

Financing local governments from the support fund

*Why is the transformation of the support fund for
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Summary of audit results

For your information

Local governments receive the majority of their revenue from personal income tax receipts and the equalisation and support fund of the state budget.

The purpose of the **equalisation fund** is to equalise the revenue of local governments, while the state does not predetermine the exact purpose of this money for local governments.

From the **support fund**, money, the intended purpose of which is determined, is allocated to local governments as grants (8) for the performance of tasks of the local government and as benefits (2) for the performance of state functions. In 2022, the total amount of the support fund will be 509 million euros, the largest share of which is the grant for general education – 380 million euros.

Abolishing the intended purpose of grants from the support fund for the performance of the tasks of the local government, i.e. lifting restrictions on use, would mean that the revenue base of local governments would be increased to a corresponding extent: personal income tax revenue + equalisation fund.

One of the main objectives of the administrative reform carried out in 2017 was to create larger and more capable local governments in Estonia, which, *inter alia*, could also be strong and reliable partners to the central government. As a continuation, the plan was to give more rights and responsibilities to local governments, and the plan initiated under the leadership of the Ministry of Finance and with the approval of the government was, *inter alia*, to increase the financial autonomy of cities and rural municipalities by lifting the state's restrictions on the use of the money of the support fund. However, the implementation of this plan has stalled because some ministries and local governments do not trust each other. As such, the right of local governments to make decisions regarding their revenue and using thereof continues to be much more limited in Estonia than, for example, in the Nordic states. The state has decided in advance for about 20% of the budgetary revenue of local governments for which purpose the funds should be used.

According to the National Audit Office, the Ministry of Finance has done an effective job over the years, calculating budget-related opportunities to increase the decision-making power and, with it, the responsibility of local governments and to abandon the labelling of funds, but the implementation of the plan is pending the decisions of the executive and legislative powers. In the plan to increase the financial autonomy of local governments, there has been less and less concreteness regarding the future, and the deadlines for lifting the restrictions on the use of funds for local governments have shifted further and further into the future (in the analysis documents, the initial deadline of 2021 has become 2035 etc.).

Main observations of the National Audit Office:

- The information gathered during the audit indicates that the lifting of restrictions on the use of grants from the support fund is hampered primarily due to the mutual distrust of the Ministry of Education and Research, the Ministry of Social Affairs, the Ministry of Economic Affairs and Communications and local governments and, overcoming this requires decisions and agreements.
- Ministries are afraid that lifting the restrictions will cause the money directed to an area until now to go elsewhere in the local government

For your information

For example, the local governments' own share in covering the wage costs of teachers has increased since 2013 about 10% faster than the support received from the state.

For your information

In addition to the tasks of the local government, the support fund is also used to finance state functions, the costs of which must be reimbursed to the local governments. Unlike the tasks of the local government, these would continue to be supported for specific purposes from the support fund in the future.

(for example, funds for teachers' wages will go to roads or vice versa), local governments, in turn, fear that the state will introduce additional area-specific requirements going forward, the cost need of which the funding model will not take into account.

- The information gathered from the parties during the audit does not contain significant or substantial arguments in support of continuing with restrictions on use, and the effect of the restrictions on use on the development that has taken place or is desirable in the supported areas is ambiguous. No evidence has been presented that would show that positive changes (e.g. increase in the number of service recipients, increase in wages) have occurred precisely due to restrictions on the use of support money. The only measurable effect resulting from restrictions on use is the expenditure of funds in the supported area, but local governments already finance these areas in a larger volume than what they receive in support from the state, and their own contribution has increased in recent years.
- The methodology for reimbursing the costs of state functions financed from the support fund is not appropriate, as the composition of the reimbursable costs differs unreasonably for functions with a similar purpose. In the processing of both population register entries and applications for subsistence benefit, the aim is to reimburse local governments for the cost of a job, but in the first case, four types of costs are taken into account in the price of the job, and in the second case, only two. The price of a job is therefore about 40% lower when processing applications for subsistence benefit, and local governments essentially suffer a loss as a result.

The National Audit Office finds that the direction taken by the Ministry of Finance and the Government of the Republic in 2017 – to lift restrictions on the use of grants of the support fund related to the tasks of the local government – offers opportunities to improve the efficiency of the use of public funds. The lack of certainty about the future, which causes mutual distrust, can be overcome by clear agreements between the parties, and reaching them should be coordinated by the Ministry of Finance. Concerns need to be clarified with all parties regarding all grants at the same time. The current practice – searching for solutions separately by grants and parties – has not led to success. The reform has also been slowed by the tactics of different institutions to justify the postponing of decisions with the need to further analyse the situation.

The National Audit Office finds that it is important to define the process initiated by the Ministry of Finance and approved at the level of the government together with the parties and to make decision on when the restrictions will be lifted so that both the ministries and local governments can operate in the conditions of a clear perspective.

Given the above, the National Audit Office made recommendations to the Minister of Public Administration: consider the possibility of entering into a concrete agreement on the lifting of restrictions on use and its deadlines by involving the parties during the state budget negotiations with local governments in 2023. It would then be possible to initiate amendments to the relevant legislation by the end of the same year in order to stipulate the deadlines for amendments to the legislation.

The National Audit Office made a recommendation to the Minister of Social Protection to harmonise the methodology for reimbursement of the costs of state functions.

Both the Minister of Public Administration and the Minister of Social Protection agreed, in principle, with the recommendations received, promising to adhere to them in their activities in 2023.

It is good to note that the lifting of restrictions on use has gained a clearer perspective in the case of some grants already by the time of completion of this audit. Shortly before the publication of the audit report, amendments to the Social Welfare Act were adopted in the Riigikogu, by which it was decided to transfer the grant for alternative and continued care service and death grant from the support fund to the revenue base of local governments from 2024.