Honoured Chairman of the Council,
Dear Mayor,

Our ref 30.06.2017 no 2-1.9/17/50095/3

Observations of the National Audit Office about the risks of the administrative reform

The audits of the National Audit Office have indicated over the years that a positive change in the capability of local governments is unlikely to occur unless an administrative reform is carried out. The situation of local governments has an impact on the functioning of the entire state. The reform can be a success if local governments do the right things the right way and at the right time. In order to find the potential stumbling blocks, the National Audit Office analysed and summarised the experience of previous mergers (2013-2014), reviewed the merger contracts of local governments and observed the preparation of mergers in general. We noticed that certain areas seemed to be receiving less attention in the course of the changes, either because they were technical in nature or because the focus usually remained on the issue of whether to merge and with whom. These issues mainly concern change management, internal control, financial accounting and management, data and assets. The National Audit Office finds that the issues pointed out in this letter should be regarded as potential risks, and failure to address them could mean a rocky start for the new local governments and have a negative impact on the residents of the local government. The purpose of describing the risks was not necessarily the creation of new knowledge, but the desire to summarise the lessons of previous mergers for those responsible for the new local governments being ready for the takeoff.

I Changes are not thought through, as few specialists are involved

Various committees have the most important role in the preparation of the mergers. Local government leaders and politicians do a lot of work in the steering committees, but area-specific details get little attention, as specialists are not heard or involved in decision-making.

- **There is the risk that** area-specific problems do not get enough attention during the preparation of the mergers if the committees only consists of general leaders.

A separate challenge related to area-specific knowledge is getting the officials who will probably not continue in the new local government to cooperate in the name of the successful merger. Leaders should try to figure out how to prevent important area-specific knowledge from disappearing when officials leave.

The National Audit Office also sees problems in relation to the merger grants. Their area of application is rather broad pursuant to law, but they are mainly spent on investments. Merger contracts indicate that grants are often distributed in such a manner that everyone involved in the merger gets something. However, the merger grant should not be regarded as a political bargaining tool that helps to iron out the differences in the opinions of neighbours. It would me statesmanlike to think about the interests of the new, not the old local government when the use of the grant is decided.

- **There is the risk that** the merger grant is used to make investments that have not been thought through and are of little use in the long term. This means that there is less money left for the transition activities that determine the seamless start of the new local government (see areas II-IX).

II Loss of data upon the transfer of databases and archives

The structure of databases and the information systems related to them are often different in local governments. Transferring data into the system chosen for the new local government is therefore a process prone to errors.

- **There is the risk that** data will be lost when databases are merged, their quality will deteriorate or the data will not be as easily accessible as before.

The risk of losing data also threatens document archives.

- **There is the risk that** important documents are lost in the course of the merger, as the archives have not been appropriately streamlined, they are not exhaustively transferred to the new local government or there are disagreements about the documents that must be preserved.

The National Audit Office has previously also noted that local governments have many databases (some on paper) that do not comply with requirements and are not secure, which is a risk in itself. The merger of local governments increases the level of this risk even further.

- **There is the risk that** the sensitive data collected by the local government end up in the wrong hands during or after the merger if the elementary security requirements for keeping a database are not observed.

The merging local governments should prepare detailed overviews of all of their databases kept in information systems and on paper, and guarantee that data are securely kept and the risk of them leaking is minimal. This also applies to the databases that the new local government does not intend to use.

It is also known that some local databases are duplicates of national databases. The merger is a good time to consider whether continuing to keep the local database would be reasonable. For example, the local land registers vs the national MAKIS (land tax information system).

The report "Overview of databases kept in municipalities, towns and cities" of the National Audit Office has some ideas about dealing with databases.

In relation to the above, the National Audit Office also points out the Government of the Republic Regulation on the organisation of information management[1], which entered into force recently and includes the requirement that by 1 July 2018, all of the agencies performing public functions must have a detailed overview of the information generated in the course of the performance of their main functions, its sources and the places where it is kept. The overview must be created in such a manner that it can be easily updated, as the necessity and usability of information must be constantly monitored.

[1]Government of the Republic Regulation no 88 of 25 May 2017 "Fundamentals of organisation of services and information management"

As the work processes of the new local government must be analysed anyway in the course of the merger, it would be reasonable to also think about the creation of the required overview of the information generated in the course of processes.

III Contradicting accounting policies and inaccurate financial data

The policies of financial accounting in local governments are the same, but they also include some flexibility. Therefore, there are examples of cases where local governments have approached the same accounting issues in different ways. The audits of the National Audit Office have also revealed that accounting policies are sometimes incorrectly interpreted. The general quality of accounting also differs significantly in different local governments.

- **There is the risk that** accounting recognises the financial status and economic result of the new local government incorrectly, unless the accounting policies and procedures are harmonised in advance. There is also the risk that inaccurate revenue and expenditure forecasts are made upon budgeting, as the source data may not be comprehensive or they are incorrect.

In the opinion of the National Audit Office, merging local governments should take a closer look at their accounting before the accounting period of the new local government and make sure that the same accounting policies are followed when keeping account of the assets and liabilities received from the merged local governments.

- **There is the risk that** malfunction may occur in the circulation of documents related to economic activities and in accounting, which may end in failure to meet payment deadlines if the organisation of accounting in the merged local governments is not promptly harmonised. The tasks and liability of the process participants must be clearly established in the accounting policies and procedures of the local government.

The accounting policies and procedures of the new local government could be prepared before the merger and enforced in the first months of 2018.

IV Incomplete overview of assets and liabilities, loss of assets

The level of detail of asset and liability accounting as well as stocktaking rules and practices may be different in the merging local governments.

- **There is the risk that** some assets and liabilities are left out of further accounting if the merging local governments do not streamline, take stock of or document all of the assets and liabilities for the new local government. This can create situations where the local government unexpectedly has to find money for covering liabilities, as it was not aware of them before.

- **There is the risk that** some assets disappear due to negligence or malice in the course of mergers or that unapproved transactions are carried out.

In the opinion of the National Audit Office, it is important to agree on uniform principles before taking stock of assets and liabilities, and to carry out the stock-takes in all of the merging local governments in the same manner. All effective contracts and ongoing litigation should also be thoroughly examined.

V Additional expenses and inequality in the organisation of services and support

The Administrative Reform Act only provides a deadline for the adoption of the statutes of the new local government (within six months of the election results). The remaining legislation must be established within reasonable time.

- **There is the threat that** the local government will incur extra costs if the adoption of the new procedures of services and support is delayed for a long time. Their parallel administration is already a potential extra cost. The longer it goes on, the bigger the risk of the local government incurring litigation expenses (e.g. in matters of unequal treatment).

The alternatives for the harmonisation of services and support could be prepared for the new council on the basis of the existing procedures of the merging local governments and the merger contract before the merger takes place. It would be good if they could then be processed and enforced within six months of the election results, like the statutes.

Another factor to consider upon the harmonisation of public services is that the use of the present e-forms of local government services in the www.eesti.ee portal is about to end. When services are reviewed, it would be good to consider all of the possible alternatives and the costs associated with them.

VI Additional expenses related to amendment of contracts and discontinuation of important services

The contractual rights and obligations of the merging local governments will transfer to the new local government by way of legal succession. Basically, this means that the new local government will take the place of the merged local governments in all contractual relationships after the emergence of its legal capacity (on the day elections are announced). Everything will remain the same apart from the name of the local government and the contracts will remain in force. Problems may occur if a contract has to be amended or terminated. This is relatively likely due to the harmonisation of the services related to the contracts (e.g. organised waste transport) or the expiry of the legal act that is the basis of the contract due to the adoption of the relevant legal act of the new local government.

If this is not regulated in the contract or by law, it will not be possible to demand unilaterally that the contractual partner start following the new legal act of the local government. The possibility that contractual penalties will have to be paid must also be considered when a contract is amended or terminated.

- **There is the risk that** additional costs will be incurred in relation to legal disputes if one's obligations as a contractual partner are not acknowledged and everything is not done correctly when the amendment of a contract is undertaken.

The different validity terms of contracts may also create problems.

- **There is the risk that** there will be faults or interruptions in the provision of some local services (e.g. waste transport) if there is no definite action plan for the event that the contracts of the merging local governments in the same field expire at different times.

In order to prevent such unexpected situations, it would be reasonable to thoroughly analyse such contracts before the new local government starts operating, think about the need to amend (also extend) and terminate contracts in consideration of public procurement rules, prepare calculations of the associated costs and decide how to proceed. The National Audit Office finds that outsourcing legal or other specialist consultations in these issues would be fully justified (and the merger grant could be used to cover its costs) in order to avoid paying the higher costs arising from potential litigation.

VII Postponement of planned procurements and ineffective use of money

The merger and the elections will certainly have an impact on the procurements of local governments as well. It may happen that the procurements depending on the decisions of the senior leaders or managing bodies of the local government will be put on hold at the time of the mergers, as the decision-makers are busy elsewhere or the new managing bodies have not been formed yet.

- **There is the risk that** procurements will not take place as planned and the things promised to local residents will not be ready in time.

If possible, all activities that according to procurement plans should take place at the time of the merger and elections, should be moved forward to prevent any problems.

Risks also arise from contradictions in the existing procurement procedures and practices of the merging local governments, unless they are quickly harmonised. Some local governments may not have a procurement procedure at all.

- **There is the risk that** purchases with similar purposes are not made in a consolidated manner in the new local government and money is wasted when purchases are made if the establishment of the new procurement procedure takes too long.

The risks are even bigger after the enforcement of the planned legislative amendments, which will increase the procurement thresholds and more purchases will be regulated by the local procurement procedure. The procurement procedure of the new local government could be adopted in the first months of 2018. Preparing the procurement plan for 2018 well in advance is also important and it could be done when the budget for 2018 is drafted.

VIII Unreasonable borrowing

Pursuant to law, a merging local government can take loans and other similar debt obligations only with the approval of the councils of the other local government that merge with it. This must guarantee that they are aware of each other's borrowing plans and their consequences. However, this poses some threats as well.

- **There is the risk that** borrowed money is used to make investments before the merger, which are not reasonable from the viewpoint of the new local government. This risk is bigger in the local governments facing compulsory mergers.

The National Audit Office finds that each single case of borrowing should be viewed against the background of the needs and possibilities of the new local government. The permission of the other merging local governments to increase the loan burden should be given lightly or as an unavoidable trade-off for the merger.

IX Unlawful severance pay

The social guarantees for officials established in the merger contracts are often bigger than permitted by law.

- **There is the risk that** the severance pay offered to officials does not comply with law and taxpayers' money is wasted on this. Litigation and the associated costs are also possible.

The National Audit Office finds that the law must prevail in the event of contradictions between the law and the merger contract. All employees should be informed about this clearly and well in advance in order to reduce the risk of disputes.

When the money related to redundancies is being planned, it is also important to keep in mind that local governments subject to compulsory merger can only request compensation from the state for the severance pay related to redundancies made before 1 January 2018.

X Problems in the development of an internal audit system

The internal audit system of the local government as a cross-sectoral issue needs special attention during the preparation of a merger. The National Audit Office has repeatedly found deficiencies in this when conducting its audits and admitted that the systems tend to not work. The administrative reform is expected to have a positive impact on the development of this as well.

During the preparation of internal procedures as well as the structure and tasks of agencies and positions, it is important to consider whether the planned organisation of work forms a comprehensive and functioning system in terms of internal audit. It is also necessary to understand that a larger local government requires a different approach in terms of internal audit. The measures that smaller local governments could count on may not work in a larger local government.

The National Audit Office also advises larger local governments to think about the establishment of the position of an internal auditor or the regular outsourcing of this service. This would add professionalism and a risk-based approach, and bring some new quality to the systems.

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The National Audit Office hopes that the above observations are useful and give reason to think whether everything that needs to be done is done during the preparation of the administrative reform, so that the new local government has a good start and the goal of the administrative reform – Estonia has more capable local governments – is achieved.

Kind regards,

/digitally signed/

Airi Mikli
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Local Government Audit Department

Cc: Minister of Public Administration
Chairman of the Association of Estonian Rural Local Governments
Chairman of the Management Board of the Association of Estonian Cities