounting and reports of the county governments.

Waiting lists for forensic examination hinder the administration of justice

The NAO audit of 'Waiting lists for forensic examination' examined two national institutions that perform expert analyses – the Forensic Service Centre (FSC, area of government of the Ministry of the Interior) and the Bureau of Forensic Medicine of Estonia (BFME, area of government of the Ministry of Justice) – with regard to their ability to produce expert analyses within reasonable time. The NAO found in the audit that the demand for DNA and fingerprint examinations is bigger than the capacity of the forensic institutions to conduct them, which is why getting the analysis results takes unreasonably long time. Excessive length of the waiting lists for expert analyses reduces the total efficiency and reliability of the justice system, and increases the costs of administration of justice. Long proceedings are in direct opposition with the criminal policy objectives of the state.

For example, the demand for DNA examinations has multiplied by seven in the period 2002-2004. While all orders were still completed in 2002, less than a half of the ordered expert analyses were completed in 2003 and 2004. At end of 2005, the waiting list for DNA expert analyses in BFME was so long that completion of all analyses at the same level efficiency would have taken two years and four months on the condition that no more analyses were ordered after that.

The NAO found that only about 60% of the DNA and fingerprint examinations on the BFME waiting list are ‘active’. The criminal proceedings, which were the basis of other expert analysis orders on the waiting list, had been terminated or suspended. As the analysis orders were not cancelled and the national forensic institutions were not notified in due time, several analyses were completed, which were no longer required.

The quality of the examination rulings (including the objective of analysis) was poor, which in turn unnecessarily increased the burden on the experts. 2/3 of DNA and fingerprint examination rulings and 1/3 of the rulings of forensic medical examinations of the deceased contained errors. Almost half of the materials of fingerprint and DNA examinations were defective.

The results of the NAO audit provide substance for analysis also from the viewpoint of procedural economy. The analysis indicated that, considering the number of ordered DNA and fingerprint examinations, 25% or *ca* 1,850 examinations are associated with crimes in the second degree with the damage amounting to 2,000 kroons or less, which incidentally is also the average cost of a DNA and fingerprint examination. The NAO pointed out this fact in order to emphasise the need for the prosecutor conducting the proceedings to assess the necessity of ordering an expert analysis with greater care in a situation of long waiting lists.

The NAO submitted a number of proposals to the Minister of the Interior and the Minister of Justice, aiming to achieve parity between the volume of necessary examinations and the funds and human resources allocated for examination, as well as to improve the procedure for ordering the examinations. The Minister of Justice and the Minister of the Interior have started taking steps to implement the proposals of the NAO; among other things, a policy decision on merging the BFME and FSC has been made.

Measures implemented to prevent fires are insufficient

As Estonia is among the first in terms of the ratio of fire fatalities in the European Union, the NAO conducted an audit of ‘Fire prevention in residential buildings’. For example, in 2005, there were 10,614 fires in Estonia and 9.9 persons per 100,000 people died in fire, while the respective number in Finland was six times less. The number of fires per 1,000 people was 2.5 in Finland, 7.9 in Estonia, 3.8 in Latvia and 4.4 in Lithuania. The number of fire fatalities per 100,000 people was 10.2 in Latvia and 8.4 in Lithuania. More than 700 persons have been killed by fire in Estonia during last five years. Compared to the persons killed in traffic accidents, the number of is almost the same. The NAO audited the efficiency of the two main measures of fire prevention in the rescue service – shaping fire-safe behaviour and ensuring the adherence to fire safety requirements.

The NAO found that regrettably little work has been done to ensure fire safety of residential buildings, prevent fires and change the indifferent attitude of the people, even though fighting the causes of fires would be much better for reducing the damage than fighting the consequent fires themselves. The preventive measures that have justified themselves elsewhere in the world have not been implemented enough in Estonia. For example, the schools do not provide children with sufficient knowledge of fire prevention in everyday life.

Effective national supervision is important in preventing fires and that includes establishment of reasonable requirements for residential premises and ensuring actual compliance with these requirements through substitutive enforcement or punishment in the case of non-compliance. The NAO believes that supervision of fire safety of residential premises is insufficient, because more than 82% of the fire fatalities occur in residential buildings. In Estonia, the requirement to install a smoke alarm in the existing habitation areas will become effective only on 1 July 2009. 52 % of the people interviewed by the NAO do not protect their home with smoke detectors, fire extinguishers, fire blankets or fireproof doors. In Finland, smoke alarms have been installed in 98% of homes.

The NAO submitted proposals for solving these problems to the Minister of Economic Affairs and Communications and the Minister of the Interior.

Collection of instalments for privatised land is not secured and management of claims is expensive

By the end of 2005, the accounting records of the county governments included land purchase instalment claims in the total amount of 2.2 billion kroons, including 109.3 million recorded as uncollectible claims. In 2005, the performance of land instalment claims created 347.5 million kroons of revenue for the State Treasury; in addition, new deferred payment contracts were concluded with the total value over 400 million kroons. According to the State Treasury, nearly 7 million kroons were spent on the management of land instalment claims in 2005. All county governments employ at least one person who manages the land instalment claims.

Payments for land privatised in the course of the land reform may be deferred for up to 50 years, and the persons privatising have access to several benefits. Interest is calculated on the amount payable in one year and not the total amount of debt as usual. Consequently, the use of deferred payment is much more advantageous than a bank loan. Privatised land can be resold and the purchase debt can be transferred to the new owner under concessionary terms, subject to the approval of the county governor. Having noticed problems with the recording of land instalments in the accounting of county governments and difficulties in ensuring collection of payments within the schedule, the NAO organised an audit of 'Recording and securing the collection of the land instalment claims' in order to clarify the extent and reasons of the problems.

The audit indicated that the information technological databases of the county governments do not support management of instalment claims and, therefore, do not ensure the collection of the amounts payable. Claims to make the delayed payment have often not been submitted immediately, but in the case of possible bankruptcy of the debtor this could create a risk that the state will be unable to collect the amount payable. Cancellation of the privatisation contracts due to delayed payments and compulsory execution of the instalment claims by way of selling the land as a security are both complicated for several reasons. In practice, the claims that have not been paid on time are simply left to grow.

Generally, the new owner of the land that has been resold is permitted to continue the payment to the state in instalments instead of requiring the owner to pay the total redemption price immediately. However, the price of the land has multiplied and the amount of the instalment debt is small compared to the purchase price of the land. The law does not establish sufficiently clear guidelines for the county governors in protecting the interests of the state when privatised land is resold. The law could be interpreted as stipulating that the county governor has the right to refuse continuation of payment by instalments only in certain restricted cases, but an opposing interpretation is also possible. The practice of the county governments has been variable.

In 2003, the NAO organised an audit of 'Risks related to the privatisation of public land on deferred terms' and the resulting proposals were submitted to the Minister of Finance and the Minister of the

Environment. Many of the problems highlighted have not been solved within the past three years; as far as the NAO is aware, the sale of privatisation debt claims has never been seriously considered. In the assessment of the NAO, legislative amendments to the Land Reform Act should be considered to stipulate that the full redemption price should be paid to the state at once. The NAO considers it reasonable to specify in the Land Reform Tax detailed bases for cancellation of the contracts.

6.10. Ministry of Social Affairs

Accounting has improved but the quality is uneven in different institutions

'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Social Affairs for the purpose of assessment of the consolidated annual report 2005 of the state' indicated that 35 state asset objects of the ministry and seven subsidiary institutions were revaluated with their fair value as on 31 December 2005 in the course of the revaluation of state assets managed by the Ministry of Social Affairs. The revaluation increased the fair value of the fixed assets of the ministry by *ca* 177.3 million kroons. However, one building in Tallinn city centre was not revaluated. The fair value of this building is significantly higher than the current residual value on the balance sheet and, therefore, the NAO is not assured that the recorded value of the fixed assets managed by the ministry is fair.

The NAO discovered in the course of the audit that some assets subject to registration in the state assets register had not been registered; some written-off or transferred assets were not deleted from the register. This did not enable getting reliable information from the state assets register and did not ensure efficient use and monitoring of preservation of the state assets.

The Ministry of Social Affairs and the institutions administered by the ministry have not taken all necessary steps to depreciate fully any fixed assets that have become unusable. The institutions in the area of government had some deficiencies in the organisation of inventories. Deficiencies were also discovered in the documentation of inventories. For example, the final inventory statements did not list physically worn and outmoded unusable fixed assets, which were no longer in use.

The institutions in the area of government of the Ministry of Social Affairs did not always comply with the requirements of the Public Procurement Act. For example, they did not invite tenders from three tenderers, did not submit contract award notices or submitted them much later than required by law. Some assets had been acquired under financial lease contracts, which conflicts with the State Budget Act.

In order to eliminate the shortcomings, the NAO recommended the Minister of Social Affairs apply additional measures to ensure recording of the state assets in the area of government of the ministry with their fair value, order the data in the state assets register, provide training on financial management, organisation of accounting, Public Procurement Act, conclusion of contract and other topics to the heads of the institutions in the area of government, and increase the responsibility of the heads of the institutions in the organisation of economic activities.

Proprietary background of the beneficiaries was not always checked when paying subsistence benefits

As a result of the audit of 'The use of money allocated from state budget to local governments for paying subsistence benefits', the NAO concluded that despite the amendments to the Social Welfare Act that took effect in the beginning of 2005, the payment of subsistence benefits is still too unstable and partly uncontrollable. The conditions laid down in the law still enable different interpretations in the planning of the amounts necessary for benefits and allow discretionary decisions in the granting of benefits. It is ambiguous which revenue and expenditure must be regarded in the granting of subsistence benefits.

In the recent years, the amount of money planned in the state budget for subsistence benefits has always been approximately 20 % higher than the amount that is being used later. The subsistence level that remained unchanged for eight years was raised at the beginning of 2005, but until today, it has not been bound to the minimum means of subsistence, although according to the law, the minimum consumption expenditure to satisfy the primary needs (food, clothing, footwear, and other goods and services) must be taken into account when establishing the subsistence level. At the moment, the subsistence level covers only the cost of the minimum food basket for the first family member.

Subsistence benefits are paid by local governments. The audit revealed that the granting and paying of subsistence benefits in local governments has been organised differently.

The NAO found that the existing audit systems do not ensure that the subsistence benefits are being paid only to those in need. The beneficiaries in the sample had often not informed the social workers of their incomes, which caused the payment of the benefit on the basis of incorrect data. The incorrectly paid amounts formed 4.6% of the audited benefits. Proprietary situation of families was also not taken into account when granting the benefits, although local governments are entitled to do that. Thus, many persons owning several real estates, vehicles or land received the benefit. The granting and paying of subsistence benefits to such persons/families became possible only because the social workers did not verify the data on the persons from the Tax and Customs Board database, traffic register or land register.

As a result of the audit, the NAO proposed the Minister of Social Affairs to budget in the future in cooperation with the Minister of Finance the funds for the subsistence benefits on the basis of actual need and to correlate the subsistence level with statistical indicators. The NAO also made in its report further proposals, which would facilitate the granting of benefits and strengthen the control system.

Internal audit systems in the payment of the parental benefit can be improved

During the audit of ‘Organisation of payment of the parental benefit’, the NAO did not find that the parental benefit had been allocated incorrectly, but it did find several shortcomings in the system.

During the period of receiving the parental benefit, persons earning income did not notify the Pension Board thereof, as a result of which the benefits paid exceeded the permitted level and had to be reclaimed later. Although the law obligates the beneficiaries of the parental benefit to notify the Pension Board of any and all circumstances pertaining to the payment of the benefit and the size thereof, they often failed to do so.

The data about earning income, which is subject to social tax, moved from the registers of the Tax and Customs Board to the pension register with a delay of several months. During the audit, the NAO found several instances where the beneficiary had earned higher income than permitted, but the respective data had not reached the Pension Board yet. Therefore, the Pension Boards could not start making the reclamations in due time. Since the data on income earned reached the Pension Boards late, the payment of the parental benefit was often already over and the overpaid benefit could not be withheld from future payments under an agreement with the beneficiary, but had to be reclaimed from the beneficiary.

The NAO also found that the agreements for the repayment of the benefit were concluded for a surprisingly long period. The NAO does not consider it right that the repayment term is up to ten times longer than the period of benefit. The current regulation does not establish any limits to the repayment term stipulated in the repayment agreement. The Social Insurance Board has notified after the audit that the terms of repayment of overpaid benefits have been shortened to 6-8 months on the average.

6.11. Ministry of Foreign Affairs

Accounting in the ministry and foreign representations is at a good level

In the assessment of the NAO, the organisation of accounting and procedures for collection and recording of state fees are at a good level in the Ministry of Foreign Affairs and the audited foreign representations (Embassy in Brussels and Permanent Representation of Estonia to the EU).[19] The NAO discovered no significant shortcomings in the internal audit system for the implementation of Schengen assistance. The Ministry of Foreign Affairs has implemented most of the proposals made by the NAO in the last year.

In respect of legality of transactions, the NAO made a remark on tax accounting. The Ministry of Foreign Affairs has not recognised as fringe benefits the compensation for the cost related to the participation of its employees in receptions, business lunches and other events.[20] According to the explanations of the ministry, the representative events are regarded as principal activity and the participation of the employees in these events as belonging to their professional duties, which is why the said expenses are not subject to fringe benefit tax. The 2005 budget of representation expenses of the Ministry of Foreign Affairs was 17 million kroons. The NAO agrees that the nature of the activities of the Ministry of Foreign Agrees requires participation of its employees in receptions, business lunches and other events, but in the assessment of the NAO, the current legislation does not provide for any basis for the Ministry of Foreign Affairs to refrain from calculation and payment of the fringe benefit tax. In his response to the NAO, the Minister of Foreign Affairs agreed with the proposals of the NAO and explained that the ministry has prepared a draft to specify the Income Tax Act.

Deficiencies in the implementation of public procurements are repeating

As a result of the audit of 'Implementation of public procurement in the ministry of foreign Affairs', the NAO found that most of the public procurements have been implemented by the ministry in compliance with the requirements of the Public Procurement Act and the public procurement organisation procedure laid down by the Secretary General of the Ministry of Foreign Affairs. However, the NAO found some deficiencies that repeat year after year.

For example, no tendering procedure was organised for several procurements: technically single public procurement (purchase of telephone exchanges and telephone sets) was implemented in two parts, the value of both parts remained below public procurement limit, and thus no open or restricted tender procedure was organised, because individual procurements could not be aggregated into a single procurement; no tendering procedure was organised for the procurement of electronic communication service for the embassy and consular representation. The implementation of several procurements has not been carried out with required diligence: the requirements of the procurement contract (design project of reconstruction work and supervision service provided by the author) did not comply with the requirements laid down in the invitation to tender documents and in the successful tender; procurement contract for consulting services (preparation of the documents of reconstruction work and public procurement) was concluded ex post facto after partial provision of the service, although the successful tender had been submitted four months earlier. The Minister of Foreign Affairs considered the proposals made by the NAO appropriate and proposed a plan of action for the implementation of the proposals.

6.12. State Chancellery

Organisation of accounting is at a good level

[19] 'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the Ministry of Foreign Affairs for the purpose of assessment of the consolidated annual report 2005 of the state', 'Organisation of accounting and legality of transactions of the Estonian Embassy in Brussels and the Permanent Representation of the Republic of Estonia to the EU'

[20] Income Tax Act, § 48

The purpose of the 'Audit of the accuracy of the annual accounts 2005 and the legality of the transactions of the State Chancellery for the purpose of assessment of the consolidated annual report 2005 of the state' was to assess the indicators in the annual accounts of the State Chancellery important from the viewpoint of the consolidated annual report of the state and the legality of transactions behind these indicators. The important transaction class in the State Chancellery from the point of view of the state's annual report included fixed assets. In addition to the said transaction class, the NAO also audited appropriations of the European Union. In the assessment of the NAO, the accounting has been organised at a good level in respect of the audited areas.

The State Chancellery had acquired assets under financial lease contracts, which is conflict with the State Budget Act.

The NAO proposed the State Secretary to improve the management and audit systems for the implementation of measure 1.4 of the Estonian National Development plan to ensure purposeful and proper use of the assistance, and recommended amending the directive for the establishment of the working group and the procedures of the working group in such manner as to avoid conflict with the Structural Assistance Act and to define clearly the tasks and responsibility of the working group and experts. The NAO recommended that the audits required by the Structural Assistance Act should be organised by the Internal Audit Department, and a monitoring plan should be prepared and approved.

In his reply, the State Secretary provided additional explanations to the observations in the draft audit report and described the activities planned for the implementation of the proposals of the NAO.

6.13. Miscellaneous

Organisation of accounting in constitutional institutions is at a good level

Pursuant to the State Budget Act, the NAO audited the accuracy of the annual accounts 2005 and the legality of the transactions of the Supreme Court, the Office of the Chancellor of Justice, the Chancellery of the Parliament and the Office of the President of the Republic. For the most part, the earlier proposals of the NAO relating to the improvement of accounting and internal audit system have been implemented.

Similarly to previous years, the Chancellery of the Parliament had rented without charge to its own employees the residential premises not required for principal activities. When assessing the legality of the transactions, the NAO found that some leasing contracts were audited, which could be regarded as financial lease contracts (primarily for the acquisition of cars and office equipment). The use financial lease conflicts with the State Budget Act. There were instances of failure to organise public procurements in the Chancellery of the Parliament and the Office of the President of the Republic.

European Commission support project failed and Sonda Commune has to repay the money

In the audit of 'HASCO project of the European Commission in the Commune of Sonda' the NAO focused on the review and analysis of the activities and documents of the assistance project 'Oil Shale Semi-Coke Processing Into Soil Improver, Soil Improver Used to Stabilise Slurry and Restore Damaged Soils for Foresting mainly with Hybrid Aspen' (hereinafter 'HASCO project') funded by the European Commission.

The European Commission approved the project, which was financed out of the Financial Instrument for the Environment (LIFE), on 2 August 2002. According to the project plan, the total cost of the project was 55.5 million kroons of which 19.9 million was to be contributed by the European Commission. The European Commission made a payment of 505,994 euros (7.9 million kroons) for commencing the implementation of the project. In addition to the said amount, Sonda Commune contracted a loan in the amount of 3.8 million kroons from the Environmental Investment Centre as short-term funding for the co-financing of the Commune. The European Commission terminated the

HASCO project on 23 February 2005, because the Commission could not verify, which results had been achieved upon implementation of the project, and notified of the claim for repayment of the money.

According to the assessment of the NAO, the project failure was caused by the following reasons:

- The supervision of the activities of the Sonda Commune Government by the Sonda Commune council was insufficient, because the council did not demand the submission of the project to the council and did not pay sufficient attention to the implementation of the project and the problems highlighted in the memorandum of the Commune auditor.

- Project management was insufficient: the project management work groups did not do any real work; the financial resources and expert knowledge of some partners involved in the project were not suitable for achievement of the project goals; expenditures were not in compliance with the project budget; there was no control over the performance of tasks.

- The report submitted to the European Commission on 17 December 2004, in which the Commune claimed that most of the project goals have been achieved, was deficient. The results of the project as presented in the report were not confirmed by source documents; the report indicated expenditures that had not been made or had not been supplied with evidence.

Consequently, the demands of the European Commission were justified in the assessment of the NAO, because Sonda Commune had violated the assistance rules: they did not submit the required reports; they did not prevent a conflict of interests; they did not conclude proper agreements with the partners; and they did not preserve the documents proving the implementation of the project.

The failure of the HASCO project has created a situation where the obligations taken in the framework of the assistance project constitute the main part of the annual budget of the Commune and it is, therefore, unlikely that the Commune would be able to repay the funds. It is unclear at the moment who would perform these obligations in such case. In addition, the Government of the Republic has currently proposed no solutions on how to prevent local government units from getting solvency problems, what to do in respect of the local governments that are in difficult financial situation and how to supervise the financial situation of the local governments.

The NAO made a proposal to the Sonda Commune to prepare an action plan for the performance of the obligations and submit it to the council of the Commune for approval, and to the Minister of Finance to speed up the submission to the Parliament of the draft acts regulating the financial management and resolution of the insolvency of local authorities drafted by the ministry.

In the reply to the draft audit report of the NAO, the Mayor of Sonda Commune agreed with the suggestions of the NAO. In his reply, the Minister of Finance promised to submit the draft acts regulating the financial management and resolution of insolvency of local authorities to the government by October 1 this year. The Minister of the Environment found that the observations included in the report could be taken into account in the future when updating and developing procedures for the implementation of the structural funds.

7. Economic Activities of Local Governments

Observations of the NAO on the problems in the local government units are based both on the observations from the first audits of the local governments and the information on the field collected so far. As the number of audits is currently relatively small[21], the conclusions cannot be extended to all local governments. However, it is enough to state that additional external control over the economic activities of the local governments is necessary.

Internal audit systems need significant improvement

According to the initial observations of the NAO, smaller local government units lack an efficient internal audit system. The NAO regards as parts of the internal audit system of the local government primarily the activities of the internal audit committee; publication of information pursuant to the Local Government Organisation Act and the Public Information Act; existence and relevance of the norms regulating work procedures (internal procedure rules, internal accounting rules, instruments governing the drafting and implementation of budget, procedures regulating the management of assets, etc.); existence and relevance of job descriptions; efficient document management and regular conduct of inventories.

The role of audit committees was mostly formal

The Local Government Organisation Act stipulates that the council should form an internal audit committee to supervise the activities of the local government unit as a part of the internal audit system. According to the observations of the NAO, the audit committees failed in several instances to achieve the objective specified by the law and their role remained mostly formal. This is caused primarily by the lack of necessary competence and experience in the members of the council, but also by the reluctance to make the audit committee work efficiently. For example, the members of the opposition parties in the council, who would be more interested in highlighting the problems, were not nominated members of the committee.

Procedures established by local government were not followed

The Local Government Organisation Act stipulates that the council is competent to adopt several procedures governing the activities of local government (procedure for granting support and providing services paid for from the budget of the city or Commune, procedure for managing the assets of the Commune or the city, procedure for the use and disposal of the reserve fund), as well as the procedures governing the administration of the local government units in compliance with the general administrative procedures (internal procedure rules, operations procedure, etc.).

According to the observations of the NAO, the described procedures had not been updated in local governments, which is why they are not relevant in the current legal and economic environment. There were also important deficiencies in the observance of the established procedures by the local governments. As a result, the heads of different local government authorities have exceeded the limits of their competence, have used public funds in a non-purposeful and non-transparent manner, and have been impractical in the management of assets. The responsibility of these managers has become ambiguous and there is no overview of the assets, rights and obligations of local government.

Necessary asset records were not kept

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[21] Structure of internal audit system, organisation of accounting (incl. disclosure of financial information) and legality of transactions in Saare Commune in 2004 and 2005;
Structure of internal audit system, organisation of accounting (incl. disclosure of financial information) and legality of transactions in Vormsi Commune in 2004 and 2005;
Structure of internal audit system, organisation of accounting (incl. disclosure of financial information) and legality of transactions in Rakke Commune in 2004 and 2005

The audited local governments lacked a comprehensive overview of their assets and the value of these assets. The accounting of fixed assets and recording of transactions related to the fixed assets were not at the required quality level. According to the observations of the NAO, local government units still have assets, which have not been recorded, fixed assets have not been revaluated, assets have been incorrectly classified, assets are not inventoried with sufficient frequency and thoroughness, which is why the financial reports of the local government units do not reflect the actual status and value of the assets.

Problems were observed in drafting and following the budget

Pursuant to the Local Government Organisation Act, the council is solely competent to adopt and amend the Commune budget, approve the annual report and nominate and auditor. The budget of a local government unit is drafted pursuant to the procedure provided for by the law, taking into account the local development plan. According to the Commune and City Budgets Act, the Commune Government shall organise the implementation of the budget pursuant to the procedure established by the council.

The quality level of budgeting in the local government units was not good. The draft budgets were often submitted without letters of explanations and the adopted budgets were very general. This complicates significantly the monitoring of implementation of the budget and contributes to the non-purposeful use of public funds. The budgeted funds were not used only for their intended purpose and the budget was not amended if the funding needs changed. In addition, supplementary budgets were not adopted for expenses for which the budgets did not allocate any funds or which were under-financed by the budget, i.e., the values of the contracts concluded exceeded the budgeted amounts.

Local governments need to be monitored from the state level as well

Assessment of the consolidated financial reports of all rural municipalities and cities indicates that the financial situation has improved in the last year. However, short-term assets do not exceed short-term liabilities. This indicates that local governments have not any reserve funds for possible difficult periods. A cause for precaution is the fact that local governments have actively contracted loans and increased their long-term loan obligations by a total of 0.5 billion kroons in one year. The continuous growth of the loan burden of the foundations, companies and other institutions governed by the local governments needs monitoring as well.

The NAO points out that the current practice has indicated that when a local government has assumed obligations that exceed their capacity, the state will be forced later to support the local governments with solvency problems. Although the contracting of loans by the state and local government has been restricted by law to ensure a long-term budget balance and the resulting ability to perform the duties to the public, the NAO believes that the state as a whole needs to be attentive to prevent the public sector from assuming significant hidden obligations through foundations, companies and other institutions, which could become a long-term burden for the public sector.

8. Implementation of Proposals of the NAO

The NAO considers its main objective to contribute to the improvement of the state. Therefore, the NAO does not present to the Parliament only an annual list of problems, but makes also proposals to improve the situation. Even though these proposals are of recommendatory nature, the government has in each year presented its positions and promised to implement the proposals.

Only a few of the proposals made in the last years have been fully implemented. The best progress has been achieved in improving the financial reporting and accounting of the state. Implementation of other proposals has been very modest. The following overview is compiled on the basis of the proposals made in the previous annual audit reports of the NAO, which the government has accepted and promised to implement, but has not yet done so. All proposals mentioned remain topical in the assessment of the NAO.

State still lacks a real property policy

In order to gain more benefit from the investments in the buildings and prevent future losses from unused real property, the NAO proposed that the government should lay down a real property policy of the state, incl. the rights and obligations of different parties (the ministries, the Ministry of Finance, and Government Real Estate Ltd – "GRE") in its implementation. The government assigned to the Minister of Finance the task of supplementing the principles of the real property policy and the rights and obligations of the Ministry of Finance in the Government of the Republic Act. In addition, the government had already (7 October 2004) assigned the Minister of Finance the task of developing a new draft State Assets Act by 31 December 2006 and an action plan for the management of buildings by 12 November 2004. So far, the Ministry of Finance has not completed these tasks. The Government of the Republic has discussed the real property policy and the issues related to GRE on some occasions, but none of the proposals of the NAO has been implemented. In order to accelerate development, the Ministry of Finance assembled a work group for real property development strategy in August this year and it also includes specialists from outside the public sector.

The NAO also recommended the ministries identify the real estate objects (particularly office and residential premises), which are required for the principal operations of the state, and transfer the remaining premises. The government agreed to this proposal and assigned the ministers the task of compiling a list of transferable assets by the beginning of drafting period for the 2006 budget and transferring in 2006 the residential premises not required for service. Some ministries (such as the Ministry of Education and Research) compiled these lists and transferred unnecessary buildings, but some have not done so.

In order to simplify accounting and improve control over state assets, the NAO proposed that the state assets register should be brought up to date with the actual situation and that the public authorities should be required to enter all buildings, facilities and land (registered as cadastral units) in the land register within a couple of years. The buildings and facilities should be also entered in the register of construction works. The government undertook to order the state assets register by the end of 2005 and to include in the new State Assets Act the deadlines for entering data in the land register and the register of construction works. The draft State Assets Act has not yet been submitted to the government and, having audited the accounting records of the ministries, the NAO still discovered deficiencies in the data of the state assets register.

The NAO recommended establishment of guidelines for the size of and requirements for the work premises of public authorities, but this has not been done.

Limited progress has been made in the management of companies

In order to assess better the performance of the state in the management of companies with state participation, the NAO proposed to establish the objectives of participation and dividend expectations in the case of all companies with state participation, and to consider using more loan funds instead of the equity capital to finance investments.

The government decided that state's participation in a company is justified only if this creates significant monetary revenue for the state, the company is a natural monopoly, or the company performs public functions.[22] The government assigned the ministries the task to establish the objectives of participation in the companies by 31 May 2006 and to determine the optimal share of equity and external capital in the year 2009. The Minister of Finance was required to include in the new State Assets Act a separate provision on the establishment of the principles and procedures of state participation.

The NAO assessed the implementation of the said government decision by the Ministry of Economic Affairs and Communications and the Ministry of the Environment that manage 2/3 of the companies with state participation, using the 2006 reports on the participation in the companies from these ministries as a basis. The analysis indicates that the government decision has not been implemented. Both ministries asserted in their reports that the state should not surrender participation in the companies managed by them, but they did not mention any of the three predefined reasons for state's participation in these companies. The ministries believed that these prescribed reasons did not permit spelling out all the reasons of participation in companies. However, the submitted reports do not explain any other reasons or indicate which duties of the state are supported by the participation in the companies or which objectives have been set by the state for these companies.

Any more dividends from the companies with state participation cannot be expected either. An exception is AS Eesti Energia, which will pay 2.1 billion kroons of dividends to the state on the income from the CO2 emissions in the next three years. The Ministry of Economic Affairs and Communications and the Ministry of the Environment have set for the companies with state participation development goals, which lag behind the general economic growth, predicting the reduction in productivity of the funds invested in the companies in the period 2006-2008.[23] According to the reports of the ministries, the sales revenue of the companies where the state has majority participation increases annually on the average by 3.5%, which is a third less than the overall economic growth forecast of the Bank of Estonia. However, the predicted profit of the companies was expected to remain at the 2006 level. The state also plans not to withdraw 60% of the annual profit, so that the share of equity capital in the companies will increase. Consequently, the companies will continue to use mainly the funds of the owner, i.e., the state, to finance their investments, and will remain modest in using external capital.

The ministries predict that the increase in equity capital will exceed the increase in profit of the companies, so that the productivity of the state assets invested in the companies is expected to decrease in the period 2006-2008. For example, the state leaves in the companies managed by the Ministry of Economic Affairs and Communications more than 700 million kroons of their profit in the next three years and, consequently, will have earned by the end of the period only a half of the current amount on each kroon invested.

The NAO also proposed that the public investments in companies with non-profitable core business should be transferred. The government agreed and the ministers undertook to implement this proposal. In the beginning of July 2006, state had participations in 46 companies, being the sole owner of 30 of these companies.[24] Between July 2005 and August 2006, the state transferred its participation in four and liquidated it in one company. Five other transfers that were also promised were not completed. The value of state's participations has been estimated at 22 billion kroons in the consolidated annual report, which constitutes 16% of the monetarily appraisable state assets. In 2005, the state withdrew

[22] Government of the Republic Decision No 53 of 22.12.2005
[23] The report of the Ministry of Economic Affairs and Communications did not reflect the long-term financial objectives of AS Eesti Energia and AS Vedelkütusevaru and, therefore, the present calculations do not include these companies.
[24] Data from the Ministry of Finance

owner’s income from 20 companies and 851.7 million kroons were paid into the state budget as dividends.

Sustainable use of mineral resources is not ensured

In order to improve control over extraction of mineral resources and to ensure their sustainable use, the NAO recommended establishment of annual usage limits on non-renewable and renewable natural resources. This has been done so far only for peat. The Minister of the Environment has promised to establish such limits on oil-shale as well and a respective development plan is in preparation. The usage limits have not been set on other mineral resources.

In order to determine the sustainability of peat extraction, the NAO proposed to classify peat at the legislative level as renewable or non-renewable natural resource. The Minister of the Environment promised to include the amendment of the legislation on the classification of peat reserves in the work plan for 2006, but no decisions have yet been made in this respect.

The NAO proposed to develop a system of guarantees to compensate any future losses of the state due to failure to rehabilitate the peat extraction areas. The Minister of the Environment promised to carry out an audit of abandoned peat fields and to clarify the need for rehabilitation. The minister also promised to develop a concept of the guarantee system in cooperation with the Minister of Finance and to submit it to discussion at a cabinet meeting by 30 June 2006 at the latest. At present, the audit has been initiated and will be carried out within three years. The guarantee system has not been developed nor discussed.

Development of the quality of the work of internal auditors and supervision of their work is not systematic

The NAO has recommended paying more attention to the quality of the work of internal auditors and to consider certification of their skills. The Minister of Finance promised to develop quality criteria and assess the quality of the work of internal auditors by 30 April 2005, but no agreements have been made regarding the quality assessment criteria and the quality of the work of the internal auditors has not been assessed in the last few years. In 2005, the assessment was limited to examination whether the internal audit function of the Ministry of Justice complies with international standards. In May this year, the cabinet discussed a concept of internal audit development submitted by the Ministry of Finance. The Ministry of Finance believes that, among other things, competence criteria and supervisory system should be established for the internal auditors. No deadlines have been set for the development and implementation of these measures.

Financial reporting and control needs further refinement

The NAO recommended the government implement single accounting software in order to improve the quality of accounting. The Minister of Finance was expected to submit a respective action plan by 30 November 2004. At present, successful test projects have been carried out, but the action plan has not been discussed by the government.

In order to improve the annual reporting of the government, the NAO proposed to the Parliament that the management report included in the consolidated annual report should be associated with the strategic budgeting plans and their implementation. The Government of the Republic assigned the Minister of Finance the task of preparing a transition to activity based budgeting, but the transition has not taken place.

The NAO proposed to specify section 29 (3) of the State Budget Act that prohibits the ministries from taking loans, using a financial lease and assume other such liabilities. The State Budget Act has not been amended.

The audits ordered from private auditors in the case of companies with state participation, legal persons in public law and foundations established by the state should be more extensive so that auditor's report would also include an assessment, whether the management has used budget funds and assets legally. The Ministry of Finance wanted to test the arrangement in one company with state participation before submitting its opinion to the cabinet, but testing has not been started, the deadline for presenting the opinion to the cabinet has expired, and a new deadline has not been set.

The NAO also recommended that the government should develop and approve a so-called good practice for the payment of benefits, which would specify the minimum requirements for the administration of benefits. No respective guidelines have been submitted to the government for discussion.

Problems of public service have not been solved

The Public Service Act is outdated and the remuneration schemes used in the public sector are highly variable. The NAO proposed that the government should initiate a legislative amendment to change the remuneration schemes of the public sector. The government has attempted to propose a new draft Public Service Act for several years and many discussions have taken place, but unfortunately, no real progress has been made.

Land reform is not completed and the extent of state land reserve has not been determined

The NAO recommended to complete the prolonged land reform, to determine the extent of the state land reserve in the process and, thereafter, decide whether the remaining land should be sold or transferred to municipal ownership. The government assigned the Minister of the Environment the task of preparing the draft legislation for the completion of the land reform and submitting to the government the results of determination of the land reserve. Some steps have been taken to complete the land reform, but the state land reserve has still not been determined.

Response of the Government of the Republic