

## User Charges and Fees in Theory and Practice: The Estonian Case

Kenneth A. Kriz<sup>1</sup>

Karsten Staehr<sup>2</sup>

Alari Paulus<sup>3</sup>

### Abstract

In this paper we examine Estonia's progress toward implementing and integrating user charges and fees into the intergovernmental financial relations. We start with reviewing some facts about Estonia and its public finance system. We then move to consider the legal basis in the country for the use of fees and charges by local governments. We continue with a statistical description of local government user charges and fees in order to estimate the importance of this financing source for local governments. We seek to assess and analyze the implementation of user charges and fees by looking at case studies of three local governments. We then close by applying the theory of user charges to the Estonian case, and make policy and administrative recommendations.

We find overall that many differences exist between the ideal of user charges and fees and their actual implementation. Locally determined administrative and service fees contribute very little to the local government coffers and are used only to a limited extent to change the public's behavior or to attain other regulatory objectives. Local user charges are preliminary levied in the education sector (principally kindergarten), but also for some activities within culture and art, sports and recreation, health, and social services, and also for public utilities. The setting of the user charges in these areas appears to be only remotely guided by efficiency criteria. For example, the user charges are in almost all cases far from being able to recover cost (long term marginal costs). Distributional concerns – and perhaps also a degree of political and administrative inertia – appear to play significant roles when user charges are determined within these areas. User charges for locally provided services like water, sewage, heating and garbage collection are generally set in order to recover costs. The calculation of the costs might however not fully incorporate the economic costs of the provision, in other words it may not reflect long-term marginal opportunity costs. Several recommendations are made based on the results, including studies to determine average costs of service as well as educational programs for administrators and elected officials.

### Chapter 1. Introduction

As Estonia entered the 21<sup>st</sup> century, the occasionally tumultuous reform period is over and the country is entering a new phase of deep structural reforms, institution building and new ways to organize the public sector – and society in general.<sup>4</sup> Important areas, which have already seen substantial changes and where further reforms are likely, comprise inter-governmental relations and the fiscal relationship between local governments and the central government.

Local self-governance is important if public services are to reflect local requirements and adjust to changing needs. The ability of local governments to provide services is, however, crucially dependent on their ability to finance the services. Possible revenue sources include grants from the central government, shared taxes, local taxes, and user charges and fees. Local taxes and user charges and fees comprise own-source revenue over which the local governments can exert influence in substantial ways. Thus, user charges and fees are essential sources of own revenue enabling local governments to provide adequate levels of public services. User charges and fees are a potential way for local governments to reduce reliance on central governments for revenue. The study of user charges and fee is therefore of great importance for an overall assessment of the functioning of the local government sector.

Independent local governments were re-established in Estonia at the end of the Communist period, but most of the legislation establishing and enabling local governments and their finances were written during the 1993-95 period. The system is essentially a two-tier system where local governments have substantial *de jure* autonomy but where the autonomy is *de facto* restricted, because of financial and other constraints. Most local governments in Estonia remain heavily dependent on the central government for revenue (Hoag and Kasoff 1999, p. 923). The

---

<sup>1</sup> Assistant Professor, School of Public Administration, University of Nebraska at Omaha, Omaha, USA.

<sup>2</sup> Visiting Lecturer, Eurofaculty, University of Tartu, Tartu, Estonia.

<sup>3</sup> Masters degree student, School of Economics and Business Administration, University of Tartu, Tartu, Estonia.

<sup>4</sup> This view was forwarded most publicly by Prime Minister, Juhan Parts: "Our first development stage, the 10 years after independence, has ended. But we can live even better. We can learn to work more, not with our hands, but with our heads." (Tarm 2003).

fiscal relations were relatively stable during the second part of the 1990s, but have since 2000 been subject to a number of changes.

## Chapter 2. Estonia and its local governments at a glance

### 2.1 Demographic and economic background

Estonia is the smallest and northernmost of the three Baltic States. With 1.36 million inhabitants in 2003, the population has declined markedly since it reached a peak of 1.57 millions in 1990.<sup>5</sup> The declining population is the result of net emigration and a “natural decrease” of 5,000-8,000 persons per year. The population density is relatively low at 30 persons per square kilometer. The population is concentrated in a handful of cities, with nearly 50 percent of the population living in the cities of Tallinn, Tartu, Narva, Kohtla-Järve, and Pärnu (Statistical Office of Estonia 2004). The countryside is generally sparsely populated in spite of almost all land being arable, partly as a result of large structural changes in the agricultural sector since the transition started (OECD 2000, annex I).

The age composition also varies substantially within Estonia. Harju county, comprising Tallinn and surroundings, has a relatively large fraction of its population in the working age (70.3%). Conversely, a number of counties in southern Estonia (for example Valga, Võru and Põlva counties) have relatively many children and elderly and a relatively small fraction of their population in the working age (63-64%).

Estonia is often considered one of the most successful transition countries with its rapid and comprehensive economic reforms (Aslund 2002, Staehr 2004).<sup>6</sup> After production declined in the early 1990s, GDP growth has averaged 5.1% during the period 1995-2003. Nonetheless, with its unfavorable starting point, Estonia’s income level is still low compared to the west European countries (Eurostat 2004). Using market exchange rates the Estonian GDP was € 6.9 billions in 2002 or € 5100 per capita (vs. € 24050 for the EU-15 countries). Using purchasing power parities to adjust for the relatively low price level in Estonia, GDP per capita was € 9660 in 2002 (vs. € 24050 for the EU-15). The living standard in Estonia might be higher than these numbers would suggest because of a substantial informal sector in the country.

There are considerable income differences within the country and the differences are growing over time (Table 2.1). The capital region in northern Estonia has a GDP per capita, which is more than twice the level of any other region. The northeastern region, which in Soviet times had much heavy industry, is emerging as the poorest region in the country.

**Table 2.1 Regional GDP per capita, % of Estonia average**

	1996	1997	1998	1999	2000	2001
Northern Estonia	147.9	152.1	154.9	153.3	155.7	158.8
Central Estonia	72.0	68.6	68.0	71.9	66.6	65.3
Northeastern Estonia	69.3	66.1	60.6	58.9	58.0	54.3
Western Estonia	75.9	75.6	75.2	75.2	74.3	71.2
Southern Estonia	67.9	65.0	63.7	65.0	64.3	63.3

Source: Statistical Office of Estonia, Regional Development Database

Other indicators show a similar regional pattern. The registered unemployment rate is lowest in the capital region and highest in the northeast. The average income per household is highest in the north and lowest in northeast. The income tax revenue transferred to the local municipalities is above the national average in the relatively prosperous area around the capital, while the northeastern and southern parts of Estonia also in this respect are disadvantaged.

This rough sketch of the demographic and economic background already suggests that the challenges of the local public governments vary greatly throughout Estonia. The areas with the highest income, in particular Tallinn, also have the highest percentage of its population in the working age. The de-industrializing areas in the northeast have depressed income levels and high unemployment in spite of relatively favorable demographics.

<sup>5</sup> Unless otherwise indicated, data is from the Statistical Office of Estonia, [www.stat.ee](http://www.stat.ee), Regional Development Database or Statistical Database.

<sup>6</sup> Many observers assert that relatively astute transition planning and monetary policy combined with more openness (and access) to foreign capital and goods were determining factors in Estonia’s relatively robust economic transition (Bronstein 1995, Shen 1994, Staehr 2004).

The rural areas in southern Estonia have relatively low income and a large fraction of the population outside the working age.

## **2.2 Local governments in Estonia**

The creation of autonomous local governments in Estonia dates as with the majority of Central and Eastern Europe to the economic transition. During the drive for Estonian independence, local government reestablishment began with small steps. Laws and decrees passed by the Estonian Soviet Socialist Republic in 1989 and 1990 established the first truly local governments in Estonia during the Communist era. However, it was not until the passage in June 1993 of the fundamental enabling statute for local governments, the Local Government Organization Act (LGOA), that local government development was fostered. LGOA delineated the basic functions, responsibilities, and authority structures of local governments (RT I 1993, 37, 558; consolidated text RT I 1999, 82, 755 - Riigi Teataja (RT) is the "State Gazette" of Estonian laws). As of 2003, there were 247 municipal governments in Estonia, 205 rural authorities (*vald*) and 42 towns (*linn*) respectively.

The structure established for governments in the LGOA was nominally a three-tier federal system, with the central government deciding national issues, county governments handling regional issues, and municipal governments administering programs to meet local needs. In practice, however, the system is a two-tier federal system, central and local with very limited autonomy for (the centrally appointed) county governments and relatively little autonomy for local governments. The LGOA was amended only a few times until 2000, then underwent three major revisions in two years.

The population distribution of Estonian municipalities is skewed. The majority of Estonian municipalities are small, with 86 per cent of municipalities having less than 5,000 inhabitants.

## **2.3 Functions of municipalities**

Under the LGOA and the Estonian constitution (Chapter XIV) municipalities have only a small measure of autonomy in decisions about which functions they will execute on behalf of their citizens. There are certain general government functions which are prescribed in the LGOA (Chapter 1, Section 6 (1)):

The functions of a local government include the organization, in the rural municipality or city, of social assistance and services, welfare services for the elderly, youth work, housing and utilities, the supply of water and sewerage, the provision of public services and amenities, physical planning, public transportation within the rural municipality or city, and the maintenance of rural municipality roads and city streets unless such functions are assigned by law to other persons.

There are also social service functions prescribed in the LGOA (Chapter 1, Section 6 (2)):

The functions of a local government include the organization, in the rural municipality or city, of the maintenance of pre-school child care institutions, basic schools, secondary schools, hobby schools, libraries, community centers, museums, sports facilities, shelters, care homes, health care institutions and other local agencies if such agencies are in the ownership of the local government. Payment of specified expenses of such agencies from the state budget or other sources may be prescribed by law.

Independent representative councils (*volikogu*) are authorized to decide issues for the jurisdiction, including the provision of services beyond those specifically assigned in the LGOA. There are also restrictions on unfunded mandates from the central level – the central government cannot impose functions on municipalities without funding them from the state budget.

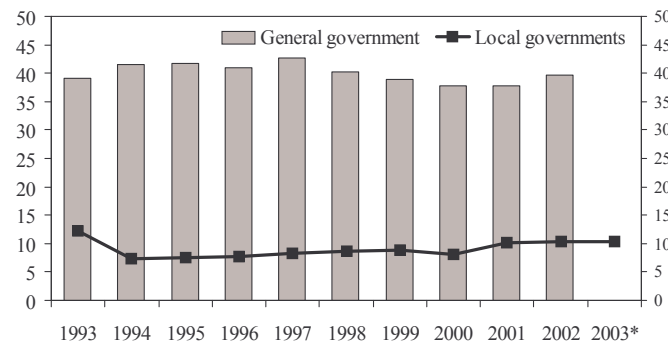
The relationship between the central and local governments in Estonia is one of central preemption. Local governments have the authority to deal with local issues, but the central government exercises supervisory control over not only the legality but also the purposefulness of the local government activities. Additionally, county governors exercise supervisory control over their local governments (LGOA Chapter 11, Sections 66 and 661). In the exercise of supervisory control, the central government can preemptorily (LGOA Chapter 11, Section 661(2)):

1. issue a precept for the elimination of deficiencies in a legal instrument or act;
2. suspend the performance of an act or the validity of a legal instrument; and
3. invalidate a legal instrument.

## 2.4 Trends in Spending

Local governments have increased their importance in service provision over the last several years. Figure 1 shows the share of gross domestic product accounted for by local government spending and general government spending. The figure reveals that while government spending as a whole has been decreasing since the mid-1990s in terms of its size compared to the overall economy, local government spending is increasing. This suggests a shift in spending from the central level to local governments. It may also suggest a shift in spending priorities toward education and social services (assigned to local governments) and away from national defense and other central government functions. The changes could also show increasing use of conditional grants from the central government.

**Figure 1.** Local and General Government Spending as Percent of GDP, 1997 - 2002



Sources: Local: Statistical Office of Estonia (1993-95), Ministry of Finance (1996-2003). General IMF (1998, p. 17), Statistical Office of Estonia, [www.stat.ee](http://www.stat.ee), Statistical Database, Economy, Government Finances, Execution of General Government Consolidated Budget. Own calculations. \* = preliminary data

## Chapter 3. Local Government Finances: An Overview

### 3.1 Local Government Finances in Transition

The basic public finance systems were established during the early transition period and were amended recently, showing the start of a new phase of transition. The Rural Municipality and City Budgets Act (RT I 1993, 42, 615) was also passed in June of 1993. The Act gave authority as well as guidance to local governments in budget and finance matters. It was amended a few times until 2002 and then extensively over the next two years.

The Local Taxes Act (RT I 1994, 68, 1169) was passed in September 1994 and remained largely intact in its original writing until 2000. It underwent extensive amendments twice in 2000 and then twice in 2002. The Local Taxes Act established the authority and procedural requirements for local governments to impose and collect tax revenue. The authority granted in these Acts is relatively small in terms of financial resources. Specifically, local governments have right to impose the following local taxes: sales tax, boat tax, advertisement tax, road and street closure tax, motor vehicle tax, animal tax, entertainment tax and parking charge<sup>7</sup>. The ability of local taxes to raise revenue is very limited (see also table 3.1) and only advertisement tax and motor vehicle tax are used in larger cities, accounting for 80-90% of all the revenue from local taxes.

Much higher significance can be contributed to shared state taxes: personal income tax and land tax. These account roughly for a half of all revenue. The share of personal income tax received by the local governments has been changed several times. In 1990-93 local governments received all the personal income tax, 52% in 1994-95 and 56% in 1996-2003 (see also IMF 1998, p. 10). As a result of last income tax reform, 11.4% of the *taxable personal income* is received by the local governments in 2004<sup>8</sup>. Therefore, with overall tax rate of 26 per cent, the share of tax revenue received by the local governments has dropped approximately to 44%. This will increase and attain the initial level again as the overall tax rate decreases step-by-step down to 20% by 2007. Although, the land tax is in principle a state tax, local governments collect all the tax revenue and decide the tax rate within given limits (0.1-2.5%)<sup>9</sup>.

<sup>7</sup> Parking charge is classified as a local tax since 2003; earlier it was included in operating revenues.

<sup>8</sup> The Income Tax Act (RT I 1999, 101, 903).

<sup>9</sup> The Land Tax Act (RT I 1993, 24, 428).

However, the primary revenue source for most local governments in Estonia remains central government transfers (Hoag and Kasoff 1999). According to the State Budget Act (RT I 1999, 55, 584) the expenditures related to duties the state has imposed by law on a local government are funded through appropriations from the state budget. These are either assigned for a specific purpose or allocated through the support fund. The purpose of the support fund is to supplement and equalize the revenues of local governments arising from the different revenue basis (Pedastsaar 2001, p. 7). The act also states that the size and the distribution of the support fund are determined annually on the basis of an agreement between local governments, their associations and the central government. In 2004, the size and distribution of support depended on several demographic and economic indicators, e.g. the size of different population groups (children, pupils, workforce and elders), length of streets and roads, and revenues from personal income tax, land tax and extraction of mineral resources<sup>10</sup>.

### 3.2 Local Government Revenues Developments

Table 3.1 presents an overall breakdown of the revenues of the Estonian local government sector since 1993.<sup>11</sup> The breakdown is relatively coarse as required to attain data comparability over the full sample.

**Table 3.1 Local government revenues, % of total except where noted**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 <sup>b)</sup>
(1) Local taxes and state fees	3.4	1.5	1.2	2.8	2.1	1.3	1.5	1.5	1.5	1.6	1.6
(2) Property income	0.0	2.0	3.2	4.8	7.1	6.6	6.6	11.2	16.6	12.1	6.7
(3) Operating income	3.4	4.0	4.1	3.5	3.9	4.1	4.1	4.3	3.2	6.3	7.0
(4) Transfers from local governments	0.0	1.8	2.3	2.1	1.8	1.7	1.8	1.8	1.5	1.5	2.2
(5) Grants from central government	24.2	33.2	27.0	22.4	25.1	26.8	27.6	24.2	33.7	35.6	37.2
(6) Shared tax revenue	69.0	59.4	64.5	64.4	59.9	59.4	58.5	57.0	43.5	42.9	45.4
Total revenues <sup>a)</sup>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total revenues <sup>a)</sup> , billions EEK	2.68	2.18	3.07	4.06	5.33	6.34	6.79	7.10	9.99	11.13	11.81
Total revenues <sup>a)</sup> , % of GDP	12.3	7.3	7.5	7.8	8.3	8.6	8.9	8.1	10.2	10.3	10.3

<sup>a)</sup> Total local government revenues exclude loans, assigned revenues from previous years and "other transactions".

<sup>b)</sup> Preliminary data. New account methodology introduced from 2003.

Sources: For 1993-95: IMF (1998, p. 19), for 1996-2003: own calculations based on Ministry of Finance (1996-2003). GDP data for all years from Statistics Estonia.

Revenue attained from locally imposed taxes and from the state fees allocated to the local governments has since the mid-1990s contributed 1-2% of the budget. Property income covers several revenue sources derived from property owned by local governments, for example the sale or renting out of municipal property and sale of shares in companies. User fees for services specifically related to the use of land or other natural resources are also included here. The relatively large share of total revenues coming from property income during the period 2000-02 is to a large extent the result of large share sales by the local governments of Tartu and Tallinn. Operating income paid by the public for locally provided services like kindergartens, health, culture, etc. has recently increased. The receipts from these services paid by other local governments (when the services are delivered to individuals living in these entities) amount to 1.5-2.5% percent of total revenues. The sum of the revenue sources depicted in rows (1)-(4) is the Estonian local governments' *own revenue*, revenues collected by local governments and over which they have a high degree of autonomy. Own revenue accounts for only 15-20% of total revenues.

Direct transfers from the central support fund for local governments grew rapidly from 2000 to 2001. This was the result of a political decision to start financing most of the local education costs (mostly teachers' salaries) via earmarked funds from the central government. Finally, row (6) shows the local governments' share of tax revenue from mainly the personal income tax and the land tax. Support grants from the center have increased markedly since the mid-1990s, mostly as a result of the new financing of local education. The tax revenue transferred from the central government to local government has correspondingly attained less importance. Still, these revenue sources over which the local governments have essentially no autonomy amounted to more than 80% of the total budget revenues in 2003. Another interesting feature is the relatively large year-to-year changes in property and operating revenues. The developments in these and other entries capturing *inter alia* user charges and fees will be discussed in chapter 5.

<sup>10</sup> The State Budget Act of 2004 (RTI, 2004, 1, 1).

<sup>11</sup> The main source is unpublished annual databases detailing income and expenditures in all Estonian local governments (Ministry of Finance 1996-2003). These databases also comprise source data for aggregate local government budget data available from Statistics Estonia ([www.stat.ee](http://www.stat.ee), Statistics, Regional Development Database, Economy, Government Finances).

### 3.3 Local Government Expenditures Developments

Table 3.2 shows the development since 1993 of local government expenditures grouped according to economic classification. Data until the mid-1990s is unreliable and varies between various sources. The current operating expenditures have amounted to approximately 80% of total expenditures since the mid-1990s. The higher share of total expenditures taken up by wages and salaries since 2001 is the result of a reclassification of teachers' salaries. Capital expenditures have since the mid-1990s hovered around 20% of total expenditures with no apparent trend. In sum, the distribution of local resources between current expenditures and investment projects appear to be relatively stable.

**Table 3.2 Local government expenditures by economic classification, % of total except where noted**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
(1) Current expenditures	84.2	84.7	77.9	72.6	79.2	77.5	76.9	80.8	80.5	79.8
(2) Goods and services	59.5	78.8	75.1	64.3	61.4	..	60.8	64.0	65.3	69.6
(3) Wages and salaries	19.1	34.4	24.6	32.3	31.9	..	31.4	33.0	39.1	38.4
(4) Other goods and services	40.4	44.4	50.5	32.0	29.5	..	29.4	31.0	26.3	31.2
(5) Subsidies and transfers	24.7	5.8	1.9	7.4	16.2	..	14.0	14.3	13.8	8.9
(6) Other	0.0	0.2	0.9	0.9	1.6	..	2.1	2.5	1.4	1.3
(7) Capital expenditures	15.8	15.3	22.1	27.4	20.8	22.5	23.1	19.2	19.5	20.2
Total expenditures	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total expenditures, in billion EEK	2.6	2.2	3.6	4.7	5.5	6.4	7.0	6.9	9.7	11.2
Total expenditures, % of GDP	12.0	7.2	8.8	9.0	8.7	8.7	9.1	7.9	9.9	10.4

.. indicates missing value.

Sources: 1993-95 IMF (1998, p. 17, 19), 1996-97 "Government Finance" by Statistical Office, 1998 IMF (2002, p. 17), 1999-2002 Statistical Office, www.stat.ee, Statistical Database.

The expenditures classified according to sectoral use are shown in Table 3.3. Education expenditures dominate local government, accounting for 40-45% of total expenditures. The next largest category of expenses is for the economy; this area covers expenses that are related to maintenance of streets and roads, public transport and provision of utilities. Administrative expenditures for things like general government organization account for another 10 percent of total local government spending. The expenditure distribution of Estonian municipalities has remained relatively stable over the later part of transition. Administrative expenses have been broadly stable, along with relative expenditures on public health and social welfare. Expenditures on education have risen rather dramatically, but this only reflects the reclassification of education expenses, especially for teachers' salaries. Expenditures for state defense and public order, expenditures for sports and recreation, and expenditures for other financial operations have also increased.

**Table 3.3 Local government expenditures by sector, % of total except where noted**

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 <sup>a)</sup>
(1) Administration	11.1	15.5	15.1	12.3	11.8	11.3	10.8	11.2	9.1	8.6	9.0
(2) Public order and security	3.0	0.7	0.6	0.6	0.5	0.4	0.3	0.3	1.0	0.9	0.9
(3) Education and science	33.7	45.1	45.0	42.0	40.5	40.0	39.3	38.8	45.0	44.1	44.1
(4) Culture and art	5.3	6.2	6.5	7.1	7.3	8.4	8.2	7.9	6.7	6.8	8.6
(5) Sports and recreation	1.0	1.5	1.6	1.8	1.7	2.1	2.5	3.5	3.6	3.5	4.5
(6) Public Health	1.7	0.9	1.1	1.8	1.6	1.7	1.5	1.5	1.4	1.3	0.6
(7) Social welfare	4.0	2.8	3.5	4.4	10.8	11.5	10.7	10.6	9.2	8.6	8.9
(8) Economy	30.9	25.7	24.3	27.5	23.7	22.2	24.5	23.8	22.1	24.1	23.4
(9) Other	0.0	0.0	0.0	0.5	0.2	0.3	0.1	0.1	0.2	0.5	0.0
(10) Transfers	9.4	1.6	2.1	2.0	2.1	2.1	2.2	2.2	1.7	1.7	..
Total expenditures	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total expenditures, in billion EEK	2.6	2.2	3.3	4.5	5.3	6.4	7.0	7.0	9.7	11.4	12.2
Total expenditures, % of GDP	11.9	7.2	8.1	8.6	8.3	8.7	9.2	8.0	9.9	10.5	10.6

.. indicates missing value.

<sup>a)</sup> Preliminary data. New account methodology introduced from 2003.

Sources: For 1993-95: IMF (1998, p. 19), for 1996-2003: own calculations based on Ministry of Finance (1996-2003). GDP data for all years from Statistics Estonia.

## Chapter 4: The Legal Basis for Fees and Charges

User fees and charges in Estonia emerge from two separate legal frameworks. Fees are centralized, authorized and regulated by one law. User charges are fragmented, with authority and regulation spread throughout the law. User charge determination is also decentralized to local governments, in most cases within limits set by the central government.

### 4.1 Fees

The legal basis for fees in Estonia is the State Fees Act, passed by the parliament Riigikogu on 22 October 1997 and entered into force 1 January 1998. It is a long and rather complex law, full of exemptions and prescriptive language for specific situations. This version of the Fees Act replaced the much shorter and less complex Fees Act passed during the transition (25 September 1990). The original act was amended 29 times between 1990 and 1997, so the replacement seemed a near inevitability. However, the developing nature of administrative law in Estonia is evident in the fact that the *new* act has been amended nearly 70 times in the 6 years since its passage.

The Act is divided into three sections and four annexes. The first section, which comprises the first four chapters of the Act, defines fees and lays out approximately 40 general areas where fees would have to be paid. These include judicial acts, registration acts (as in registering a non-profit organization), marital property register acts, building register acts, and fees that must be paid as the result of any number of other Acts, including the Feedingstuffs Act, the Gambling Act, and the Lottery Act. The State Fees Act then goes on to define who must pay the fee (virtually all natural and legal persons).

Section 5 of Chapter 1 of the Act defines who may collect fees. These groups include “a government or local government agency, a state agency administered by a government agency and an agency administered by a local government agency, another agency performing functions in public law, a court, or a rural municipality or city secretary who performs an act subject to a state fee.” (RT I 2001, 55, 331 – hereafter State Fees Act). Estonian county governments are thus prohibited from using fees. This is somewhat natural because the county governments in Estonia are mostly administrative arms of the state. They provide very little services independent from the mandates and financing of the state.

Section 6 of Chapter 1 of the Act then defines the allocation of state fees. The basic allocation is that state fees are paid into the state (central government) budget. However if the state fees are for acts of attestation performed by rural municipality and city secretaries, then they are paid into the corresponding rural municipality or city budget. This suggests that the perception that fees are the natural province of the central government, with local governments only getting revenues in specific circumstances. Since the mid-1990s the share of state fees received by the local governments has been less than 0.5%.

The preeminence of the state is also shown in Chapter 2 of the Act. This chapter lays out administrative procedures for authorities collecting fees. There is very little discretion left for local governments. When this chapter mentions the term discretion it is given to the central government. An example is when the Act delegates power for the establishment of the receipt of fees in cash, which discretion is given to “...the Government of the Republic or, with the authorization of the Government of the Republic, by a regulation of the Minister of Finance” (State Fees Act Chapter 2, Section 7(7)).

Section 10 of Chapter 2 further slams the door on local government discretion through prohibiting bodies charging state fees from charging additional fees for the performance of acts subject to state fees. Therefore, there is no discretion for local governments to set rates according to assure cost recovery or capture of benefits. The bulk of Chapter 2 contains regulations regarding the refund of fees. Again, state government is given discretion where it is forthcoming.

Chapter 3 of the Act delineates the exemptions to having to pay fees. These exemptions are too numerous to list here, but they can be broken down into several categories. First are exemptions for plaintiffs in certain types of cases, such as plaintiffs and appellants in actions or appeals concerning wages. The second class of exemptions is for parties to government actions, such as when someone sues an election committee. The third broad category of exemption is from payment of state fees for commercial register and commercial pledge register acts, such as when a general partnership registers to become a limited partnership and vice versa. The fourth category is exemptions for non-profit organizations and foundations that must register under the Act. The next category is exemptions from filing under the land register acts. These exemptions include rural municipality or city

governments which submit petitions for entry of restituted land in the land register. There are several remaining exemptions in the Act but most are relatively minor.

Chapter 4 of the Act contains regulations for the supervision of fees and charges. It begins by delineating who are authorized to supervise the collection of fees and charges. These include government (central) agencies when the collecting agency is under their administration, the Tax and Customs Board in all agencies which charge state fees, and local government agencies when the collecting agency is under their administration. Then Chapter 4 goes on to delegate the collection of non-paid fees to the Tax and Customs Board. If the fee is still not paid after the term listed on the precept has expired, the Tax and Customs Board may enlist the aid of a bailiff in collecting the fee.

The second section of the Act delineates the fees that can be charged and their rates. The fees are primarily for specific services, such as issuance of permits or entries into various registers. The list of services is too exhaustive to present, taking up almost 100 pages of text. A sample of the general categories of services for which fees must be charged are shown in Table 4.1. The language in section II is extremely prescriptive: “A state fee of 500 EEK shall be paid for the entry of a sole proprietor, general partnership or limited partnership in the commercial register” (Chapter 6, Division 1, Section 40(1)). There are some interesting choices made as far as the rates. For example, accommodation establishments (hotels, hostels) are charged a fee of 100 EEK for receiving a certificate as an accommodation establishment. However, if an establishment wishes to receive a “certificate of category” that it is of a certain quality, it must pay fees according to Table 4.2. While it is possible (but unlikely) that the marginal cost of certifying a property as a one-star hotel may be less than that to certify a property as a five-star establishment, the pattern of fees seems curious. The marginal economic benefit of five-star designation is almost certainly much greater than the 800 EEK difference between the charge for a five-star certificate and a one-star certificate.

**Table 4.1 Services on Which Fees Must Be Charged Under the Estonian State Fees Act**

<b>Category</b>	<b>Division</b>
<b>Court Related</b>	
<b>Acts of Registration Departments of Courts and Land Registries</b>	Commercial Register Acts
	Non-profit Associations and Foundations Register Acts
	Commercial Pledge Register Acts
	Land Register Acts
	Marital Property Register Acts
	Ship Register Acts
<b>Acts Performed by Administrative Agencies</b>	Traffic Register Acts
	Punishment Register Acts
	Building Register Acts
	Vital Statistics Office Acts
	Acts Performed Pursuant to Feedingstuffs Act
	Acts Performed on the basis of Customs Code
	Acts Performed on Basis of Weapons Act
	Acts Performed on Basis of Explosive Substances Act
	State Activity Licenses
	Acts Performed on Basis of Integrated Pollution Prevention and Control Act

**Table 4.2 Fees for Certificate of Category, Accommodation Establishments**

<b>For Establishments of up to 50 Rooms</b>		<b>For Establishments of Greater than 50 Rooms</b>	
<b>Category Designation</b>	<b>Fee</b>	<b>Category Designation</b>	<b>Fee</b>
1-Star	300 EEK	1-Star	500 EEK
2-Star	400 EEK	2-Star	600 EEK
3-Star	700 EEK	3-Star	900 EEK
4-Star	900 EEK	4-Star	1,100 EEK
5-Star	1,000 EEK	5-Star	1,300 EEK



#### **4.2 User Charges**

In contrast to fees, user charge authorization and limitation is fragmented throughout Estonian statutes and administrative rulings. While an exhaustive list of areas where local governments can impose user charges is beyond the scope of this paper, below we discuss the legal foundations of user charges for the common functional areas where charges are levied.

**Education:** Education charges are established and constrained by two laws. The Law on Pre-School Child Institutions (RT I 1993, 40, 593 as amended by RT I 1995, 12, 121) establishes that local districts may decide on the proper rates to charge to defray food and educational costs of kindergarten children. However, it also allows the Ministry of Culture and Education (now the Ministry of Education and Research) in agreement with the Ministry of Social Affairs to set limits for these charges. In 2004 the guidance from the Ministry of Education and Research is that food costs are to be covered by charges to parents, and part of the cost of education is to be covered by charges. The total charge cannot exceed 20 percent of the minimum wage level set by the central government (Estonian Ministry of Education and Research, 2004).

The Basic Schools and Upper Secondary Schools Act (consolidated text RT I 1999, 42, 497 – Basic Schools Act) provides a legal basis for the development of the primary and secondary education system. Most of the law is mute on the specifics of educational finance, but contains two important clauses. In Section 8 of Chapter I, the act states that “Attendance of state schools and general education schools of local governments is free of charge” (state schools are primary and secondary schools run by the Ministry of Education and Research). Also, Section 31, Subsection 4 of Chapter V holds that students have the right to “use the buildings, premises, library, teaching aids, sports equipment, technical means and other equipment of their school for extracurricular activities free of charge”. These two sections effectively prohibit local governments from charging fees for basic education purposes. The financing of food costs is not addressed directly in this Act, except that the central government will cover the costs of school lunches for students in grades 1-4, and “if possible, for other students, except students of state schools whose catering costs are covered from the state budget” (Basic Schools Act Chapter V, Section 321, Subsection 1). Interestingly, though, the grant from the central budget to the local governments is based on the number of students and the calculated cost of a school lunch established by the central government.

**Utilities:** The Public Water Supply and Sewerage Act (RT I 1999, 25, 363 – PWSSA) governs the establishment and operation of public drinking water supply and wastewater removal systems. This Act authorizes a two-part charge for service consisting of a connection charge and a usage charge. The connection charge is required to be sufficient to cover capacity needs and system standards as well as ensure “justifiable profitability”, but local governments have the right to establish maximum connection charges. The usage charge is to be set by the rural municipality or city government with jurisdiction over the usage area and approved by the local government council. The usage charge should be adequate to cover production costs, comply with quality and safety requirements and environmental requirements, and ensure “justified profitability” (PWSSA Section 14).

The requirements for public heating systems are similar to those of water supply and wastewater removal. The District Heating Act (RT I 2003, 25, 154) also authorizes a two-part tariff. The connection fee authorized in Chapter III, Section 12 is calculated by the public or private company supplying the service, and is supposed to: cover investment needs; ensure compliance with environmental, quality, and safety requirements; and assure “justified profitability”. The company supplying heating services also sets the price of heating service. The maximum charge for heating service must be published three months before the charge is to take effect, and is required to be calculated so that the necessary operating expenses, including the expenses incurred upon the production, distribution and sale of heat, are covered; necessary investments for the performance of operational and development obligations are made; environmental, quality, and safety requirements are met; and justified profitability is ensured (District Heating Act Chapter II, Section 8). The maximum price of heating services must be approved by the Energy Market Inspectorate, an extra-judicial board, for large providers or by a local government council for smaller providers (District Heating Act Chapter II, Section 9).

**Public Transport:** Fares for local public transportation services are governed by the Public Transport Act (RT I 2000, 10, 58). Under this Act, service carriers are responsible for setting fares. However, the following local governments can set upper tariff rates per kilometer and maximum ticket prices in public regular services: county governors in the intra-county carriage of passengers organized by means of bus, ship, small ship, ferry and air traffic; rural municipality and city councils or authorized agencies in the carriage of passengers organized by means of bus, tram, trolleybus, ship, small ship and ferry traffic within the rural municipality or city; and city

councils and agencies authorized thereby in the urban carriage of passengers organized by means of railway traffic.

**Social Welfare:** Under the Social Welfare Act (RT I 1995, 21, 323; consolidated text RT I 2001, 98, 617), a fee may be collected from a person for social services provided to the person or his or her family. The fee is supposed to reflect the extent and cost of the service and the financial situation of the person and family receiving the service. The institution which provides or pays for the service is to set the fee. However, the limits and procedure for collection of fees collected for social services are to be established by the Ministry of Social Affairs (Social Welfare Act Chapter VII, Section 45).

## Chapter 5. Revenues from user charges and fees

Accurate, relevant, disaggregated revenue data on Estonian user charges and fees is difficult to obtain. Revenue data at an appropriate level of disaggregation is available only for the period 1996-2003. Even then, the “extraction” of user charges and fees data from Estonian Ministry of Finance databases involves challenges and inherently difficult judgments. First, it is often difficult to assess the underlying economic contents of a number of the database categories.<sup>12</sup> For example, the entry “advertisement tax” (on billboard advertising) could be either a fee or a tax on advertisement. Second, payments for closely related services enter the accounts in different places, for example the fee for the issuance of permits for mining activities and the fee paid for the extraction of mineral resources are listed as different entries under different headings. Third, relatively large amounts of revenues are collected in various non-specified entries, often labeled “Other”. In general it has been difficult to establish to which extent the “Other” entries also comprise user charges and fees. Fourth, some clearly specified fees do not generate any noticeable revenue (for example below 1000 EEK in total). These microscopic entries are generally not reported. Fifth, the underlying statistical methodology was altered from 2002 to 2003. We have undertaken every effort to make the 2003 data comparable to previous years, but some discrepancies likely still remain. Finally, a number of public services are provided by private or publicly held companies, for example water and sewerage, waste disposal, and heating (as discussed in chapter 4). Most often, revenue from these activities cannot be traced in the Ministry of Finance databases. In other cases, revenues from government-owned enterprises will be reported under “operating income” in the database.

With these caveats in mind, Table 5.1 gives an overview of the local government revenue sources, which we assess to comprise user charges and fees.

**Table 5.1 Revenue from local government user charges and fees, % of total revenue except where noted**

User charge or fee	1996	1997	1998	1999	2000	2001	2002	2003 <sup>b)</sup>
(1) State fees	0.03	0.02	0.01	0.01	0.01	0.00	0.03	0.22
(2) Roads and streets closing tax	0.08	0.09	0.09	0.04	0.04	0.04	0.05	0.06
(3) Fees for miscellaneous clerk services	0.04	0.05	0.05	0.05	0.04	0.04	0.03	0.00
(4) Fees for extraction of water and minerals	0.83	1.19	1.05	0.97	1.04	0.84	0.88	0.95
(5) Fees for fishing and hunting permits	0.005	0.006	0.004	0.004	0.003	0.000	0.000	0.001
(6) Fees for attaining building title	0.35	0.45	0.54	0.28	0.11	0.34	0.13	0.19
(7) Fees for permits to use public facilities	0.22	0.19	0.07	0.04	0.03	0.02	0.23	0.15
(8) Fees for business permits	0.10	0.25	0.18	0.16	0.16	0.10	0.02	0.01
(9) Fees for mining permits	0.001	0.000	0.008	0.001	0.014	0.000	0.000	0.018
(10) User charges for education, culture, sports, health etc.	4.39	4.24	3.95	4.17	4.37	3.45	4.22	3.41
(11) Miscellaneous user charges and operating income	0.91	1.04	1.58	1.46	1.49	1.13	3.34	3.40
<b>(12) Total user charges and fees</b>	<b>6.9</b>	<b>7.5</b>	<b>7.5</b>	<b>7.2</b>	<b>7.3</b>	<b>6.0</b>	<b>8.9</b>	<b>8.4</b>
Total revenues <sup>a)</sup> , billions EEK	4.06	5.33	6.34	6.79	7.10	9.99	11.13	11.81
Total own source revenues, billions EEK	0.54	0.79	0.87	0.94	1.33	2.27	2.39	2.06

<sup>a)</sup> Total revenues exclude loans, assigned revenues from previous years and “other transactions”.

<sup>b)</sup> Preliminary data. New account methodology introduced from 2003.

Sources: Own calculations based on Ministry of Finance (1996-2003).

The table shows that local governments’ revenue from state fees has been unsubstantial until 2003. This is not surprising given the centralized nature of fee implementation in the country. In 2003, the local governments became entitled to retain the revenue from issuing building permits, which has increased rather dramatically in

<sup>12</sup> We have received valuable suggestions regarding the classification from Sulev Liivik (Estonian Ministry of Finance) and the interview subjects in our case studies (see section 6).

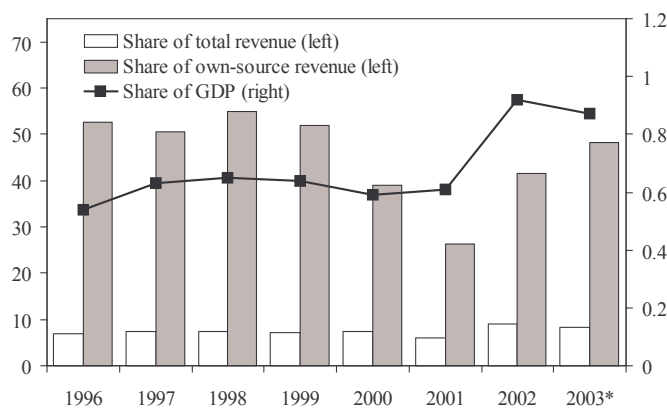
percentage terms the revenue flow from fees to local governments. Local governments can impose a number of local taxes, of which a few in essence are fees. For example, the roads and streets closing tax is essentially a fee paid when construction companies and utilities need roads to be closed off for a period of time. An advertisement tax on billboards represents a borderline case between a fee and a tax. We have chosen not to include the advertisement tax in Table 5.1. Also not shown in Table 5.1 are parking fees which from 2003 figure separately in the Ministry of Finance databases. In 2003 total parking fees were 32.2 million EEK, amounting to 0.3% of total local government revenues (or 1.8% of own source revenues).

Among a number of other fees (rows (3)-(9)) only the fees on extraction of water and mineral resources bring in substantial revenue to the local governments. On average approximately 1% of all revenue and 6% of own source revenue pertains to the extraction fee. However, in regions where extraction is a major economic activity, in particular the northeastern part of the country, this fee is an important revenue source.

Row (10) shows the combined sum of user charges and fees for public services like pre-schooling and education, culture and art, sports and recreation, health services, and social welfare institutions. The fees are partly paid by the public, but also by other municipalities whose inhabitants make use of the services. These fees, amounting to 3.5-4.5% of the total revenues of local governments in Estonia, will be analyzed in more detail below.

Row (12) shows the total of the user charges and fees depicted in Table 5.1. User charges and fees comprise a relatively stable share of the local governments' total revenue. The share appears relatively small at 6-9% of total revenue. However, user charges and fees constitute a much larger share of the local governments' own source revenues, approximately 25-50%. Still the local user charges amount to only between 0.5% and 1% of GDP throughout the period considered (Figure 2). The difference between the share of overall revenue and own-source revenue is reflective of the relatively low level of revenue autonomy in Estonian local governments, as we documented in chapter 2.

**Figure 2.** User Charges and Fees as Percent of Total Local Government Revenue, Own-Source Revenue and GDP, 1996 - 2003



Source: Own calculations based on Ministry of Finance (1996-2003). \* = preliminary data

Table 5.1 shows that user charges are a far more important revenue source than the fees. Table 5.2 provides a detailed breakdown of the user charges for a number of services delivered by local governments. Among user charges only the user charges for pre-schooling and education generate substantial revenue. As outlined in chapter 4, these charges mostly come from kindergarten fees, in some cases payment for food at higher education levels and user charges for various other kinds of educational activities (for example evening schools). Noticeable is also that half of the educational user charges are paid by other local governments. These are inter-governmental transfers when inhabitants from one municipality make use of the education facilities in another municipality. User charges for culture and art, for sports and recreation and for social services increased substantially in 2003, but they still constitute an insignificant share of the total revenue.

**Table 5.2 Revenue from specific user charges, % of total revenue except where noted**

Service	Payer	1996	1997	1998	1999	2000	2001	2002	2003 <sup>b)</sup>
(1) Kindergartens and education	Public	1.94	1.82	1.73	1.76	1.82	1.38	1.92	2.07
	Local governments	1.99	1.73	1.54	1.65	1.67	1.36	1.41	..
(2) Culture and art	Public	0.15	0.16	0.14	0.14	0.16	0.14	0.30	0.53
	Local governments	0.01	0.01	0.01	0.01	0.01	0.00	0.01	..
(3) Sports and recreation	Public	0.07	0.08	0.09	0.08	0.09	0.09	0.10	0.30
	Local governments	0.002	0.003	0.003	0.002	0.001	0.001	0.001	..
(4) Health services	Public	0.01	0.08	0.06	0.07	0.12	0.06	0.02	0.02
	Local governments	0.01	0.01	0.01	0.01	0.00	0.00	0.00	..
(5) Social welfare	Public	0.14	0.26	0.28	0.36	0.39	0.32	0.38	0.48
	Local governments	0.07	0.07	0.09	0.09	0.11	0.09	0.08	..
Total revenues <sup>a)</sup> , billions EEK		4.06	5.33	6.34	6.79	7.10	9.99	11.13	11.81

.. indicates missing value.

<sup>a)</sup> Total revenues exclude loans, assigned revenues from previous years and "other transactions".

<sup>b)</sup> Preliminary data. New account methodology introduced from 2003.

Source: Own calculations based on Ministry of Finance (1996-2003).

Table 5.3 shows rough measures of cost recovery rates for the group of locally provided government services, based on the user charge revenues in Table 5.2 and expenditures in corresponding categories. The measures are only approximations as the revenue and the expenditure sides do not always correspond closely. For example, most of the user charge revenue for education derives from user charges for kindergartens and various non-traditional educational activities. At the same time, the bulk of expenditures are for primary and secondary education, which are essentially without user charges. This reduces the interpretability of this data, however, the general figures are illustrative of trends and proportions.

Table 5.3 shows that cost recovery rates are all below 10% of incurred expenditures. The drop in cost recovery for kindergartens and education from 2000 to 2001 is most likely linked to the changes in the school financing system introduced from 2001. The user charges for municipal health services vary markedly, again partly reflecting repeated changes in the health financing system. It is obvious that full cost recovery is not a priority for any of the services listed in Table 5.3. These services are considered part of the Estonian social welfare system, as discussed in chapter 4 government laws and regulations put in a number of cases strict limits on the size of the user charges.

**Table 5.3 Cost recovery for specific local government service, % of expenditure within each category**

Service	1996	1997	1998	1999	2000	2001	2002
(1) Kindergartens and education	8.5	8.8	8.1	8.4	9.2	6.3	7.4
(2) Culture and art	1.9	2.3	1.8	1.8	2.2	2.2	4.5
(3) Sports and recreation	3.7	5.2	4.4	3.1	2.7	2.5	2.9
(4) Health services	1.1	6.2	4.3	5.0	8.6	4.7	1.8
(5) Social welfare	4.4	3.1	3.2	4.1	4.8	4.6	5.2

Source: Own calculations based on Ministry of Finance (1996-2003).

## Chapter 6. Case Studies

The data in chapter 5 along with the background information earlier in the paper present macro level data on user charge and fee financing in Estonia. Often times, however, macro level data misses the essence of how finance is conducted. In order to ascertain the actual practice of rate determination and administration of charges and fees as well as to assess administrative capacity in the use of charges and fees, we decided to undertake case studies of local governments in Estonia. These case studies involved the review of budgets as well as interviews of local government finance personnel and political leaders. The three case studies were selected on the basis of size and geographic location. The country's largest municipality was chosen along with two smaller municipalities. Table 6.1 describes the case study governments and their relevant characteristics.

**Table 6.1 Case Study Municipalities**

Government	Population	Geographic Location
Viiratsi Parish	4,000	South-Central
Türi Town	6,700	Central
Tallinn	397,000	Northwest

### Viiratsi Parish

Viiratsi Parish (vald) is a small rural municipality in south-central Estonia. The parish population is 4,000, with approximately 1,300 living in Viiratsi borough. The majority of the population of the parish works in neighboring Viljandi town, the seat of Viljandi County (maakond). Viljandi has a population of 20,000 and several industries. The area also sees some tourism as Estonia's second largest lake and many other outdoor recreation activities are nearby.

In terms of its fiscal structure, Viiratsi's budget is shown in Table 6.2. The revenue structure of Viiratsi is similar to the average Estonian structure, with the exceptions that property revenues are lower than average percentage of revenues, and that education and social welfare shares are slightly higher than average. Viiratsi's budget shows the typical insignificant amount of state fees collected. Though the education and social welfare charge shares appear to be higher than the Estonian average, the parish still recovers only a small portion of the cost of services with its charges, as shown in Table 6.3.

**Table 6.2 Viiratsi Parish Budget, 2003 (figures in EEK)**

REVENUES			EXPENDITURES		
Source	Amount	Percent of Total	Category	Amount	Percent of Total
Taxes	10,450,000	40.46%	General government	5,821,000	22.54%
Sales of goods and services			State defense	5,000	0.02%
State Fees	2,000	0.01%	Public order and security	33,000	0.13%
Operating Income - Education	539,000	2.09%	Economy	866,000	3.35%
Operating Income - Recreation & Cultural	8,000	0.03%	Environmental protection	425,000	1.65%
Operating Income - Social Welfare	792,000	3.07%	Dwelling and communal economy	625,000	2.42%
Sales of goods and services	64,000	0.25%	Health care	88,000	0.34%
Sales of property	25,000	0.10%	Recreation, culture and religion	2,774,000	10.74%
Property income	115,000	0.45%	Education	10,900,000	42.20%
Grants	10,774,000	41.72%	Social protection	4,290,000	16.61%
Residual at the beginning of year	1,859,000	7.20%			
Loans	1,200,000	4.65%			
<b>TOTAL REVENUE</b>	<b>25,827,000</b>	<b>100.00%</b>	<b>TOTAL EXPENDITURES</b>	<b>25,827,000</b>	<b>100.00%</b>

Source: Viiratsi Parish Budget, 2003, and author's calculations.

**Table 6.3 Viiratsi User Charge Cost Recovery**

Service	Percent of Costs Recovered
Recreation & Cultural:	
Libraries	0.09%
Newspaper	6.72%
Education:	
Kindergartens	9.57%
Primary Schools	3.59%
Secondary Schools	14.79%
Social Institutions for Elderly*	32.08%

\*Includes both Alms-House (Nursing Center) and services for elderly.

Source: Author's calculations from Viiratsi Parish Budget, 2003.

Interviews with parish officials extended the information in these areas. One of the most interesting things from Table 6.3 is the heavy subsidization of kindergartens. The Law on Pre-School Child Institutions allows for charges up to 20% of the legal minimum wage. Currently that would indicate a maximum allowable charge of 500 EEK/month. The charge is currently set at 330 EEK/month in Viiratsi. Parish officials indicated that this was due to highly price elastic demand. According to the officials, the average monthly income in Viiratsi is 3,300 EEK (Interview: Luik and Kannimäe – it should be pointed out that this is much lower than the reported average for Viljandimaa, which was 5,772 according to the Central Statistical Office (Statistical Office of Estonia, 2004). However, the officials also added that they had not changed the fee in the last four years.

Other areas of interest from Tables 6.2 and 6.3 are the subsidization of the local newspaper and other recreation and cultural activities. The parish spends 2.774 million EEK per year on recreational and cultural activities and receives income from sales of only 8,000 EEK per year. When asked about this, local officials would only say that they have traditionally charged only symbolic charges for the use of recreational facilities and recreation and cultural activities.

In addition to the budgetary revenues, other activities funded by user charges include heating, water, and sewer services. The heating service is privatized in Viiratsi and charges are set in negotiation with the private provider. In the interview, the local officials said that this negotiation can be contentious and that the existing heating contractor had threatened in the past to shut off service if rate increases were not granted. However, the officials also claimed that there were other providers available so that the citizens could be afforded some guarantee of competitive rates. The water and sewer services are owned by a company wholly-owned by the local government. The system is in need of upgrade and improvements. Currently rates are essentially set to recover short-term marginal costs. The parish will likely rely on European Union structural funds to achieve the repair and improvements necessary for the smooth operation of the system, but the ability to come up with the local matching funds required by the EU and the Estonian central government is problematic. The parish had existing debt outstanding in the amount of 4.554 million EEK as of the end of 2002. This is around 14% of annual revenues, not a large amount by Estonian local government standards (the nationwide average for local governments was over 34%), still budgeted loan repayments in 2003 were 5.8% of planned expenditures. Additional amounts of parish debt may restrict the amount of expenditures for other purposes.

#### *Türi Town*

Türi is a small town located near the geographic center of Estonia. The town of population 6,700 is located at the junction of several major transport routes. It also hosts a branch of the University of Tartu for environmental studies as well as the oldest primary school in Estonia. The town gets seasonal tourism because of its designation as the “Spring Capital” of Estonia. However, the predominant industries in the central part of Estonia are agriculture and mining. The area around Türi is also seeing a growth in residents that work in Tallinn, but prefer to live in a more rural area.

The budget for Türi town is shown in Table 6.4. Türi is much less reliant on central government transfers than is Viiratsi. This is likely due to a lower budget deficit in the previous year. The formula for the Budget Stabilization Fund (the major source of central government aid) is dominated by a term for the previous year’s budget deficit (Ainsoo et. al. 2002). State fees are somewhat higher in Türi than in Viiratsi, probably due to the change in central government policy that allowed building permit revenue to be kept by municipal governments. Given its closer proximity to Tallinn, the area around Türi is experiencing faster growth.

Given the way that Türi accounts for its revenues, it is not possible to calculate cost coverage ratios for specific items. However, there appear to be some differences between Viiratsi and Türi in terms of their use of charges. Türi’s cost recovery for kindergartens is higher, with a charge of around 440 EEK per month against a cost of 1300 EEK, a cost recovery rate of 35% (Interview: Milt). The charge is of a similar magnitude to Viiratsi’s charge, but the cost is lower. Cost recovery for all levels of education is 8.9%, a similar proportion to Viiratsi. Cost recovery for recreation and cultural activities is slightly higher in Türi, at 8.3%. This may be due to the relatively higher incomes in Türi, allowing for higher charges. Türi recovers a much smaller portion of the costs of social protection, but spends a far lower percentage of its budget on social protection. The driving factor here may be a higher proportion of elderly in Viiratsi. In Viiratsi, 9.6% of budgeted expenditures are for services to the elderly, while Türi only spends 1.4% of its expenditures on this function.

In other areas of user charge finance, the heating, water and sewer, and garbage functions are private companies with partial municipal government ownership. Cost recovery is low in heating and water services, but still the companies have difficulty in collecting from customers. Transportation services are provided for school children and for pensioners and disabled individuals. Local governments in the area collectively own and administer a

transportation center, with costs allocated by ridership and mileage. The central government subsidizes the service. Still, only three bus lines have full cost recovery.

**Table 6.4 Türi Town Budget, 2003 (figures in EEK)**

REVENUES			EXPENDITURES		
Source	Amount	Percent of Total	Category	Amount	Percent of Total
Taxes	19,702,000	59.10%	General government	7,099,000	21.30%
Sales of goods and services			Public order and security	165,000	0.49%
State Fees	21,000	0.06%	Economy	1,066,000	3.20%
Operating Income - Education	1,110,000	3.33%	Environmental protection	1,302,000	3.90%
Operating Income - Cultural	499,000	1.50%	Dwelling and communal economy	3,631,000	10.89%
Operating Income - Social welfare	8,000	0.02%	Health care	298,000	0.89%
Operating Income - General government	5,000	0.01%	Recreation, culture and religion	5,993,000	17.98%
Sales of goods and services	71,000	0.21%	Education	12,518,000	37.55%
Sales of property	116,000	0.35%	Social protection	1,264,000	3.79%
Property income	125,000	0.37%			
Grants	9,566,000	28.70%			
Other	1,000	0.00%			
Residual at the beginning of year	2,869,000	8.61%			
Net loan repayment	-759,000	-2.28%			
<b>TOTAL REVENUE</b>	<b>33,335,000</b>	<b>100.0%</b>	<b>TOTAL EXPENDITURES</b>	<b>33,335,000</b>	<b>100.00%</b>

Source: Türi Town Budget, 2003.

### *Tallinn*

Tallinn is Estonia's capital and largest city. It lies on the Northwest coast of Estonia, approximately 80 km due south of Helsinki, Finland. It is a city with a bustling port, and also a center for tourism, finance, and industry in the Baltic region. It has been estimated that Tallinn and its surrounding area account for over 50% of total economic activity in the Estonian economy (Tallinn City Council, 2003).

Tallinn's budget is summarized in Table 6.5. The city is less reliant on central government grants than the national average and both of the two smaller municipalities. It receives more revenue from sources derived from municipal property and takes up a larger portion in loans. Some of the loan activity was essentially a refunding transaction (new debt issued as older debt was paid off), but approximately 234.75 million EEK was new money to be used for investments. The city made approximately 830 million EEK in new investments in 2003, with the largest investment in roads, utilities, education, and housing (Tallinn City Council, 2003). The city of Tallinn has a larger budget for transportation, and spends less on education and general government. Spending on transportation involves both bus and tram services and the maintenance of large airport and bus terminals. The lower spending on general government and education may partly reflect an economy of scale effect.

The structure of Tallinn's budget makes cost recovery calculations difficult. However, in interviews with city finance officials, we were able to extract some information that would help this effort. In the kindergarten education area, for example, food costs are born entirely by the parents of the child, and fees cover 6% of other costs of education. There are currently waiting lists for kindergartens, but the rate has not been adjusted to "clear" the market. Instead, the city is refusing to take children from neighboring jurisdictions that do not pay for their children in a timely fashion. In addition, the city is required to subsidize private kindergartens in the amount of 1,350 EEK per child per year (Interviews: Saat and Tammearu).

**Table 6.5 Tallinn City Budget, 2003 (Figures in EEK)**

REVENUES			EXPENDITURES		
Source	Amount	Percent of Total	Category	Amount	Percent of Total
Taxes	2,098,000,000	45.55%	Administration	317,966,000	6.90%
Property revenues	479,970,000	10.42%	Safety and security	24,788,000	0.54%
Rental profits	86,113,000	1.87%	Public weal	76,631,000	1.66%
Dividends	65,400,000	1.42%	Others in economy	344,124,000	7.47%
Investment income	6,000,000	0.13%	Housing	158,759,000	3.45%
Advertising fees	24,000,000	0.52%	Health care	50,890,000	1.10%
Fines	27,604,000	0.60%	Culture	192,494,000	4.18%
Grants	671,000,000	14.57%	Sports	458,216,000	9.95%
Other	683,150,000	14.83%	Transport	441,846,000	9.59%
Loan	465,000,000	10.10%	Reimbursement	276,150,000	6.00%
			Education	1,029,516,000	22.35%
			Social care	301,169,000	6.54%
			City planning	14,488,000	0.31%
			Other	919,200,000	19.96%
TOTAL REVENUES	4,606,237,000	100.0%	TOTAL EXPENDITURES	4,606,237,000	100.00%

Source: Tallinn City Budget, 2003.

Heating service is provided by a private company, who in turn rents the infrastructure from the city. The remark was made in the interviews that the value of the company was falling. This was interpreted that full cost recovery is not being achieved by the company. The setup is similar for water service, except that the city is required to perform maintenance on the infrastructure that it owns. Charges are set by the board of the private company, on which the city has one representative. The government can set consumer rate caps, but these can be increased. The city owns a minor ownership share in the sewer provider. Bus service is provided by a government-owned company, with the city retaining the bus fare and the fares set by negotiation on a cost-plus-return on investment basis (Interviews: Saat and Tammearu).

## Chapter 7. Analysis and Conclusions

### 7.1 Theory of User Charges and Fees

User charges and fees reduce the reliance on general taxes as a means to finance the provision of local public goods. In theory, the use of charges and fees should accomplish at least two broad goals. First, it should make the recipient of a service face the true costs of their consumption decisions, creating an incentive for efficient choice (Fisher 1996, 179). The second goal of service provision using charges and fees is to reduce expenditure pressures on general taxes. Using a charge or fee to finance the majority of a service means that a larger portion of general taxes is available to meet compelling interests in the general budget of the jurisdiction. This may also have the effect of reducing funding pressures on the now protected service. In essence, the market becomes the arbiter of the true value of the service. Third, imposing user charges and fees can enhance social welfare through reducing queues for resources and also improve distribution decisions beyond the political and bureaucratic imperative forced by funding revenues from general taxes (Bierhanzl and Downing 1998).

Two of the most important fiscal structure questions facing local government are which services should be financed via charges and fees, and to what extent the service should rely on charges and fees. Here there are at least four general principles for efficient determination of the use of charges (Fisher 1996, 180). First, user charge financing should be used on services where a large portion of their marginal benefits accrue to direct users. In other words, if there are strong externalities created by the service, the service is not a good candidate for using charges and fees. Second, assuming that the first condition is met, exclusion of non-payers from using the service must be feasible. If it is difficult to exclude non-payers from using the service, then over time the charging mechanism will break down.



Third, charges and fees are more justifiable from an efficiency standpoint when demand for a service is more price elastic. In the extreme case of perfectly price inelastic demand, price does not matter. Therefore, even if consumers underestimate cost, demand would be exactly the same as in the case of perfect costing. The fourth principle of the use of charges and fees is that marginal benefits, not total benefits (or average benefits), should determine the level of user charges. Often times, a basic level of service is enough to provide for general social benefits, and any service above this level should be paid for by direct users of the service.

The setting of rates is an important administrative function in establishing fees and charges. Consideration must be given to allocating costs among various groups (Fisher 1996, 179-184). There are at least three general rules that should be observed in setting charges. First, costs of construction or acquisition of a public facility should be paid by those groups in society who will benefit from the existence of the facility. This includes direct users and those who benefit from positive externalities created by the service. Consider for example the financing of water treatment facilities. Direct users benefit, but all in a jurisdiction potentially receive a positive development externality from businesses having lower costs (potentially leading to greater levels of economic development). Also, there is an "option value" that is created by the new public investment. If individuals wanted to take advantage of the service, they could relocate to do so. As long as individuals are somewhat mobile within a region over time, there is some option value to the development of public infrastructure.

The second rule is that operating (use) costs should be allocated according to the marginal benefit and marginal cost of the service. There are a couple of important points in this area. First, external benefits of service should not be borne by direct users but by all groups receiving benefits from additional levels of service. Second, marginal cost is the appropriate cost basis for allocating charges. Marginal cost may vary according to age of infrastructure, geographic labor cost differences, and many other factors.

The third rule for cost allocation is that extra charges should be levied in situations when marginal cost increases over typical marginal cost due to congestion externalities. The classic example here is a bridge. During non-congested periods, the marginal cost of service is small, nearly zero. However, during "peak" periods, high marginal costs can be created through congestion (recognized as time delays in travel). An extra "congestion charge" should be levied to bring marginal costs and marginal benefits into line.

However, as pointed out by Bailey (1994) and Dewees (2002), in practice the use of charges and fees is more challenging than theory would suggest. Accounting data is often used to set fees and charges, and in most cases this data is not set up to capture the economic marginal cost of provision of services. For example, depreciation is often not recorded and if it is, the choice of methods (straight-line, accelerated) is essentially arbitrary. Also, average cost versus marginal cost is typically calculated out of accounting data. Data on externalities is required to set prices optimally, and can be prohibitively difficult to calculate. Bailey (1994, 757-758) recounts several extremely arbitrary "rules of thumb" that have developed in the United Kingdom regarding which services are suitable for fees and charges along with recommendations on rate setting. Finally, there are time dimensions to marginal cost which are difficult to reconcile with theory. For example, services that require periodic capital investment should include a depreciation charge, but this effectively makes current users pay for improvements which will benefit new users the most.

## ***7.2 Analysis and Conclusions***

It is evident that user charge and fee policies in Estonia are not "textbook" cases in their design or administration. However, there may be reasons for this that typical analyses would not consider. The economics of a transition country may not be conducive to traditional methods of cost recovery in the public sector. Also, cultural and traditional concerns for equity may outweigh efficiency considerations. But recognition of this situation should not be confused with acceptance of it as normative guidance for financing publicly provided goods.

There are several ways in which Estonia violates principles of user charge and fee financing. First and most importantly, the central government collects fees for services of what amount to local public goods. To take an example, while there is probably a small positive spatial externality created from the filing of marriage licenses due to control over citizen identification, the vast majority of benefits of this service accrue to individuals and to local courts who must handle family matters. Therefore, near full cost recovery through charges is probably in order and the charge rate should be set by local authorities. This problem is compounded when the central government does not reimburse local governments for expenditures necessary to maintain filing offices (Interviews: Saat and Tammearu). There are likely to be economies of scale in registration type activities, so the existing system of one national rate is likely to produce welfare transfers from smaller jurisdictions to larger ones.

The second problem with the existing system is the ad hoc rate setting process. This is evident both at the central level and at the local level. At the central level, an example is the fee for making entries into the land register or marital property register. The effective rate (rate/value of transaction) has a “U” shape, starting out relatively high and then decreasing for transaction values up to 1,000,000 EEK. There can be no cost explanation for this shape. The marginal cost of filing an additional entry is unlikely to vary across transaction values. And the marginal benefit pattern suggested by this rate system is hardly comprehensible. In effect, this fee acts then as a partial fee representing the cost of the service and as a tax on the value of land with a “U” shaped incidence. At the local level, the charge for kindergarten is also curious. Each jurisdiction sets its own charge within limits set by the Law on Pre-School Child Institutions, but not one of the three jurisdictions which we talked to seemed to have a set methodology. Also, some curious comments were made about the reasons for not raising rates. Families were perceived to be quite cost sensitive, and yet rates were not set to ensure cost recovery. This could be in direct conflict with traditional user charge theory.

Finally, there seems to be a problem with the determination of functions that are suitable for user charge financing. Educational charges might well be set low due to the presence of high levels of positive externalities (though this was never elucidated or hinted at by interview subjects). However, the heavy subsidization of recreational and cultural activities deserves some further justification. Most, if not all, of the benefits of these activities will flow to individuals. In a classic economic sense these individuals should bear a greater percentage of the full marginal cost of the service.

There are a couple of caveats that should be offered to traditional analysis of user charge situations. First, people in transition countries such as Estonia may be constrained by low incomes. Traditional pricing theory assumes that individuals can substitute into or out of a product as the price changes. If individuals are constrained by income, then some choices move out of the consumption possibilities set. However, it should be noted that in this case, we should expect the following things to happen. First, investment should fall in those businesses that provide the service – this may be experienced by the closing of businesses. Second, prices of inputs to these services should fall – in the case of education this would be primarily the wages of instructional staff. As input prices fall, the cost of the service should also fall until an equilibrium is reached. None of this is seen in the Estonian case. Although there have been calls for consolidation of some schools, there is little evidence of this occurring. There must be barriers present to the orderly working of the education price mechanism in Estonia, which is often the case in low-income countries.

The second caveat relates to the points raised by Bailey (1994) regarding the setting of fees and charges. Local governments in Estonia appear to lack the administrative capacity to properly set fees and charges. Comments by the central Ministry of Finance’s Director of Local Government Affairs pointed out that central government legislators are wary of the administrative capacity and public outlook of local government officials (Interview: Liivik). However, as with any decision, the decision to remove autonomy from local governments in rate setting has both benefits and costs. The benefit is clearly to have a more uniform and accountable fee system (though curiously there appears to be no systematic audit mechanism for fee collection transmission to the central government). The cost is the potential for welfare transfers and inefficient shifting of resources. The same concept should accompany sweeping amnesties of questionable rate decisions by local governments. The benefit of heavily subsidizing recreational and cultural activities is a potentially fitter and more culturally acute citizenry. The cost is the opportunity cost of not improving roads, transit systems, education, and many other areas. Citizens should be given the information necessary to understand the choices that they are making when receiving subsidies of this nature.

In the end, a careful rebalancing of the Estonian fee and charge system is probably in order. More local autonomy in the setting of fees and charges may be in order, but must be accompanied by training and monitoring necessary to ensure good decisions and efficient administration. Studies should be commissioned that capture the cost of services, along with careful modeling of the benefits from services. Larger municipalities can engage in these studies directly. Regional studies could be done to provide guidance for smaller municipalities with less administrative capacity. Finally, the theories of efficient and effective user charge policies should be discussed openly, along with frank discussions of administrative capacity. Estonia has for years experienced a lively debate on reforms of the territorial structure of local governments. The discussion has at times been emotional and with wide-ranging political repercussions. Interestingly the local governments’ ability to raise own revenue has only entered the discussion peripherally. One can only hope that the future debate will include the important point of how local governments can utilize user charge and other sources of own revenue in order to provide a more efficient mix of services and payments.

## References

Aslund, A. (2002): *Building Capitalism. The Transformation of the Former Soviet Bloc*, Cambridge University Press.

Ainsoo, D., et al. (2002). "Local Government Budgeting: Estonia." In Hogye, Mihaly (Ed.), *Local Government Budgeting*. Budapest: Local Government and Public Service Reform Initiative, Open Society Institute.

Bailey, S. J. (1994). "User-charges for Urban Services." *Urban Studies* 31, no. 4/5: 745-765.

Bierhanzl, E. J. and P.B. Downing (1998). "User Charges and Bureaucratic Inefficiency." *Atlantic Economic Journal* 26, no. 2: 175-189.

Bronshtein, M. (1995). "Estonia: Economics and Geopolitics." *Problems of Economic Transition* 38: 82-96.

Deweese, D.N. (2002). "Pricing Municipal Services: The Economics of User Fees." *Canadian Tax Journal* 50, no. 2: 586-597.

Eurostat (2004), <http://europa.eu.int/comm/eurostat/>.

Fisher, Ronald C. (1996). *State and Local Public Finance*. Chicago: Irwin Professional Publishing.

Hoag, J. and M. Kasoff. (1999). "Estonia in Transition." *Journal of Economic Issues* 33: 919-931.

IMF (1998). "Republic of Estonia: Selected Issues and Statistical Appendix." *IMF Staff Country Report*, no. 98/12, <http://www.imf.org>.

Ministry of Finance (1996-2003). "Execution of Local Governments' Budgets." Annual Database. Tallinn: The Estonian Ministry of Finance.

OECD (2000). *The Baltic States: A Regional Economic Assessment*, OECD Economic Surveys, no. 5. Paris: Organisation for Economic Co-operation and Development.

Pedast Saar, Eliko (2001). "Local Government Functions and Their Financing and Local Government Borrowing in Estonia." *9<sup>th</sup> NISPAcee Annual Conference*. <http://www.nispa.sk/news/conf2001.html>.

Shen, Raphael (1994). *Restructuring The Baltic Economies: Disengaging Fifty Years Of Integration With The USSR*. Westport, Connecticut: Praeger.

Staehr, Karsten (2004). "The Economic Transition in Estonia. Background, Reforms and Results." In Rindzeviciute, Egle (Ed.), *Contemporary Change in Estonia*. Sodertorns hogskola.

Statistical Office of Estonia (2004). "Government Finances: Regional Development Database," [http://gatekeeper.stat.ee:8000/px-web.2001/I\\_Databas/Economy\\_regional/08Finance/06Government\\_finances/06Government\\_finances.asp](http://gatekeeper.stat.ee:8000/px-web.2001/I_Databas/Economy_regional/08Finance/06Government_finances/06Government_finances.asp).

\_\_\_\_\_ (1993-97). "Government Finance. State Budget, Local Budgets and Extrabudgetary Funds: Yearbook", Tallinn: The Statistical Office of Estonia.

Tallinn City Council (2003). *Regulation 38: Budget Strategy of the City of Tallinn for the years 2004-2006*. Tallinn: Tallinn City Council.

Tarm, Michael (May – June 2003). "Juhan the Young." *City Paper – The Baltic States*.

## Interviews

Luik, Väino. Head of Viiratsi Parish Government. Interviewed at Viiratsi Parish Building. 4 February 2004.

Kannimäe, Sulev. Deputy Head of Viiratsi Parish Government. Interviewed at Viiratsi Parish Building. 4 February 2004.

Milt, Tähve. Deputy Governor of Järva County and Head of Finance Department of Järva County Government. The former mayor of Türi town. Interviewed at Järva County Government Building. 4 February 2004.

Liivik, Sulev. Director, Local Government Affairs, Rahandusministeerium (Ministry of Finance of the Republic of Estonia). Interviewed at Ministry of Finance. 6 February 2004.

Saat, Tiit. Consultant, Financial Service, Tallinn City. Interviewed at Tallinn City Office. 6 February 2004.

Tammearu, Veiko. Consultant of Budget Department, Financial Service, Tallinn City. Interviewed at Tallinn City Office. 6 February 2004.