

University of Tartu

Faculty of Economics and Business

Administration

**KEY ISSUES IN
DEVELOPING THE PUBLIC
ADMINISTRATION SYSTEM
OF ESTONIA BEFORE
JOINING THE EUROPEAN
UNION**

Janno Reiljan

Kadi Timpmann

Katrin Olenko

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KEY ISSUES IN DEVELOPING THE PUBLIC ADMINISTRATION SYSTEM OF ESTONIA BEFORE JOINING THE EUROPEAN UNION

Janno Reiljan¹, Kadi Timpmann², Katrin Olenko³

Introduction

Preparations to accede to the European Union (EU) have posed new challenges to the Estonian public administration system. In a country with a European social structure, the public administration system has to fulfil important tasks in promoting democracy, ensuring regionally balanced development and providing regular public services. Prior to accession to the EU, the aspect of regional development becomes especially important, as nearly 80% of the overall EU Budget will be targeted through the Common Agricultural Policy and Structural Funds towards rural and regional development of the Member States. One has to admit that today the administrative system of Estonia is not yet able to fulfil all the assignments that the EU requires from its Member States. Among other issues, the country's weak administrative capacity has also been repeatedly pointed out by the European Commission.

The main problem, however, does not lie in the non-compliance of the Estonian administrative system with the EU requirements, but in its ability to create favourable conditions for the development of the nation state. The increasing regional imbalances as well as the growing gap between the living standards of the rural and urban areas provide evidence that the Estonian central authorities are not able to fulfil their tasks sufficiently well. Local authorities often

¹ University of Tartu, Faculty of Economics and Business Administration, Professor of International Economy, PhD, D of Sc. (Econ.) E-mail: Reiljan@cie.ut.ee

² University of Tartu, Faculty of Economics and Business Administration, MA Student, BA (Econ.), E-mail: kadi@ec.ut.ee

³ University of Tartu, Faculty of Economics and Business Administration, PhD Student, MA (Econ.), E-mail: katinka@ec.ut.ee

lack opportunities to effectively represent the interests of the local people. Estonia's development logic does not correspond to the principles of the EU: in the EU the Member States, together with an increasing concern for the exclusive and balanced development inside the nation states, are also responsible for ensuring a closer integration between the Member States. Estonia would need to develop and strengthen its administrative system considerably, in order to be able to protect its national interests both before and after becoming an EU member.

According to Article 9 of the European Charter of Local Governments which was ratified by the Estonian Parliament, Riigikogu, on 28. September 1994 (RT2, 1994, 26, 95), Riigikogu has the obligation to provide the country's municipalities with sufficient financial resources to be used at their discretion within the framework of their powers. Alongside that the need to protect financially weaker local authorities calls for procedures of financial equalisation or equivalent measures which are designed to rectify the adverse effects caused by the unequal distribution of the potential sources of finance and of the financial burden. However, such procedures or measures should not diminish the discretionary powers that local authorities may exercise within their sphere of responsibility.

In Estonia the financial situation of the local governments has been destabilised over the last few years and has in many cases even deteriorated. On the one hand, the number of functions assigned to local governments has grown, on the other, local governments lack a stable legally determined income base, which would enable them to make long-term plans of local development and effectively manage diverse local issues. The personal income tax incentives granted by the central government are eroding the income base of local governments, especially of financially weaker municipalities. The overall amount of the grants from the Support Fund of the State Budget did not change throughout 2000 and 2001, in nominal terms. In real terms, then, the governmental transfers have even decreased. True enough, the supplementary budget for the year 2002, which was adopted on 19. July 2002, made available 185 million kroons (11.8 Mio EUR) for the support of local govern-

ments and has thus somewhat improved the situation, however, this has not reversed the general trend.

The functions legally assigned to local governments are fully (renovating local roads, requirements on school canteens, implementing the Law on unemployment insurance) or partly (teachers' salaries, allowances, social benefits) without financial coverage. According to estimates, the gap between the responsibilities delegated to local governments and the possible sources of income is about 2 billion kroons (0.13 billion EUR) (Lauritsen, 2000). Together with weakening the income base, the central government has considerably reduced the amount of state investment grants to local governments and delegated the power to dispense grants to the ministries, who are not fully aware of the local circumstances. The present financing scheme of schools which proceeds from costs per pupil needs to be rectified as the current system overlooks the level of fixed costs that does not depend on the number of pupils, thus putting smaller schools with less students under great strain. Hence, the fiscal policy of the central government makes it difficult for many local governments to fulfil the tasks set to them either by the Constitution or other laws and the Government has failed to accomplish the tasks assumed through the ratification of the European Charter of Local Governments by *Riigikogu*.

According to E. Ulst, researcher at Tartu University, the Estonian fiscal system is more centralised than those of other countries, including the Baltics. Besides centralisation, the other big problems are local governments' insufficient fiscal autonomy, their mentality of dependency, orientation towards snatching a more sizable share from the State Budget, their lack of motivation to search for alternative income sources, and their indifference towards managing or non-managing the local matters. Personal income tax is a very sensitive indicator for the economic activity and should remain the main source of revenue for the local governments also in the future. In the nearest future it seems reasonable to increase local governments' share from personal income tax revenues (Ulst, 2000).

Increasing local governments' share from personal income tax revenues would raise the number of those local governments that are capable of coping with the finance provided from tax or other

own revenues, which would make them more interested in increasing their tax income. On the other hand, the inequality between the revenues available to local governments would also grow. Thus despite the growth in the overall level of the municipalities' tax revenues, the income equalisation system will still have to play an important role. Factors such as the demographic situation, the existence/non-existence of infrastructure, including kilometres of road, the number of children in schooling age, the number of pensioners, and the density of population should be taken into account.

The shortcomings in local governments' income base were also pointed out by the representative of the European Council, who visited Estonia in order to investigate how the Estonian legal acts correspond to the European Charter of Local Governments. The review was made in connection with the passing of 5 years since the ratification of the European Charter of Local Governments by Riigikogu in autumn 1994. In the economic part of his report, the Council's representative suggested to the parliament that local governments should be granted with the right to impose a personal income tax and also determine its rate.

In Estonia, it is necessary to solve the contradiction between the command-economy-like administrative system and the aim of democratic development by:

- Ensuring that local governments are made independent from the central government;
- Enforcing the central authorities to proceed with their administrative tasks in designing the strategies and policies of national development;
- Enabling local governments to fulfil their administrative tasks;
- Establishing a proper balance between the rights and duties, opportunities and responsibilities of administrative institutions;
- Legitimate financing of the central government and local governments proportionally with the tasks assigned to them;
- Working out the norms and calculation methods that would ensure full financial coverage of the assignments placed on the local governments;

- Creating a financial mechanism that would stimulate municipal initiative.

Local governments should, by using their legally determined mandates and measures, form a level of authority that would not depend on the central government in fulfilling its tasks of organising local matters. In reality, rural municipalities are reliant on the central government, because without a stable (based on legally determined standards and financing mechanisms) income base, their independence cannot be realised. Instead of getting a proper legitimate income for financing the decentralised functions, municipalities are now both forced to wait for subsidies dispensed at the discretion of the central government, as well as appeal to investment funds from ministries.

According to the common understanding of management theories and practice, a successful reform requires proper underpinnings and sufficient preparations. When a reform is undertaken, the aims of the restructuring should be clear, the required resources and available instruments identified, sources and schemes of funding determined, and the direct and indirect impacts of the applied measures on particular spheres of the society analysed. In a democratic society, in addition to the abovementioned, the reforms must have the citizens' support as an important precondition. The public must be convinced that the reforms will improve their living standards. Uncertainty about the future may create a psychological barrier in people, which hampers carrying out the reforms and reduces their effectiveness.

Preparation of the administrative reform is a particularly influential task as its results affect each citizen's everyday life as well as fundamentals of the existence of the democratic state. Asymmetry in handling administrative problems and partiality of the solutions may be detrimental economically, socially and politically to the state and its citizens. In Estonia, unfortunately, no comprehensive analysis of the fundamental problems accompanying the administrative reform has been made yet.

For this reason, the aim of the present working paper is to analyse the key problems of the Estonian evolving administrative system, and suggest possible solutions. Most attention will be paid to deter-

mining the relationships between local governments and the central government. Firstly, the problems related to the evolution of the democratic administrative concepts in Estonia will be discussed. Secondly, the role of local governments in the society will be investigated. Subsequently the level of financing of local governments' functions and its dynamic will be analysed and some recommendations will be made for assigning the proper financing schemes to the functions. Further we will study why it is necessary to accomplish the administrative reform in Estonia. Finally, the necessity and problems related to the widely debated administrative territorial reform will be elaborated on.

1. The deficit of democratic administrative concepts in Estonia

1.1. Historical development of the Estonian administrative system

Before the Second World War Estonian local governments had a two-tier administrative system. In 1939 there were 281 primary-level local governments (248 rural municipalities and 33 towns) and 11 counties as secondary-level local governments (Ulst, 2000). The area of responsibility of primary-level local governments (rural municipalities) was limited; the functions that required more profound knowledge and extensive resources were assumed by county governments. In four primary-level towns — Tallinn, Tartu, Pärnu and Narva — the two levels of governance were integrated (Preem, 2000).

With the start of the Soviet occupation period, village soviets were created as sub-units of rural municipalities, after that rural municipalities and counties were eliminated in connection with establishing districts (rajoonid — *Est.*) (Ulst, 2000). As village soviets represented the central government in local communities, local governments in the true meaning of the word practically ceased to exist.

After independence was regained in 1991, districts (rajoonid) were renamed into counties and most village soviets became rural

municipalities, thereby retaining the ideological system and organisation of Soviet-time public administration. In 1993 a unilevel local governments system was introduced. Rural municipalities and townships obtained the position of local government units with equal legal status, whereas counties as administrative units represented the central government. In September 2002 there were 247 local governments (42 towns and 205 rural municipalities) and 15 counties in Estonia (Ministry of Internal Affairs..., 2002). Most of today's rural municipalities are the successors of former village soviets, whose size and territorial organisation is the result of several, often spontaneous, changes. (Haldusreform..., 2000). When designing rural municipalities, the natural historically developed hubs have often been ignored and small towns have been separated from their surrounding rural areas (Preem, 2000).

The purpose of introducing a single-level system of local governments was to bring the authorities as close to people as possible, thereby guaranteeing involvement of democracy in society. As the experience of the other democratic states shows, in this way the principle of subsidiarity was followed, according to which the functions of the state should preferably be performed by the level of governance closest to citizens. The European Charter of Local Governments, adopted by the European Council member states in 1985 and fully ratified in Estonia in 1994 (RT2, 1994, 26, 95) also requires application of the subsidiarity principle. Regrettably, the questions of guaranteeing the administrative capacity at the level of local governments have not been adequately handled in Estonia. In building up the administrative system, no sufficient heed was paid to the problems caused by the unequal economic development and growth rates of different regions. The local governments' financing system has been designed in such a way that it leaves most local governments without a possibility to efficiently promote the economic progress of the rural municipality or town; the development of municipalities has been made dependent on the availability of central government grants.

1.2. Administrative reform in Estonia

According to the current situation in Estonia, a number of rural municipalities are unable to fulfil all the functions vested in them, incl. insurance of the development related activities and efficiently extending high quality public services, available to all inhabitants (Haldusreform..., 2000). Hence, the need for an administrative reform is growing intensively. The main purpose of the administrative reform is to guarantee that local governments would get a legally determined autonomous income base that would allow them to normally fulfil the tasks assigned to them.

There have been attempts to separate from the administrative reform the administrative territorial changes. As early as in 1995 a legal possibility was created for amalgamation of municipal units. In later stages it was tried to stimulate this process by promising to grant one million kroons (64,000 EUR) to every municipality merging with another. These promises, however, were not kept and the main part of the merger costs was never reimbursed to the local governments. As a result, the territorial reform has advanced rather slowly — only eight pairs of local government units have merged (mainly central and surrounding rural municipalities) (Haldusreform..., 2000). It is obvious that if the reform proceeds without a complex comprehensive plan, the controversial and sophisticated problems of the Estonian administrative system will never be solved.

The main weakness of the administrative reform that started in 1999 was its focus on the administrative restructuring of the local government system instead of designing the organisational structure in accordance with the requirements and opportunities of the local governments. Hence the tendency to deal with displacement of civil servants under the label of administrative reform or the so-called administrative territorial reform. In view of developing democracy, displacement of civil servants has low priority, as this should ensue from the organisational structure of the administrative system that seeks to meet the needs of society in the best way.

The preliminary draft project of the administrative reform prepared by the Ministry of Internal Affairs of Estonia envisaged improve-

ment of the current system in the following areas: in the organisational, budgetary and administrative territorial systems of local governments and in the functions assigned to them as well as in the respective amounts of resources. Although the project specially emphasised that all these areas are interconnected and relevant for ensuring local governments' administrative capacity, and therefore need to be handled in interaction with one another and applied in parallel in the process of improving the local government system (Haldusreform..., 2000), in reality the discussions concentrated mainly on the size and overall number of local governments. The present Government has given up the plan to use coercive measures in order to bring about amalgamation of rural municipalities, but it supports financially those local governments that merge of their own free will.

According to the democratic principles, the decision about establishing the boundaries of the municipalities should lie within the competence of the relevant local governments and the intervention by the central government should be limited to assisting and consulting. The Law on territorial organisation of Estonia (RT1, 1995, 29, 356) gives the right to initiate changes in the administrative territorial set-up of the municipalities both to local councils and to the central government. The Law requires that the opinion of the inhabitants of the relevant municipalities should be asked, however, it is not mandatory to follow this opinion. Also, the Constitution of Estonia (RT, 1992, 26, 349) prohibits changing the boundaries of any municipalities without prior consultation with the municipalities concerned, yet it does not require consideration of their opinion. According to a democratic way of thinking, one can conclude from the above that the central government is obliged to convince the residents of rural municipalities and towns as well as local government officials in the usefulness of the initiated territorial reform as a precondition for its successful implementation. In reality the central government interprets the legal provisions concerned as authorisation for enforcing mandatory amalgamations even against the will of the local governments and inhabitants involved. Without resolving the substantial problems and disagreements related to the administrative reform, the territorial reform

might cause more expenses than gains. This is the actual source of conflict between the two levels of government.

Hence, in Estonia the shortage of democratic approaches is endangering the development of society. The central authority is trying to maintain its right to dictate to local governments what they should do, ignoring the constitutional right of the local authorities to decide and manage the local issues independently. In a democratic society the aim should be to ensure the independence of and balance between the two levels of administration according to the principle of subsidiarity.

2. The status of local governments in society

2.1. The level of decentralisation of the administrative system

Three main functions of fiscal policy — allocation, distribution and stabilisation — can be divided between the levels of administration in different ways. According to the traditional theory of fiscal federalism, the distribution and stabilisation functions must be centralised. In centralising or decentralising the allocation function, the homogeneity or heterogeneity of the population's preferences as well as the possibility to realise economies of scope should be followed. If the preferences of the inhabitants towards provision of public services differ widely, then the allocation function should be decentralised. However, if the provision of service is connected to large economies of scope, one might consider centralisation of the allocation function. (Cangiano, Mottu, 1998: 5–6) Thus, according to this theory, a certain optimum should be reached between realisation of economies of scope and following the local preferences in public services. However, one should not overlook the fact that delegation of powers and responsibilities that accompanies decentralisation will promote the local initiative needed for further development of communities.

In the recent past in many countries all over the world (in developed as well as in transformation and developing countries) extensive programmes of fiscal decentralisation have been launched. In

the course of their implementation several additional functions have been decentralised and new financial sources have been established. Decentralisation has been accompanied by an increase in the local governments' autonomy in such areas as borrowing, tax administration and budgeting (de Mello, 2000: 365). The main gains from this decentralisation are an increase in the efficiency of delivering public services and reduction of information and transaction costs (World..., 1997), as it is easier for local governments to collect the information about the needs and preferences of the local people and ensure that all the inhabitants are provided with public services. Here of course the question arises, how much the preferences in the overall amounts and structure of the extendable public services vary in different regions of Estonia. It is likely that the preferences are more determined by other variables, such as the level of income, age, educational background, etc. than by the area of residence, although, lacking empirical evidence, it is hard to argue this.

Decentralisation may be accompanied by several problems. Excessive autonomy of local governments and lack of sufficient coordination between different levels of government allows municipalities to make inefficient decisions about spending and live beyond their actual ways and means which will result in a budget deficit and more expensive lending due to the increase in risk premiums. The resulting fiscal imbalance might endanger the overall macroeconomic stability of the state. Thus one can conclude that strictly regulated borrowing activities of municipalities, monitoring of local government's fiscal balance by the central authority and providing consultation and training to promote effective management of the broader income base and functions are the preconditions for successful decentralisation (de Mello, 2000: 366).

Countries differ significantly by their level of decentralisation of the administrative system. To some extent this may be evaluated on the basis of the budgetary resources available to local governments and the central government. In the EU Member States local governments' expenditures account for 11–86 % of the expenditures of the governmental sector. The share of local governments' expenditures is highest in the Scandinavian countries (Denmark, Finland, Sweden). In Germany, Austria and Spain they are rather

high (over 30% of the overall governmental sector's expenditures). In Belgium and Portugal, on the contrary, the share of local governments is only at 10% level (Government..., 2001). From the abovesaid it is evident that the application of the subsidiarity principle does not directly depend on how a country's public services are financed. While in some cases (Belgium, Portugal) local governments only have at their disposal the sums for administrative expenditures, in others (Scandinavian countries), they may additionally control a considerable amount of funds allocated for public services.

In the EU Member States no direct relationship between the level of decentralization and the overall size of the public sector (share of overall governmental expenditures in relation to the GDP) can be identified. While in Denmark, Sweden and Austria the high level of decentralization goes together with a large public sector (52–58% of the GDP), then in Finland and Germany the size of the public sector is close to the EU average (48% of the GDP) and in Spain it is lower than the average (only 40% of the GDP). Among the countries with centralized fiscal systems only in Portugal the size of the public sector is at the lower level than in EU average (45% of the GDP), whereas in Belgium it reaches 50% of the GDP (Eurostat Yearbook, 2002).

In 1999, the share of local governments' expenditures in Estonia formed 23% of overall governmental expenditures (Eesti Statistika..., 2000: 223) and 22% in 2000 (Eesti Statistika..., 2001: 239), which is slightly below the EU average (26%). At the same time, the level of decentralization was higher in Estonia than in Belgium, France, Luxembourg and Portugal and approximately at the same level with the UK and the Netherlands. (European..., No. 69/1999: 432–433). However, if we evaluate the development perspectives of the Estonian administrative system, then we should keep in mind its cultural and political connections to Scandinavia, whose level of decentralization is considerably higher.

In 1999, the size of the public sector in Estonia was approximately 4% of the GDP (Eesti Statistika..., 2000: 213, 223) and in 2000 even 36% (Eesti Statistika..., 2001: 239, Statistical Office of Estonia 2002), which is also lower than the EU average (47%), and

above only the relevant variables of Ireland (Eurostat Yearbook, 2002).

In some cases local governments' functions also vary considerably within the EU Member States. The municipal funds are mostly spent on such areas as education, health care, social sphere and public utilities (Government..., 2001). In Estonia local governments' areas of responsibility are stipulated by the Local Governments Organisation Act (KOKS) (RT I, 1999, 82, 755). Local governments have to take care of local issues in the following areas:

- social welfare,
- elderly care,
- youth,
- housing,
- water and sewerage,
- sanitation,
- territorial planning,
- local public transport,
- maintenance of local roads and streets.

Local governments, in case they own them, are also responsible for the administration of the following institutions:

- kindergartens,
- secondary schools,
- high schools,
- vocational and sports schools,
- libraries,
- houses of culture or cultural centers,
- museums,
- training and sports centres,
- care homes,
- hospitals and other.

KOKS (RT I 1999, 82, 755) allows local governments to establish institutions that provide local services, to hold shares in the limited companies created for providing the services, and belong to foundations or other non-profit organisations. Outsourcing the provision of services to the private or third sector and founding local institutions or enterprises for providing services are most character-

istic in the area of infrastructure and public utilities such as water systems or sewerage, where the main part of the costs related to the provision of services can be financed through the fees collected from the consumers of these services.

2.2. The structure of local governments' income and expenditures

The structure of the income and expenditures of local governments in Estonia is shown on Chart 1. In 2001 no doubt the largest item of expenditure for Estonian local governments was education. The next important category of expenditure was economic expenses (infrastructure, sanitation, planning and constructing activities, etc.). The expenses of general administration, culture and sport and social welfare were equally around 10%, the share of health care was only slightly above 1% of the overall expenditures. Among other costs the largest were loan-servicing costs (6.9% of total expenditure), from which 81% was used for repayment of loans and 19% for interests payments (Kohalike... 1996–2001). In general terms the financing of local governments' functions differs significantly from that of the central government. The tax bases that would be easy and inexpensive for local governments to administer are few and they are usually very narrow (de Mello, 2000: 366). When taxing such mobile production factors as capital, the tax rates will be brought down by the tax competition between local governments. As a result, the tax revenue will decrease throughout the country and may lead to insufficient provision of public services to the citizens. To avoid that, imposition and administration of taxes is mainly the realm of the central government. The advantages of the centralisation of tax administration consist in the realisation of economies of scale, avoiding excessive tax competition between local governments, and ensuring equal treatment of all tax payers (Cangiano, Mottu, 1998: 6). Full centralisation of taxation has, though, not been considered necessary, as it curbs autonomy too much. To avoid excessive tax competition, it is recommended to decentralize taxation of immobile factors (mainly land and property taxes).

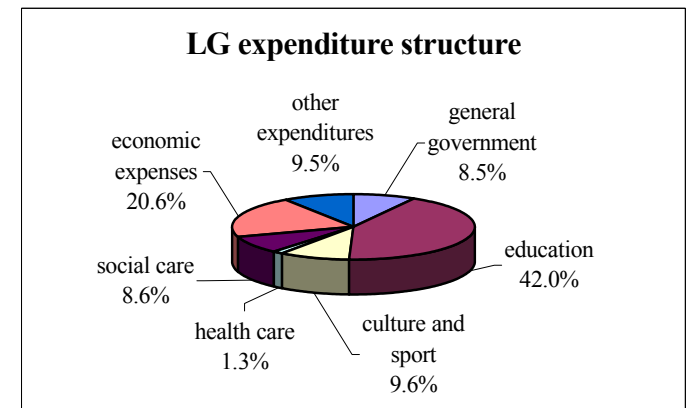
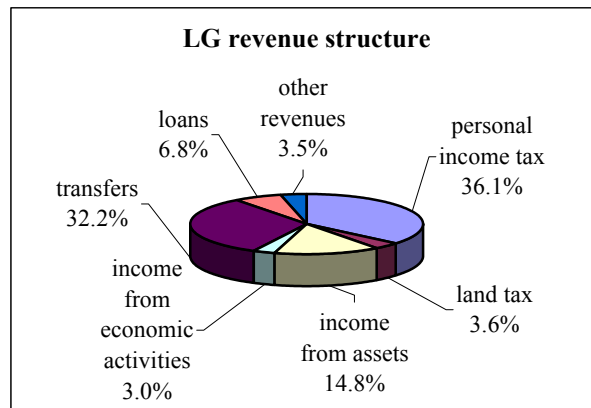


Chart 1. The structure of local governments' expenditure and income in 2001. (Kohalike... 1996–2001; calculations by authors).

Costs arising from the functions assigned to local governments very often exceed the incomes from their legally determined income base (the so-called own revenues), as the levels of economic activity and personal incomes forming the local governments' income base vary significantly. The larger the differences in the economic development of the municipalities, the more difficult it is to determine the income base that would satisfy the needs of all local governments. Income transfers are necessary in order to remove the horizontal differences between local governments that are brought up due to their varying abilities to mobilise the income (de Mello, 2000: 366). This means that with the help of redistribution of the tax revenues the central government must ensure such an income level that would be sufficient for implementing the functions delegated to the municipalities. Thus, the level of local governments' expenditures is determined by their receipts (taxes and other incomes) and vertical or horizontal transfers.

2.3. Local governments' fiscal autonomy

A local government's income structure has a significant impact on its autonomy in making decisions about the use of the income. The possibility to rely on their own income gives local governments the freedom to decide how to use their resources. In contrast, allocations from the State Budget are often targeted, which reduces local governments' autonomy in designing their expenditure structure (de Mello, 2000: 367). When a local government mostly depends on conditional transfers from the central government, it will evidently become the central government's agent that follows the latter's guidelines without adequate consideration of the local preferences and needs. Unconditional transfers, however, serve for filling the gaps between the own income base and the scope of functions assigned to the local governments.

Local governments' autonomy may be curbed by a strict borrowing policy due to the institutional factors (legal constraints) as well as market forces. There are several ways to restrict local governments' borrowing activities by means of legal provisions: prohibition of budget deficit, limiting the amounts of loans, etc. As local

governments' bonds hardly attract any wider interest, the central government is often their main buyer. In case a local government's bonds are sold on the free market, the market mechanisms will ensure that the loan burden will stay within reasonable limits (de Mello, 2000: 367–368).

Local governments' fiscal autonomy may be evaluated on the basis of the share of tax income in the overall municipal revenue (de Mello, 2000: 372). In the EU Member States it amounts from 2% in Ireland to 75% in Sweden, confirming the fact that the income structure of local governments varies widely within the EU. On average, local governments in the EU Member States get 40% of their overall income from taxes. In those countries, where the share of tax income is low, the main income source is allocations from the state budget. The share of allocations in local governments' income amounts from 19% in Sweden to 79% in Ireland, the EU average level being 42% (Government..., 2001). Thus the fiscal autonomy of local governments in Europe, from the viewpoint of the availability of own resources, is rather limited. However, the level of local governments' independency from the central government depends also on the principles and procedures applied for granting allocations as explained above. Tax income and allocations from the state budget form the major part of local governments' financial revenues. Receipts from other sources account only for 9–34% of the overall revenues, on average 18%. (Government..., 2001).

In Estonia the tax income accounted for 40.4% and state budget allocations for 32.2% of the revenues in 2001 (Kohalike... 1996–2001). Thus the fiscal autonomy of local governments is broader in Estonia than in many EU countries. The share of tax income in the revenues was larger in Austria, Denmark, Finland, France, Sweden and in Germany, while the share of budget allocations was smaller only in Austria, Sweden, Finland and Germany (Government..., 2001). At the same time, the size of allocations depends on the level of a particular municipality's own revenues — the higher a local government's own revenues, the fewer allocations it will get. This impedes the initiative of local governments to increase their own revenues. The number of local governments with high own

revenues that do not depend on the central government's support fund is less than 10% of all local governments.

Tax revenues as the main income source of the Estonian local governments may be divided into two parts:

- state taxes imposed by law, paid either in full or partly into the local budgets.
- local taxes imposed by the local councils in accordance with the law.

From state taxes, 56% of personal income tax receipts and 100% of land tax receipts are paid into local budgets. Land tax is 0.8–2.0% of the assessed value of land. The tax rate is determined by the municipal council. Sometimes resource tax is also looked upon as national tax, which is paid into local budgets. This is slightly misleading, as actually there exists no resource taxation, but fees have to be paid on the use of natural resources and on special use of water. The share of such receipts is, however, very small (Ministry of Internal Affairs..., 2002). The Local Taxes Act (RTI 1994, 68, 1169) allows local councils to impose the following local taxes: head tax, sales tax, boat tax, advertising tax, motor vehicle tax, animal tax, entertainment tax, and road and street closure tax. During the period in question only head tax and entertainment tax were not used by any of the local governments of the country. (Kohalike... 1996–2000)

The main source of revenue for Estonian local governments is personal income tax, which in 2001 provided 36.1% of the total revenues of local governments (see Chart 1). Land tax accounted for 3.6% and local taxes only for 0.6% of the revenues (Kohalike... 1996–2001). There are several reasons for the low level of local taxes. The administration of local taxes is problematic and expensive, while tax evasions are difficult to control. As a result, the income from local taxes remains low. The initiative of local governments to levy local taxes is considerably obstructed by the fact that increased own revenues will immediately reduce the amount of allocations paid from the State Budget. Thus, the issue needs to be tackled whenever starting to reform the local government financing system.

According to the Rural Municipality and City Budgets and State Budget Correlation Act (RT1 1995, 94, 1627) local governments are entitled to get support from the State Budget through the State Support Fund and as allocations earmarked for specific purposes. In distributing the payments from the Support Fund, until 2001 the forecast receipts from state taxes into local budgets (shared taxes), the number of residents in particular local government units, and differences between the municipalities were taken into consideration. From 2001 on, instead of forecast values real receipts from shared taxes over the last two years are taken into account. Basically, the Support Fund aims to balance the excessive differences among the income bases of different municipalities. The size of the Support Fund in the draft national budget and the allotments from the Support Fund are laid down in an agreement between the authorised representatives of the municipalities and the Government of the Republic. In 2001 the Support Fund accounted for 27% of all transfers to local governments' budgets. The targeted allocations (conditional transfers) were intended for financing joint activities, support the discount on transport expenses of the students of municipal schools, etc. These allotments were relatively small (less than 2% of revenue transfers). Conditional transfers have constantly decreased and the formerly state-financed functions are to be financed by local governments themselves. The Support Fund is thereby indicated as a new financing source. However, those local governments that are not entitled to get state support should cover these expenditures from their own revenues. The largest part of income transfers (around 40%) consists of targeted expenditures on education, as teachers' salaries are being paid out of the local budget since 2001 (Ministry of Internal Affairs..., 2002).

In addition to the aforementioned, also investment support to local governments (20% of revenue transfers) through the national investment programme and allocations by the ministries (the overwhelming part was made up of allocations by the Ministry of Social Affairs to finance payment of subsistence allowances, around 10% from the transfers) belong to revenue transfers. Besides that there are allocations from local governments unions and sponsors, receipts from other municipalities for services provided to them,

receipts from international organisations and from other funds and foundations, which all together accounted for 4% of revenue transfers (Kohalike... 1996–2001). Evidently, the investments carried out in the municipalities are largely controlled by the central government in the same way as are current expenditures.

In 2001, the next revenue source after taxes and state budget allocations were receipts from assets (Chart 1) that comprised mainly revenues from selling shares and assets (48% and 31% of the total amount of receipts from assets, respectively).

These were followed by funds from borrowing (6.8% from total revenues). The constraints on borrowing and guaranteeing the loans by local governments are established with the Rural Municipality and City Budget (RT1 1993, 42, 615). In 2001, 81% of the loans were taken as long-term loans from Estonian credit institutions and only 15% in the form of bond issue. Revenues from economic activities (in 2001, 3% of total revenues) included mainly own revenues of different municipal institutions (schools, care homes, etc). The main part were the own revenues of educational and research institutions. (Kohalike... 1996–2001) Borrowing is one of the few financial sources in Estonia that local governments can employ for financing their autonomous development decisions, naturally, within the legally determined borrowing limits.

3. The level and dynamics of financing Estonian local governments' functions

3.1. Dynamics of the level and structure of income

The level and dynamics of local governments' income by different categories of local units are shown in Tables 1–3. In order to ensure better comparability of the 2001 data with those of the previous years, the 2001 revenues are given without central government allocations for education (allocations for teachers' salaries which from 2001 onwards are paid from the local budgets). When grouping local government units, the type of the local government (town or rural municipality) as well as the number of inhabitants were

taken into account. In Table 1 the weighted average revenue per inhabitant in different groups of local governments is shown. As a weight the number of inhabitants was used. As the revenues have been adjusted to the consumer price index (CPI), we can consider these as real income. Table 2 shows the relative growth rates of this kind of real income on a yearly basis in different groups. Tables 1 and 2 indicate that the real income of the local governments in Estonia has been growing. The growth rate was highest in 2001 (15.2%) and lowest in 2000 (0.0%). Looking at the dynamics by different groups, we can see quite substantial differences. In Tallinn the real income growth was very significant in 2001, the income from selling shares being over 44 Mio EUR (these receipts formed 19% of the Tallinn's total revenues in the given year). This has also pushed up the average level of income from assets in Estonia. In general, the variance of real income between the groups is relatively high, which characterises the instability of the income base. The differences are largest during the last two years. In 2000, the real income in Tallinn and rural municipalities (even in the smallest ones) decreased, whereas the real income in towns (excl. Tallinn) grew considerably. In 2001, the situation was the opposite: in parallel with the decrease of real income in towns (excl. Tallinn), the real revenues in rural municipalities and in Tallinn increased.

During the period, the real per capita income was highest in smaller towns and in the smallest rural municipalities, in some years also Tallinn offered some competition for this position. However, the differences between the groups are insignificant. The real growth of the income was steadily slowing down in the rural municipalities until 2000, turning even into a negative one in rural municipalities. This was, however, followed by a considerable increase in the growth of real income. In towns (excl. Tallinn), though, a considerable variation can be observed during the whole period. In Tallinn the real growth rates were negative in 1997 and in 2000, during other years, especially 2001, the income grew considerably. In other cities and towns the growth rates were slowing down at first, but this was followed by the next upturn and in 2001 the income growth was lower again. On average the real growth rates in Estonia slowed down constantly until 2000 (from 10.4% in

1997 to 0.0% in 2000). In 2001 the revenues grew significantly (15.2%). (Kohalike... 1996–2001; own calculations). However, it is not possible to draw any conclusions about the financial situation of the local governments on the basis of the revenue situation alone, as local governments are constantly assigned new tasks that have to be carried out. The problem whether the growth of the revenues compensates for the new financing needs would require further investigation.

Table 1

**Revenues of local governments in 1996–2001 (EUR),
adjusted to CPI**

Type of LG by number of inhabitants	Average per capita revenue					
	1996	1997	1998	1999	2000	2001
Tallinn	265	237	268	289	268	418
Towns, >10,000	207	250	243	257	291	272
Towns, <10,000	234	273	287	300	323	317
Rural municipalities, >3,000	190	224	249	270	253	275
Rural municipalities, 1,500–3,000	199	255	285	301	278	297
Rural municipalities, <1,500	239	308	330	340	321	328
Estonian average	225	248	265	282	282	325

Source: Kohalike... 1996–2001; own calculations.

Table 2

**Real growth rates of local governments' revenues
in 1997–2001 (%)**

Type of LG by number of inhabitants	Change in the average per capita revenue				
	1997	1998	1999	2000	2001
Tallinn	-10.4	12.8	8.0	-7.2	55.8
Towns, >10,000	20.7	-2.8	6.0	13.2	-6.6
Towns, <10,000	16.8	5.3	4.5	7.7	-2.0
Rural municipalities, >3,000	17.9	11.4	8.2	-6.1	8.4
Rural municipalities, 1,500–3,000	28.0	11.8	5.7	-7.5	6.6
Rural municipalities, <1,500	28.7	7.3	3.0	-5.7	2.1
Estonian average	10.4	6.6	6.5	0.0	15.2

Source: Kohalike... 1996–2001; own calculations.

Table 3

**Change in percentage share of local governments' revenues
from the GDP in 1997–2001 (%)**

Type of LG by number of inhabitants	Change in shares of LG average per capita revenues from the GDP				
	1997	1998	1999	2000	2001
Tallinn	-18.5	6.3	7.5	-15.6	48.9
Towns, >10,000	9.9	-8.4	5.4	3.0	-10.8
Towns, <10,000	6.3	-0.8	4.0	-2.0	-6.3
Rural municipalities, >3,000	7.4	5.0	7.7	-14.6	3.6
Rural municipalities, 1,500–3,000	16.5	5.3	5.2	-15.9	1.8
Rural municipalities, <1,500	17.1	1.1	2.5	-14.2	-2.4
Estonian average	0.5	0.5	6.0	-9.0	10.1

Source: Kohalike... 1996–2001; own calculations.

Table 3 shows the changes in the percentage share of local governments' revenues from the GDP over the years and by different LG groups. First, the weighted average nominal income per inhabitant in different groups was calculated, again using the number of inhabitants as a weight. Next, the revenues per inhabitant, determined by the aforementioned method, were compared to the level of GDP and the percentage shares were compared during different years. Here, too, the changes are very stochastic and no clear trends can be identified. In 2000, the percentage share of the LG revenues as compared to the GDP decreased, in 1997 and 1998 it was stable and in 1999 and 2001 was increasing. Thus, due to Tallinn, in 2001 the growth rate was highest (48.9%) during the whole period. At the same time, in other towns and rural municipalities the share of the revenues as compared to the GDP decreased in 2001. Consequently, the changes in the local governments' revenues have not followed the growth path of the GDP. In the years when the GDP growth rates have been relatively high, the share of the local government revenues has been decreasing (except 2001). In 1999 when the GDP growth rates slowed down (the real growth rates were even negative), the share of the local governments' revenues as compared to the GDP increased considerably.

Estonian local governments' revenue structure by main revenue sources during 1996–2001 is shown in Tables 4 and 5. Table 4 verifies that the main income sources are personal income tax and transfers from the State Support Fund. These two types of revenues are dealt with in greater detail further on. For the remaining revenue sources the changes have been relatively unsystematic. No clear growth or downward trends can be observed.

The income from land tax increased considerably in 2000. The growth rate was highest in Tallinn (54.7%), but also quite significant in smaller towns (26.0%), in larger towns and in the smallest rural municipalities (10.7 and 7.1%, respectively). The negative real growth of the receipts from land tax occurred in 2000 only in larger rural municipalities (–4.5%), which simultaneously experienced a considerable increase in land tax revenues during 1999 (11.4%), when all the other local government groups faced low or even negative growth rates. In 2001 the revenues from land tax remained approximately at the same level on average as they had

been in 2000. The growth was highest in larger rural municipalities and in smaller towns (8.6% and 8.4%, respectively). In the smallest rural municipalities the land tax income decreased by 3.6%. In other municipalities the land tax revenues remained at the same level (Kohalike... 1996–2001; own calculations).

Also, the income from assets increased substantially during 2000 and 2001. In 2000 the growth was particularly high in larger towns (178.5%), it was also considerable in smaller towns (60%). Only in larger rural municipalities the growth rate was again negative (–5.7%). In 2001 the growth was highest in Tallinn (432%), due to selling the aforementioned shares, but rural municipalities too experienced quite a considerable growth of income from assets. The growth rates were negative only in larger towns (–55.1%), that experienced a significant growth in 2000 (Kohalike... 1996–2001; own calculations).

Table 4

**Revenues of local governments in 1996–2001 (EUR),
adjusted to the CPI**

Revenue sources	Average weighted revenue per capita					
	1996	1997	1998	1999	2000	2001
Personal income tax	108	120	132	137	132	135
Land tax	9	11	11	12	13	14
Revenues from assets	8	15	15	16	28	55
Income from economic activities	6	9	10	10	11	11
Transfers from the State Support Fund	33	30	28	29	31	32
Loans	36	20	21	24	22	25

Source: Kohalike... 1996–2001; own calculations.

Table 5

Real growth rates of local government revenues in 1997–2001 (%)

Revenue sources	Change in the average weighted income per capita				
	1997	1998	1999	2000	2001
Personal income tax	10.7	10.7	3.0	-3.1	1.9
Land tax	16.4	2.6	2.2	16.7	0.7
Revenues from assets	76.7	1.9	7.8	78.6	94.5
Income from economic activities	31.5	17.3	3.4	5.9	1.2
Transfers from the State Support Fund	-7.4	-7.3	4.6	6.1	2.9
Loans	-44.6	7.8	14.2	-7.3	12.1

Source: Kohalike... 1996–2001; own calculations.

Receipts from economic activities form the largest revenue per inhabitant in smaller towns (in 2001, 31 EUR per inhabitant), while the smallest and average rural municipalities do not lag far behind (in 2001, respectively, 28 and 25 EUR per inhabitant). Larger towns and rural municipalities are not so keen in undertaking economic activities. Tallinn, for example, received from its economic activities only 0.83 EUR per inhabitant in 2001. During the period in question, excluding 2001, revenues from economic activities increased in all the groups of local governments (except Tallinn). In 2001 the growth rates were negative in smaller towns and rural municipalities, in Tallinn the revenues from economic activities had decreased also in 1998 and 1999 (Kohalike... 1996-2001; own calculations) The large variations in the revenues from economic activities can be put down to the extremely diverse privatisation practice of the local governments — the structure of ownership of their utility companies varies greatly.

Large variations can also be observed in the local governments' borrowing practices during separate years. Here one must note that the extensive loans taken out by some municipalities in some of the years in question, have affected the whole group's average (or even

all-Estonian average). For example, the 1997 decrease was largely caused by the activities of Tallinn, whose loans in 1996 amounted to 71 EUR per inhabitant, whereas its following year's loan burden remained nearly the same. In 2001, however, on average the loan income grew due to the raised borrowing burden of rural municipalities (the increase in the loan income reached 33% in smaller municipalities and 121% in larger rural municipalities (Kohalike... 1996–2001; own calculations).

Tables 6 and 7 show the level and dynamics of the two main revenue sources of the Estonian local governments — personal income tax and unconditional transfers from the State Support Fund — by separate groups of municipalities. It appears from Table 6 that the larger the municipality, the higher its level of average income from personal income tax and vice versa — the smaller the municipality, the higher the amount of transfers per inhabitant from the State Support Fund. Thus average revenues from personal income tax in Tallinn considerably exceeded those in other towns, not to mention rural municipalities. Compared to the smallest rural municipalities, in Tallinn the average revenues from personal income tax per inhabitant were almost two and a half times higher. At the same time, in 2001 the revenues from the income tax per inhabitant in smaller towns and larger rural municipalities were higher than those of larger towns. Generally, in real terms, the receipts from personal income tax have been increasing constantly. The growth was negative only in Tallinn in 1999 and in all groups exempt small towns in 2000. During the years 1997–1999 and in 2001 the receipts from personal income tax grew in rural municipalities even faster than in towns (Table 7).

For the smallest municipalities, the allotments from the State Support Fund are at the same level with their revenues from personal income tax. In other types of local government the allocations from the State Budget are well below the revenues from individual income tax. Tallinn receives no support from the State Support Fund. In 1997–1998 the growth of the allotments from the State Support Fund was negative in real terms, while towns experienced a particularly substantial decrease. In 2000 a notable increase in transfers took place in real terms, which was again significant in towns (excl. Tallinn). In rural municipalities the growth was more

Table 6

Revenues from personal income tax and the State Support Fund in 1996–2001, adjusted to the CPI (EUR)

Type of LG by number of inhabitants	Weighted average income per capita											
	Personal Income Tax						State Support Fund					
	1996	1997	1998	1999	2000	2001	1996	1997	1998	1999	2000	2001
Tallinn	157	174	195	190	190	195	0	0	0	0	0	0
Towns, >10,000	105	114	123	127	117	116	36	30	27	30	35	40
Towns, <10,000	97	107	115	124	127	125	48	40	37	39	43	44
Rural municipalities, >3,000	82	96	109	122	117	121	46	46	41	40	39	39
Rural municipalities, 1,500–3,000	58	65	74	84	80	84	64	65	63	63	62	61
Rural municipalities, <1,500	51	58	65	68	68	74	65	66	64	68	68	67
Estonian average	108	120	132	136	132	135	31	29	26	27	31	33

Source: Kohalike... 1996–2001; own calculations.

Table 7

**Real growth rates of the revenues from personal income tax and
the State Support Fund in 1997–2001 (%)**

Type of LG by number of inhabitants	Change in the weighted average revenue per capita									
	Individual income tax					State Support Fund				
	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001
Tallinn	10.9	12.1	-2.3	-0.3	2.8					
Towns, >10,000	8.0	8.0	3.3	-7.4	-0.9	-17.3	-10.9	11.2	19.7	12.7
Towns, <10,000	11.0	7.2	8.0	1.8	-1.5	-16.3	-7.7	5.4	9.3	3.5
Rural municipalities, >3,000	17.3	14.3	12.0	-4.4	3.5	-0.7	-10.7	-1.5	-3.7	-0.3
Rural municipalities, 1,500–3,000	12.6	13.9	13.1	-3.8	5.1	2.0	-3.4	0.7	-1.4	-1.4
Rural municipalities, <1,500	12.8	12.4	12.2	-6.4	8.8	1.1	-2.4	5.6	-0.6	-0.7
Estonian average	10.7	10.7	3.0	-3.1	1.9	-7.3	-8.5	4.5	13.7	4.2

Source: Kohalike... 1996–2001; own calculations.

modest. Due to these changes, in 2000 the real revenues from the Support Fund were almost at the same level as in 1996. However, one must remember that during these years several new functions were assigned to local governments. In 2001 the allotments from the Support Fund to rural municipalities decreased to a certain degree, while the transfers to towns, on the contrary, increased. The growth was most remarkable in larger towns.

3.2. Dynamics of the level and structure of local governments' expenditures

Tables 8 and 9 show the structure of Estonian local governments' expenditures by main expenditure categories during the years 1996–2001. In order to ensure the comparability of the 2001 data with those of the previous years, we detracted from the expenditures of 2001 the educational expenditures delegated from the State Budget to the local level (allocations for teachers' salaries that beginning with 2001 are paid out of local budgets). According to Table 8, despite the above correction, education is still the main area of expenditure for local governments. It is followed by economic expenses and general administration expenditures. Expenditures on education and general administration are analysed in more detail below.

Like with revenues, in the case of expenditures too the changes during the years in question appear to be quite stochastic. Only expenditures on defence and public order have been constantly decreasing, except in 2001, when in Tallinn these expenditures increased considerably (from 0.64 to 9.2 EUR per inhabitant in real terms). This caused a significant increase in the Estonian average (305%). However, these expenditures form only a small part of the local governments' expenditures. Among the groups of local governments the changes in the expenditures are more mixed. In different years and in separate groups of local governments the expenditures on defence and public order have also increased in real terms. Leaving aside Tallinn, larger rural municipalities tend to spend most on defence and public order (in 2001 on average 1.5 EUR per inhabitant in real terms), whereas larger towns spend

least (in 2001 on average only 0.16 EUR per inhabitant). In other groups of local governments the expenditures on these areas are between 0.9 to 1.15 EUR per inhabitant (Kohalike... 1996–2001; own calculations.)

In 1997–1999 spending on culture and art grew (except in Tallinn and medium size rural municipalities in 1999). In 1998 the growth was particularly high, but in 2000 the expenditure decreased only to be followed by a new increase in 2001. The level of expenditures on culture is highest in smaller rural municipalities (in 2001 the sum in real terms was 32.7 EUR per inhabitant on average). In the remaining groups the expenditures on culture and art remained within the limits of 16 and 25 kroons per inhabitant in 2001. (Kohalike... 1996–2000; own calculations)

Table 8

**Local governments' expenditures in 1996–2001 (EUR),
adjusted to the CPI**

Expenditure areas	Weighted average expenditures per inhabitant					
	1996	1997	1998	1999	2000	2001
General administration	26	26	27	28	28	30
Defence and public order	1	1	1	1	1	3
Education and science	85	88	97	103	97	102
Culture and art	14	16	20	21	20	22
Recreation and sport	4	4	5	7	9	12
Health	4	3	4	4	4	5
Social security and welfare	9	23	23	24	24	31
Economic affairs	56	52	54	64	60	74

Source: Kohalike... 1996–2001; own calculations.

Table 9

**Real growth rates of local governments' expenditures
in 1997–2001 (%)**

Expenditure areas	Change in weighted average expenditure per inhabitant				
	1997	1998	1999	2000	2001
General administration	2.8	7.2	2.6	-0.4	7.7
Defence and public order	-6.4	-16.4	-9.6	-4.8	304.9
Education and science	4.1	10.3	5.2	-5.1	4.8
Culture and art	10.0	29.1	5.0	-8.4	12.5
Recreation and sport	4.1	37.2	28.5	36.0	36.2
Health	-6.6	22.1	-5.6	-5.5	26.6
Social security and welfare	165.4	-0.2	4.7	-0.8	25.9
Economic affairs	-7.0	4.7	18.2	-6.6	23.3

Source: Kohalike... 1996–2001; own calculations.

Spending on sports and recreation has increased fast and steadily. Here too we can notice certain randomness — during several years in some groups of local governments the expenditures in real terms (but also in nominal terms) decreased. Still in 1999 larger towns and rural municipalities spent most on this expenditure area (average expenditures in real terms 8.4 and 6.8 EUR per inhabitant, respectively). In 2000, a substantial leap forward was made by smaller towns, their expenditures in real terms rising from 5.3 EUR per inhabitant on average in 1999 to 17 EUR per head in 2000. A large part of this was caused by the boost of investments in Keila (in 2000 the nominal expenditures on sports and recreation were in Keila 211 EUR per inhabitant). Thus, one can conclude, the randomness of expenditures in some areas is often caused by large-scale state investments. In 2001 Tallinn spent most on sport and recreation — in real terms 15.85 EUR per inhabitant. However, Tallinn was closely followed by the groups of larger towns and of rural municipalities and smaller towns. The lowest level of expenditures on sport and recreation appeared to be in the smallest rural municipalities (in 2001 only 2.7 EUR per head on average). (Koha-

like... 1996–2001; own calculations)

Changes in health expenditures have varied, but as this area is relatively centralised, these expenditures are relatively low in the local governments' budgets (in 2001 among different groups in real terms from 2.5 to 4.5 EUR per person on average, except Tallinn, whose expenditures on this area have risen from 4.3 EUR per head in 2000 to 8.4 EUR per head in 2001). (Kohalike... 1996–2001; own calculations)

Social welfare expenditures grew considerably in 1997, when local governments first started to pay subsistence allowances. However, as the funds for these allowances are allocated from the state budget, there was no actual increase in local governments' expenditures. Later on the social welfare expenditures have been relatively stable (a small decrease in real expenditures in 1998 and increases in 1999 and 2000), except a significant rise (25%) in 2001, which was caused by a substantial increase in social expenditures in Tallinn (98%). Within different groups of local governments there were great fluctuations during the period in question, although no clear trends can be identified. Throughout the period, social expenditures were highest in smaller rural municipalities, which is not surprising, the population of these municipalities generally being poorer than elsewhere. In 2001, the average per capita social welfare expenditures were 36.9 EUR. Until 2001 the lowest per capita social welfare expenditures were those of Tallinn (in 2000 only 16.6 EUR in real terms, which rose to 32.8 in 2001). (Kohalike... 1996–2001; own calculations.)

Economic expenditures have likewise varied, years of growth alternating with periods of decline both in Estonian average figures as well as within separate groups of local governments. One can only conclude that during all the years in question these expenditures have been higher in towns than in rural municipalities, although recently the differences have been somewhat decreasing. This is not surprising, considering that a large part of these expenditures is spent on public maintenance services such as keeping streets clean etc. (in Estonia on average about 50%). Tallinn is with no competition the leader in this area (in 2001 the per capita spending was 134.3 EUR in real terms). (Kohalike... 1996–2001; own calculations)

Tables 10 and 11 show the level and dynamics of Estonian local governments' expenditures on education and general administration in different categories of municipalities. According to Table 11, expenditures on education have been constantly growing, except in 2000, when a slight decrease was suffered. In case of this area, no clear trends can be identified, either. In all groups growth alternates with the decline. In general terms we can conclude that the variations in per capita expenditures on education between different groups are insignificant (in 2001 from 94 EUR in larger towns to 119 EUR in smaller towns). Nonetheless, a slight trend can be noticed that these expenditures tend to be higher on average in smaller municipalities (in smaller towns and smaller rural municipalities) than in larger municipalities. As smaller local governments also have smaller schools, this supports the hypothesis that there are certain fixed costs which do not depend on the number of pupils in a particular school. As a result, the present state system of financing schools on the basis of the expenses per pupil puts smaller municipalities into worse conditions.

Regarding expenditures on general administration, real growth took place during all the years concerned. True enough, in some years in some of the groups of municipalities the level of expenditures also decreased, but no clear tendencies are evident. Expenditures on general administration are certainly higher in smaller municipalities and the differences are quite significant. In 2001 the expenditures in this area were lowest in larger towns (on average 21.15 EUR per inhabitant in real terms) and highest in the smallest rural municipalities (on the average 55.8 EUR per inhabitant). The difference is thus more than two and a half times. This refers to the possibility that the amalgamation of the smaller municipalities might save at least general administration costs. It is somewhat surprising that since 1998 the general administration expenditures in Tallinn have been higher than in other larger towns; in 2001 the difference was quite substantial — respectively 30 EUR compared to 21.15 EUR per inhabitant in real terms. The real growth rate of the administrative expenditures has also been highest in Tallinn. Also, the expenditures in this area have been higher in smaller towns than in larger rural municipalities.

Table 10

**Expenditures on education and general administration
in 1996–2001, adjusted to the CPI (EUR)**

Type of LG by number of inhabitants	Weighted average per capita expenditures											
	Education						General administration					
	1996	1997	1998	1999	2000	2001	1996	1997	1998	1999	2000	2001
Tallinn	74	75	91	93	93	100	17	17	21	21	24	30
Towns, >10,000	90	94	95	101	92	94	18	19	21	21	20	21
Towns, <10,000	104	105	107	114	120	119	31	32	34	34	34	33
Rural municipa- lities, >3,000	84	85	97	103	97	110	30	31	31	33	31	32
Rural municipa- lities, 1,500–3,000	80	88	100	112	98	103	38	40	40	42	39	39
Rural municipa- lities, <1,500	90	109	125	117	114	106	51	54	53	56	52	56
Estonian aver- age	85	88	97	103	97	102	25	26	27	28	28	30

Source: Kohalike... 1996–2001; own calculations.

Table 11

Real growth rates of expenditures on education and general administration in 1997–2001 (%)

Type of LG by number of inhabitants	Weighted average per capita expenditures									
	Education					General administration				
	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001
Tallinn	-0.5	19.9	2.9	13.8	23.3	1.7	20.4	2.5	0.2	7.5
Towns, >10,000	3.5	8.8	1.5	-2.5	3.5	3.8	1.7	6.0	-9.1	2.1
Towns, <10,000	0.3	9.4	-2.6	0.3	-0.7	1.6	1.2	6.4	5.6	-0.5
Rural municipalities, >3,000	2.6	1.0	4.3	-6.4	4.9	0.3	15.0	6.1	-6.4	13.7
Rural municipalities, 1,500–3,000	5.3	0.1	4.0	-6.6	0.0	10.0	13.7	12.0	-13.2	5.1
Rural municipalities, <1,500	5.2	-1.4	6.2	-6.7	6.5	20.0	15.2	-6.5	-2.9	-6.8
Estonian average	2.8	7.2	2.6	-0.4	7.7	4.1	10.3	5.2	-5.1	4.8

Source: Kohalike... 1996–2001; own calculations.

4. The need for an administrative reform

4.1. The problem of independence of the central and local authorities

In Estonia, one of the most problematic issues with public administration has been the irrational distribution of responsibilities between the central authorities and local governments. Also, the central government has been accused of overly excessive involvement in the local matters, which results in the disproportionate fiscal centralism and limited autonomy of the local governments. From this standpoint, Estonia would need a public sector reform in order to achieve the independence of the two levels of governance from each other, to force the central government to deal with its own matters and enable the local authorities to accomplish the functions within their competence. Thus, the administrative reform of the public sector should restructure both the central government and local governments in order to increase their administrative capacity and establish better relations between the two levels. At present the Local Governments Department of the Ministry of Internal Affairs holds responsibility for the overall organisation of local governments administrative framework. Local governments' fiscal relations are the concern of the Ministry of Finance. In addition to these two institutions, local issues are also regulated by the Ministers of Regional Affairs and of Ethnic Affairs, but also by the Public Administration Bureau of the State Chancellery. Such fragmentation of tasks is confusing and causes problems in actual defining of the responsibilities. This is also the reason why the plans for the public sector reform are episodic, contradictory and eclectic.

Comparing Estonia to the EU Member States, it seems at first (when evaluating fiscal autonomy on the basis of the ratio between the local governments' tax revenues and their total expenditures) that the level of fiscal decentralisation in Estonia is only slightly above the EU average and is higher than that of many EU countries. In reality tax administration in Estonia is extremely centralised. The central government determines all main tax bases and tax rates and administers the taxes. Local governments can only change the rate of land tax to some extent, but they completely lack autonomy regarding personal income tax. The amounts of the Sup-

port Fund assistance are directly linked to the receipts of personal income tax. Thus, the planning of a large part of LG revenues is factually carried out by the central government, not by the local governments themselves.

One of the easiest ways to increase local revenues would be by improving tax collection. As tax administration is centralised, local authorities practically have neither possibilities nor interests to contribute to more efficient tax collection. Nor can local governments take any initiative and invest in the promotion of economic development, thereby accelerating the land reform, as an increase in tax revenues would automatically lead to a decrease in allotments from the Support Fund, which means that their total revenues would nevertheless remain unchanged.

Support Fund allotments have this advantage over targeted allocations that local governments are entitled to use them at their own discretion; they do not restrict their fiscal autonomy as much as targeted allocations which are earmarked for use in particular areas and whose use is controlled by the central government. Here it is appropriate to emphasise that the European Charter of Local Governments (RT2 1994, 26, 95) also postulates that whenever possible grants to local governments should not be tied to the financing of specific projects, in order not to infringe upon the local governments' liberty to act at their own discretion within the framework of their jurisdiction. At the same time, in Estonia local governments are not supposed to take any efforts in order to get allotments from the Support Fund. Rather it can be said that the less active a local government is in generating other incomes, the more support it will receive from the Support Fund. Conditional transfers or investment supports, on the contrary, presume that the local governments show initiative, evaluate their needs and possibilities and substantiate their projects.

4.2. Local governments' functions

It has not yet been finalised which mode of distribution of functions between local governments and the central government would be optimal for Estonia. Several authors even fail to separate the

local governments' functions from those public functions that are financed by the central government through local budgets in the form of targeted allocations. The salaries of primary and secondary school teachers, but also the social benefits are legislated at the central government level by means of different laws and regulations and the task of local governments is mainly to deliver the money to the eligible persons. Table 12 highlights the areas in which between 1993–2001 changes were made in the distribution of the public sector responsibilities. The functions in Table 12 are divided between the central government and local governments depending on whether the tasks are financed from the central or local budget.

According to Table 12, the amount of tasks undertaken by local governments has increased in several areas. The health sector is, for example, covered by 6 laws and 15 lower-level legal acts, culture by 5 laws and 10 secondary acts (Moll 1997).

Furthermore, §6, section 3 of the Local Governments Organisation Act is confusing as it states that in addition to the above-mentioned tasks local governments are also responsible for managing and organising all the other local issues that: 1) are delegated to the local governments by other legal acts; 2) are not legally delegated to be managed or organised by other institutions. Such an unspecified definition has caused a situation, in which neither the central government nor local governments know exactly what functions are to be undertaken by local governments. An analysis carried out at the request of the Ministry of Internal Affairs revealed that local governments' responsibilities are regulated by almost 450 different laws and legal acts that have assigned to them over 400 different tasks (Moll, 1997). Additionally, local governments carry out tasks that appeared to be relevant in some circumstances, but are not their responsibility according to the law. This concerns, for example, partial financing of the police (insufficient fuel limits of the municipal constable force local governments to find supplementary funds to cover the fuel costs from their own budgets), but also support to medical centres, etc.

Table 12

Changes in the division of responsibilities of the public sector between 1993–2001

	1993		2001	
	Central	Local	Central	Local
Education	Universities and research institutions, teacher training, salaries of teachers in primary and secondary schools, textbooks, some investment grants	Construction, operation and maintenance of primary and secondary schools, kindergartens and art schools, vocational and sport schools	Universities and research institutions, teacher training, textbooks, some investment grants	Construction, operation and maintenance of primary and secondary schools, kindergartens and art schools, vocational and sport schools, salaries of teachers in primary and secondary schools, school transport
Health	Medical research institutes, special service hospitals and tertiary hospitals	Capital investments and maintenance of municipal hospitals and polyclinics	Medical research institutes, special service hospitals and tertiary hospitals	Capital investments and maintenance of municipal hospitals and polyclinics, a municipal doctor
Fire protection	Fire protection and emergency services			Emergency services

	1993		2001	
	Central	Local	Central	Local
Culture and sport	National libraries and museums	Construction, operation and maintenance of local libraries, cultural centres, sport centres	National libraries and museums	Construction, operation and maintenance of local libraries, cultural centres, museums , sport centres
Social care	Unemployment benefits, subsidies to local governments for other welfare including allowances	Elderly care, home visits and other social services	Unemployment benefits, subsidies to local governments for other welfare	Elderly care, home visits and other social services, allowances

Source: Eesti..., 1995: 15; Milt, 2002; Analysis..., 1999.

Over the years the principles of financing the functions have changed. If in the mid-90s several functions were covered by targeted allocations from the state budget, then later on most of them started to be funded from the general Support Fund. At the same time, the total volume of the Support Fund has increased at a lower speed than the expenditures of the local governments (except in 2000) and in real terms was almost at the same level in 2000 as in 1996.

The local governments' functions indicated above can be divided into two. The first part are the functions that are defined as an area of activity, while the other derive from having an institution of some kind (see also section 2.1.). Such a division is, however, unjustified. The responsibility to provide public services to the local population should not depend on whether an LG has or has not educational, social or cultural institutions within its boundaries. Such a division fails to encourage local governments to broaden the scope of their public services or improve their quality; instead, it provides a way to bypass the responsibility and to live at the expense of one's neighbours. Local governments should settle the accounts among themselves — for example, calculate the tuition costs per pupil and send invoices to the local governments whose people have consumed their schooling service. Until now the municipalities have not been very active in doing this.

It is also misleading that the list of local governments' tasks is viewed as an exhaustive document by the municipalities themselves. This allows them to conclude that all other tasks assigned to local governments are central by their nature; consequently, an additional flow of funds from the state budget should be provided to finance them. This approach is unjustified both on the basis of §6 section 3 of KOKS and considering that the type of tasks varies. At the same time, the vague division of the responsibilities refers to the need to revise the distribution of tasks between the central and local governments, considering the practicalities and fixing the results in the laws unequivocally.

One of the important problems in carrying out the public sector reform is the analysis of local governments' functions. On the one hand, the current functions should be reviewed and performance

appraisals carried out to see how well any of the governments has coped with particular tasks. In case it appears that the delegation of some functions has not paid off, it needs to be re-centralised. On the other hand, it is necessary to find out how big is the need for further decentralisation, i.e. whether some of the central government's functions could not be more efficiently managed by the local authorities. Subsequently the functions assigned to the local level should be clearly defined and their costs should be evaluated. In accordance with the financial needs, the income base should be investigated and respective improvements in the current financing system made.

The rationality and possibility to involve the private and third sector in the provision of public services needs to be analysed as well. Care should be taken that the prices of public services would not rise as a result. If the prices are kept stable, the private sector could enter the public services market only bolstered by its higher efficiency (lower costs). One of the areas where the means of local governments are not sufficient and where in addition to loan capital the private sector could be used more widely are investments into the infrastructure. However, it should be kept in mind that privatisation itself will not result in increased efficiency in providing public services, if the privatised enterprise maintains its monopolistic status and contracts cannot ensure sufficient municipal control over the operations (primarily over service prices) of the enterprise. The local government's support and acknowledgement are needed for the work carried out by the third sector in different social spheres (street-children, fight against drug abuse and addiction, etc.) Often municipalities' limited resources do not let them cope with these problems. There should be more co-operation with local inhabitants and enterprises; they should be involved in the decision process of important issues. Such an approach would ensure the development of local governments in accordance with the needs, interests and possibilities of the local inhabitants.

The present employment policy, too, should undergo significant reforms. Several analyses have shown that the public sector's inefficiency in many countries can be put down to the excessive low-wage under-qualified labour force. To provide the population with the necessary public services at low prices and with sufficient

quality, a small, well paid and motivated administration should be created that is aware of the tasks and is fully responsible for accomplishing them (Tanzi, 1997; Kim, 1997). Therefore the training facilities of civil servants should be developed further. In addition, in the ministries the civil servants' working results have been taken into account when paying result-based remuneration. However, the lack of a proper methodology for evaluating the results and paying bonuses is still a problem.

There are problems with the work force also at the local level. Many rural municipalities and smaller towns are short of qualified specialists or cannot employ them full time. In the regions lagging behind the local government is the main employer and the wish to reduce the unemployment would lead to excessive employment of civil servants. Such an approach is certainly unjustified. Local governments should be able to accomplish the functions assigned to them with optimal costs guaranteeing sufficient quality of the public services. To achieve this, the number of local government officials should be brought at an optimal level, their training should be intensified considerably, their rewarding improved and the officials should be made responsible for their actions and non-actions.

From the above it is evident that the public sector reform represents a package of complicated issues. Today even the most general principles of the reform are inadequately defined, nor have they been sufficiently well discussed with the stakeholders. The main aim of the reform should be to increase local governments' autonomy, and to ensure a better balance between the two levels of governance. Indeed, some control should be exercised over local governments' activities, to avoid endangering macroeconomic stability by giving local governments overly broad fiscal autonomy. Based on international practice and Estonia's earlier experience, the balanced local budget requirement as well as limits to local borrowing should be retained.

4.3. Suggestions for improving local governments' financial situation

Decentralisation of tax administration does not give the central authorities the right to declare tax revenues as their own revenues and present local governments in the role of dependants. Tax revenues are supposed to finance the provision of public services. They should be divided between the central and local governments and further down between their subordinate establishments as specified by standard, in accordance with the division of public sector responsibilities. For that the normative bases and financing schemes for each task (function) of the public sector and administrative system should be worked out. Tax receipts collected to finance common tasks should reach the administration that is responsible for the particular task in time, with a minimum cost and reasonable transparency.

As the share of the local taxes in total municipal revenues will probably remain modest also in the future, the autonomy of local governments with respect to shared taxes should be increased, thus raising their interest in improving tax collection. One possibility could be to give local governments more freedom to determine the rate of land tax, another could be dividing personal income tax into two independent shares. Tax incentives are allowed to be made, both by the central as well as local governments, only from their respective part of the tax base. Thus, the receipts of personal income tax that due to the tax incentives (for example, the fixed minimum tax-free income threshold, etc.) are smaller should be fully compensated for to local governments from the state budget. The proposal would be to separate the share of the individual income tax rate (currently 26%) into two parts — the local part would be 15% and this would go to the local budgets and the central part would be 11% which would go to the central budget. As the overall costs of the tax incentives must come from the state budget, then the local governments' receipts from personal income tax would increase considerably. The winners would be mainly these local governments, where the average income is close to the tax threshold — their revenues would grow considerably if the tax incentives were compensated for by the central government.

Moreover, the stipulation by the Roads Act (RT 1999, 26, 377) that at least 30% of the fuel excise duty should be transferred to LG budgets as a special allocation for maintenance, repair and construction of local roads seems very appropriate.

Normative fixing of the minimum volume of the national investment programmes would create a solid basis for financing local development programmes. The minimum level of investment into local objects could be 0.5% from the GDP, which on the basis of the GDP 2002 would mean a minimum of 500 million kroons. As problems with financing development investments mainly occur in municipalities with a lower income-base, this amount could be merged with the Support Fund.

The inadequate standard which guides the apportioning of allotments from the State Support Fund has deprived the local governments of an opportunity to determine and accelerate their own development. The income bases of towns and rural municipalities have been built up by the central government in this way that in more than 90% of the municipalities the more important role is played by the State Support Fund. This is a financial instrument for safeguarding the administrative authority of the centre. If a local government makes investments to support the economic development in its boundaries, then such a development-oriented activity will be punished by way of decreasing the allotments to this town or rural municipality from the Support Fund. In such a situation it is not beneficial for the municipalities to invest into the economic infrastructure if they want to increase their income tax receipts. In order to raise the local governments' interest in increasing the taxable income within their boundaries, a significant share of the increased tax receipts should remain in the hands of local governments. For poorer municipalities, transfers from the State Support Fund should remain the main income source, as far as its aim is to bridge the incomes gap. At the same time, the allotments apportioning system should be changed, so that it would no longer impede local initiative in developing the region in order to increase its tax base and accordingly its tax receipts.

The central government should establish a local income base that would guarantee the minimum level of local public services. This

presumes too, that the minimum standards will be set for local public services. If a local government wishes to make progress, it should find resources by itself. These supplementary resources will not be taken into account when calculating allotments from the Support Fund. Thus, if the local governments, as a result of efficient economic management, succeed in providing services at smaller costs, then this economy would not affect the size of their allotments from the Support Fund. No doubt such an approach would considerably enhance local governments' motivation for efficient management and would stimulate them to find supplementary resources. Under such conditions, one could say, local governments would really be fully responsible for the development of local communities and would be able to use their initiative.

In view of what was said above, the minimum volume of the Support Fund allotments and of allocations from the state budget should be fixed on a normative basis (as a % of the GDP). This would provide local governments with guarantees for long term planning. *Riigikogu* might decide to increase this minimum amount depending on the economic situation at the moment and regional needs for support. Working out these norms as well as the equalisation formula could be the responsibility of the Union of Local Authorities. Whether any representatives of the central government and county authorities might be involved in this process is a matter open for consideration. The minimum size of a Support Fund allotment for a LG could be fixed at 1% of the GDP (1.5% together with investment support).

Besides the legally determined common tasks local governments should also seek for more specific development possibilities. This means that besides receiving the normatively fixed amounts of shared taxes, local governments should be interested in increasing their own revenues. The majority of these increased own revenues should be left to local governments to compensate for their efforts in improving the entrepreneurial environment. Thus, local governments' rights in levying local taxes (incl. affecting personal income tax receipts) should be extended.

Proceeding from the costs per pupil as a basis for financing schools is wrong because it does not take into account that in addition to

variable costs that are indeed connected to the number of pupils in the school there are also fixed costs that do not depend on the number of pupils. Consequently, there should be separate principles for allocating funds to cover fixed costs that would ensure the functioning of schools, while variable costs would be calculated following the currently valid principles, according to which the allocation depends on the number of pupils.

Fulfilment of the central government's functions (such as payment of allowances, etc.) should be guaranteed on a normative basis in the form of special allocations from the state budget. Today, the deficiency of funds for subsistence allowances must be covered from local budgets, which actually means delegation of this responsibility to local governments.

Co-operation between local governments and the central government in meeting the needs of the state and citizens must be constantly improved and adjusted to new circumstances. In order to secure this a regular and effective mechanism of negotiating should be worked out to guarantee conclusion of all the necessary agreements before budgetary debates start. All legal acts regulating the costs and revenues of local governments should be mandatory and representatives of local governments should have taken part in the debates.

5. Role of the administrative territorial reform

5.1. Size of local governments

Only after having reformed the division of responsibilities of the public sector and the principles of financing the following issues can be decided: 1) what is the optimal number of tiers of governance in a particular situation, 2) what is the optimal size of local governments and accordingly also the optimal number of local governments (Gilbert, Picard, 1996: 20). Estonia has decided in favour of a one-tier local governments system. However, upon joining the European Union, the position of the regional Unions of Local Governments in the administration system should be legally determined, as the implementation of the European Structural

Funds foresees closer regional co-operation. Table 13 shows the division of Estonian local governments by the number of inhabitants. Due to the low density of population, a large part of the local governments are quite small — the number of inhabitants of more than a half of the rural municipalities and of four towns is less than 2000.

Regarding costs, larger units, thanks to economies of scope, operate more efficiently than smaller units and in their case the share of administrative expenditures in total expenditures is lower (Kalseth, Rattsø, 1995: 240). However, it should be kept in mind that local governments are not business enterprises aiming for economic efficiency, but governing institutions whose task is to ensure the presence of public authority and the development of democracy in the municipalities. Their costs and efficiency can thus be discussed only within the constraints of guaranteeing the presence of public authority and democratic development in the local level.

Table 13

**Division of Estonian local governments by
the number of inhabitants in 2000**

Number of inhabitants	Number of municipalities		
	Towns	Rural municipalities	Total
0–1,000	–	22	22
1,001–2000	4	92	96
2,001–5000	15	78	93
5,001–10,000	8	13	21
10,001–20,000	9	–	9
20,001–50,000	1	–	1
50,001–100,000	3	–	3
>100,000	2	–	2

Source: Ministry of Internal Affairs..., 2002.

Local governments can reduce costs by co-operating with one another in providing public services. This co-operation is especially

important for small municipalities (Kim, 1997: 25). The Estonian Local Governments Organisation Act (RT I 1999, 82, 755) gives local governments the right to co-operate in expressing common interests and accomplishing common tasks. This co-operation can take the following forms: joint actions, buying services from other local governments, selling services to other municipalities and establishing local governments unions. Local governments co-operate, for example, in providing public utilities services. In case of the educational, social care and health sectors the municipalities that do not have the relevant establishments (schools, hospitals, care homes, etc.) within their boundaries buy these services from other local governments (Ministry of Internal Affairs..., 2002). Joint procurement of maintenance for roads crossing several municipalities, or joint subsidising of sports/cultural centres servicing inhabitants of several municipalities, or organising sports or cultural events jointly may give considerable savings. Likewise will co-operation of local governments often contribute to the development of the economic environment, for example, in the area of tourism, establishing joint information services or setting up hiking tracks that cross several municipalities. In the conditions of intensified co-operation it may be rational to amalgamate the integrated local governments.

Regarding the current practice, it has to be admitted that the co-operation between local governments in Estonia has not yet lead to mergers. As a matter of fact, amalgamation of local governments is often quite costly and the expenditures needed could be too high for rural municipalities. Moreover, small municipal units also have their advantages. From the democratic standpoint it is important that the lowest government level would be as close to the citizens as possible. What distance between the public authority and its constituency is considered optimal depends on the level of development of the democratic way of thinking and experience gained. The less democratic awareness and experience the population has, the closer the lowest level of governance should be to the citizens: hence in such conditions the optimal size of local governments is smaller. In towns and rural municipalities people can practice the roles of voters and delegates, get experience in managing communities, learn how to balance controversial interests. From the point

of view of the central government, then, local governments appear to be certain schools of democracy, ensuring the acceptance and development of democratic principles among the citizens. Small local government units also help satisfy the local needs for public services better, as the information about the needs and wishes of the local people can be more easily and less expensively gathered in small units compared to larger ones. Thus, it is important to see that the public sector reform would not bring along excessive distancing of the authorities from the people, but would instead encourage local people's involvement in decision-making about local matters.

5.2. The level of local governments' administrative costs

In connection with small local governments, the problem of their relatively high administration costs rises. The smaller a local government, the more expensive its administration and the larger can be the share of its administration costs in its total expenditures. The higher the share of costs spent on administration, the smaller the amount of resources left for fulfilling the local government's other tasks, including investment into the development of the community. Table 14 shows, in percentage terms, the share of general administration costs and investments in the total expenditures of different groups of local governments.

It appears from Table 14 that the share of general administration costs tends to decrease with an increase in the number of inhabitants (i.e., it seems to be relatively less expensive to administer larger local governments). However, when making such conclusions one should bear in mind that:

Table 14

General administration costs and investments in 2001
(% of local governments' total expenditures)

Type of LG by number of inhabitants	General administration			Investments		
	Average	Max	Min	Average	Max	Min
Tallinn	7.6			26.8		
Towns, >10,000	8.0	13.0	5.5	5.9	14.9	0.4
Towns, <10,000	11.3	29.7	6.8	7.7	36.4	0
Rural munici- palities, >3,000	12.7	25.8	7.3	7.7	34.8	0
Rural munici- palities, 1,500–3,000	14.2	25.8	8.0	5.4	46.5	0
Rural munici- palities, <1,500	19.0	86.6	7.2	7.9	69.5	0

Source: Kohalike... 1996–2001; own calculations.

- There are towns and even rural municipalities that are smaller than Tallinn whose relative level of administration costs is lower than that of Tallinn.
- Larger rural municipalities (over 3,000 inhabitants) are on average managed more efficiently than smaller towns whose number of inhabitants is under 10,000.
- There are small rural municipalities (less than 1,500 inhabitants), whose administration costs are relatively lower than those of larger rural municipalities.

The gap between the minimum and maximum shares of administration costs is huge in case of smaller rural municipalities, but it is also fairly significant in case of other rural municipalities and smaller towns. This means that the level of expenditures targeted towards providing public services varies considerably among indi-

vidual local governments, depending on the structure of the population, historical traditions and other factors. This causes the variation of the share of administration costs that ensure the presence of the government authorities in the community. Most rural municipalities with a special status (e.g., those on the islands) are also the smallest. The same conclusions hold if we evaluate the level of general administration costs per inhabitant (Table 15). The great variation between the levels within one group of local governments speaks of a clear need to thoroughly analyse the amount and structure of the administration costs in different local governments and find out what the reasons for these differences are.

Table 15**General per capita administration costs (EUR) in 2001**

Type of LG by number of inhabitants	Average	Maximum	Minimum
Tallinn	41		
Towns, >10,000	29	45 (Haapsalu)	19 (Narva)
Towns, <10,000	46	93 (Võhma)	29 (Kunda)
Rural municipalities, >3,000	44	82 (Keila)	28 (Vasalemma)
Rural municipalities, 1,500–3,000	53	178 (Vaivara)	27 (Helme)
Rural municipalities, <1,500	75	594 (Ruhnu)	35 (Misso)

Source: Kohalike... 1996–2001; own calculations.

The share of investments in local governments' overall expenditures does not allow to draw any clear conclusions, because a large part of the investments are made on the orders of the central government. At first sight, surprisingly, the share of investments in total expenditures is on average higher in smaller than in larger rural

municipalities and even exceeds the investments share of towns. Nevertheless, this is a mere illusion. The average level of investments in smaller towns is elevated by large-scale investments in some small rural municipalities. These investments are primarily financed by the state. In 2001, 22% of the smaller rural municipalities and smaller towns made no investments at all. 12.5% of the medium-size rural municipalities made no investments in 2001 and only 5% of the larger rural municipalities did not. Within all the groups, in around 65% of the local governments (from 64% in the larger towns up to 68% in the small rural municipalities) the share of investments remained below 5% of the total expenditures. (Kohalike... 1996–2001)

5.3. The optimal size of local governments

The main concern of small local governments is how to maintain their autonomy as the equalisation grants from the central government form a relatively large part of their revenues. Table 16 shows the structure of local governments' revenues. It appears from the table that generally the tax revenues of larger municipalities are higher and allocations to them lower, although there are large differences between the maximum and minimum levels within all the groups except in larger towns. Again, it should be noted that the indicators of larger rural municipalities are bigger than those of smaller towns, which supports the fact that larger rural municipalities are better off than smaller towns in the area of own revenues and do not depend so much on allocations. The structure of the allocations is somewhat different in the case of rural municipalities and towns. Rural municipalities depend on the State Support Fund to a larger degree than towns: in the smaller and medium-size rural municipalities group the revenues from the Support Fund accounted for 55% and 53% on average, respectively, and in larger rural municipalities for 43% of the overall amount of income transfers. In the case of larger towns, the share of Support Fund allotments is surprisingly high — in 2001 on average 51% of the total receipts. In smaller towns the Support Fund allotments made up only 37% of the transfers (Kohalike... 1996–2001).

Table 16

Local governments' tax revenues, allocations and loans in 2001 (% from total revenues)

Type of LG by number of inhabitants	Tax revenues			Allocations			Loans		
	Weight. Average	Max	Min	Weight. Average	Max	Min	Weight. Average	Max	Min
Tallinn	52.0			6.2			5.8		
Towns, >10,000	45.6	70.9	30.8	29.7	45.9	14.6	10.9	17.8	0
Towns, <10,000	42.2	62.8	14.0	36.7	66.7	6.4	6.9	28.5	0
Rural municipalities, >3,000	49.9	76.2	29.5	28.1	60.0	2.1	7.7	30.5	0
Rural municipalities, 1,500–3,000	38.3	64.2	10.0	39.8	67.5	3.7	6.5	33.3	0
Rural municipalities, <1,500	36.0	57.5	3.5	43.5	77.0	8.7	6.3	31.9	0

Source: Kohalike... 1996–2001; own calculations.

In all the groups there are municipalities with a sufficiently high income level who are not entitled to allotments from the Support Fund. In addition to Tallinn these are mainly affluent rural municipalities in the Harju county and also some rural municipalities in the Ida-Virumaa county that receive high revenues from the so-called natural resource tax. In general, the borrowing capacity of smaller municipalities is also lower than that of larger ones, which also decreases their autonomy.

Thus, based on the data provided it is neither possible to accept nor reject the hypothesis that amalgamation of local governments would increase their autonomy, support cost effective management and promote the acceleration of the development-based investment activities. A more comprehensive and thorough investigation is needed. Without previously solving the conceptual problems of the administrative reform (precise assignment of functions, working out financing schemes) the local governments cannot develop into independent governmental units that can deal with issues of local development in a most rational way. In designing the administrative territorial reform, the relatively low population density of Estonia as well as its large regional variety should be taken into account, but also attention should be paid to the number of larger centres and their connections with the surrounding areas, as well as significant regional differences in the locations of government agencies but also remarkably different historical development and specific territorial conditions (Haldusreform..., 2000). The administrative territorial reform cannot be regarded as a simple technical merger.

It is not easy to define the optimal size of local governments. For example, in Sweden, a country of highly developed democracy and a high level of incomes, the minimum size of municipalities — *Kommunes* — is generally 8,000 inhabitants. In regions with a low density of population the *Kommunes* are smaller (even only 2,000 inhabitants), but being in a special status, they fulfil their functions, getting considerable special support from the government. At the same time in Finland, a sparsely populated country, the minimum number of inhabitants in a local government is 4,000 (Preem, 2000). Today it is impossible to predict what the optimal size of

Estonian local governments will be as it depends on the definition of their functional responsibilities. In the present conditions rural municipalities with more than 3,000 inhabitants can be considered to be the most viable, as the average data of expenditures in this group showed even better results in general terms than those of small towns. The problem with smaller towns could be solved by merging them with their surrounding rural municipalities into one local government unit. For the local governments working in specific conditions (small islands, areas with a very low population density, etc.) the general financing system is evidently not applicable, in this case their need for a significant state support should be considered.

Even though it may reduce the local governments' autonomy in defining their priorities, the central government should monitor the activities of local governments in the area of population policy, in order to avoid the outflow of people from rural areas. While a small village school, a house of culture or a library usually has no economic reasons for existence, they all may have an important role to play in settlement policy. Therefore, it is necessary to be careful that the reduced number of administrative territorial units would not bring along even more concentration of the population in the cities and their surroundings. As due to its very low population density Estonia is especially sensitive to this danger, the central authorities should strive for the stabilisation of settlement in rural areas in order to ensure both internal and external safety.

An alternative to the merging of local governments could be the re-introduction of the two-level local governments system in Estonia, so that the major part of governance would be carried out by the counties, and local governments' functions would be more limited than they are today. In addition to amalgamating local governments, it may be rational to divide a local government into several new municipalities if this government's separate parts are weakly tied with one another and constantly face confrontations due to their differing interests. To keep the confronting parts together against their will would bring more harm than use.

Conclusion

The current administration system in Estonia has caused the situation in which many local governments are not able to sufficiently well fulfil the functions assigned to them, for instance, to ensure the development activities in the area and efficiently deliver high-quality public services which ought to be readily available to all inhabitants. Thus, there is a need for an administrative reform. The aim of the administrative reform should be to ensure substantial independence to the two levels of governance in order to allow both levels to carry out the functions assigned to them. Therefore, both the central government and local governments need to undergo the reforms and the relationship between the two government levels should be organised better.

As yet the governments have failed to work out, formulate legally and guarantee financially the policies assigned to the central government such as educational policy, cultural policy, communication development strategy, etc. Tax collection functions inefficiently, which implies that the finances necessary for providing public services are not received. The plan for financing strategic investments necessary for future development of Estonia has not been worked out. At the same time, the central government assigns to the local level responsibilities without providing the necessary funds for fulfilling these tasks. Failed actions of the central government make it difficult or even impossible to solve concrete tasks at the local level.

One of the most important points in the process of carrying out the administrative reform should be the analysis of local governments' functions and evaluation of the accompanying needs in expenditure. In accordance with the needs in expenditure, the revenue base of the local governments should be revised. When making corrections to the current financing system of local governments, the aim should be to create such a system of financing that would stimulate local initiative. This would allow balancing local governments' rights and responsibilities as well as opportunities and obligations.

A local government should be a unit of governance that is independent of the central government and fulfils its tasks in taking

care of the living and working conditions of the local people, using the legally provided mandates and measures. In reality Estonian local governments appear to be overly dependent on the central government. Without a stable (with legally determined norms and system of financing) income base local governments cannot become independent.

The problems of the administrative territorial reform could be dealt with only after local governments' functions and their financing schemes will have been adjusted. One possibility for more efficient cost management and insurance of high-quality public services could be encouraging co-operation between localities that could eventually lead to the voluntary amalgamation of some local governments. However, the reality does not support this tendency.

Analysing the Estonian data, it may be concluded that the rural municipalities with more than 3,000 inhabitants face fewer problems than other rural municipalities. The average costs of this group were in most cases better than those of smaller towns. The problem with the smaller towns group could be solved by merging them with their surrounding rural municipalities into one local government unit. The local governments operating in specific conditions (small islands, areas with a very low population density, etc.) need a significant amount of state support.

An alternative to merging the local governments could be re-introduction of the two-level local government system in Estonia, in which the major part of the governing functions would be carried out by the counties and the local governments' functions would be more limited than today. The size of local governments depends first of all on the division of power and responsibilities between the central government and local governments, but also on many other factors (such as population density, roads, strength of the naturally developed hubs, etc.).

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Kokkuvõte

Eesti ettevalmistamine Euroopa Liiduga ühinemiseks esitab uusi nõudmisi ka riigi halduskorraldusele. Euroopaliku ühiskonnakorraldusega riigis on haldussüsteemil täita vastutusrikkad ülesanded nii demokraatia arendamisel, regionaalarengu tasakaalustamisel kui ka igapäevaste avalike teenuste pakkumisel.

Eesti kohalike omavalitsuste finantsolukord on viimastel aastatel destabiliseerunud ja paljudel juhtudel halvenenud. Ühelt poolt on kasvanud kohalike omavalitsuste vastutusalasse antud ülesannete hulk. Teisest küljest puudub kohalikel omavalitsustel seaduste alusel kujunev stabiilne tulubaas, mis võimaldaks valla või linna arengut pikaajaliselt planeerida ja sihikindlalt juhtida.

Kohalikele omavalitsustele seadustega pandavad ülesanded on kas täielikult (kohalike teede remont, euronõuded koolisööklatele, töötuskindlustuse seaduse rakendamine) või osaliselt (õpetajate palgarahad, toimetulekutoetused) rahalise katteta. Hinnanguliselt on lõhe KOVile pandud kohustuste ning võimalike tuluallikate vahel suurusjärgus 2 miljardit krooni. Koos tulubaasi nõrgendamisega on keskvalitsus viimastel aastatel oluliselt vähendanud kohalikele omavalitsustele suunatavaid riiklikke investeeringuid ja andnud nende jaotamise õiguse regionaalseid vajadusi mittetundvate ministriteeriumide pädevusse. Seega muudab keskvalitsuse fiskaalpoliitika paljud kohalikud omavalitsused võimetuks ellu viima neile põhiseaduse ja muude seadustega pandud kohustusi ning Vabariigi Valitsus ei täida Riigikogus ratifitseeritud Euroopa kohaliku omavalitsuse hartaga võetud kohustusi.

Käesoleva artikli eesmärgiks ongi analüüsida Eesti halduskorralduse arendamise sõlmprobleeme ja nende lahendamise võimalusi. Peamine tähelepanu pööratakse keskvalitsuse ja kohalike omavalitsuste suhete korraldamisele. Kõigepealt käsitletakse demokraatliku haldusmõtte tekkimisega seotud probleeme. Teiseks vaadeldakse kohalike omavalitsuste rolli ühiskonnas. Seejärel vaadeldakse Eesti KOVide funktsioonide rahastamise taset ja dünaamikat ning tehak-

se ettepanekud rahastamise viimiseks vastavusse KOVide ülesannetega. Edasi analüüsitakse haldusreformi vajalikkust. Lõpuks vaadeldakse palju kõneainet pakkunud haldusterritoriaalse reformiga seonduvaid probleeme.