



Mihkel Oviir

Auditor General  
National Audit Office of Estonia

# Extension of the National Audit Office's Powers to Audit of Local Governments: Limitation or Constitutional Protection of Local Democracy?

On 1 January 2006, an amendment to the National Audit Office Act<sup>1</sup> entered into force in Estonia, which extended the powers of the National Audit Office to include auditing of the activities of local governments. The National Audit Office thus became the external inspection body for local governments.

The purpose of this article is to highlight the problems pointed out during the discussions that preceded the extension of the National Audit Office's powers, as well as the positions of the participants in the discussion in favour of and against the extension, and to briefly summarise the first results of the National Audit Office's activity as the external inspection body for local governments.

The dilemma referred to in the title mainly lies in the need to weigh the balance between two constitutional principles. On the one hand there is local government autonomy — a local government's right to independently and finally resolve and manage local issues. On the other hand there is the principle of democracy, which pertains to the public nature of power and the legal liability of those who exercise power, and of democratic control, including the nation's right to know how public resources are being used.

## 1. Local government following the principle of autonomy

The Constitution of the Republic of Estonia<sup>2</sup> clearly recognises the principle of local government autonomy, implying local governments' right to independently and finally resolve and manage local issues (in § 154 of the Constitution). This is thus a guarantee given to local governments by the Constitution. According to the Constitution, a local government is free to manage its procedures while being a part of the state as a whole.<sup>3</sup>

<sup>1</sup> Riigikontrolli seaduse ja kohaliku omavalitsuse korralduse seaduse muutmise seadus. – RT I 2005, 32, 235 (in Estonian).

<sup>2</sup> Eesti Vabariigi põhiseadus. – RT I 2003, 29, 174; 2007, 33, 210 (in Estonian).

<sup>3</sup> V. Olle et al. – Eesti Vabariigi põhiseadus. Kommenteeritud väljaanne (Constitution of the Republic of Estonia. Commented Edition). Tallinn: Juura Õigusteabe AS 2002, p. 641 (in Estonian).

The European Charter of Local Self-Government (hereinafter also referred to as the Charter), which Estonia ratified on 28 September 1994<sup>4</sup>, recognises the right of local incorporated territories to local governments, while leaving it up to each state to decide on their organisation.

The preamble of the Charter contains important principles for setting up local governments, including the principle of local government autonomy, whose implementation entails the existence of local authorities endowed with democratically constituted decision-making bodies and possessing broad autonomy with regard to their responsibilities, the ways and means by which those responsibilities are exercised, and the resources required for their fulfilment.<sup>5</sup> The principle of local government autonomy serves the purpose of decentralising public authority and limiting and balancing the authority of the state.<sup>6</sup>

According to § 154 (1) of the Constitution of the Republic of Estonia, local governments resolve and manage local issues independently, while the bases for their activity are provided by law. The Constitution recognises local governments — bodies of persons constituted on a territorial basis — as legal subjects separate from the state and not being part of the authority of the state in the narrower sense. This is why the activities of local governments must comply with constitutional principles.

Section 14 of the Constitution specifies the guarantors of fundamental rights (i.e., the addressees of personal rights and freedoms).<sup>7</sup> The provision mentions local governments in addition to the authority of the state. Local governments' duty to guarantee the fundamental rights of persons arises from the fact that this is a duty of the state authority in its entirety.<sup>8</sup> On the basis of the opinion of the Constitutional Review Chamber of the Supreme Court, local governments exercise the authority of the state both when complying with their state duties and when acting within their guaranteed autonomy; i.e., the relationship of local governments to fundamental rights applies to both their public-law and private-law activities.<sup>9</sup>

The legal delimitation of a local government organisation should take into account the long historical development of local governments and the developments and trends of the political system. Any indirect interference by the state must also be justified by overriding public interest and follow the principle of proportionality.<sup>10</sup>

For example, the European Charter of Local Self-government also provides that, as far as possible, grants to local authorities shall not be earmarked for the financing of specific projects; neither does the provision of grants remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction (Article 9). The Charter thus places great emphasis on the appropriateness of the local government's funds for its duties. For example, although local governments may borrow money under certain conditions, there are cases where the excessive loan burden of local governments has caused problems and even led to the insolvency of local governments. It should be stressed that bankruptcy proceedings with respect to local governments are precluded by constitutional law principles: the local government's constitutional guarantee and the principle of the rule of law.

## 2. The National Audit Office as a state body exercising economic control

Pursuant to § 132 of the Constitution, the National Audit Office shall be, in its activities, an independent state body responsible for economic control. The main function of the National Audit Office as set out in the Constitution — the content and scope of economic control — is specified in the National Audit Office Act.<sup>11</sup> According to § 137 of the Constitution, the organisation of the National Audit Office shall be specified in the law. The law thus referred to in the Constitution is the National Audit Office Act, which specifies the organisation and the bases for the activities of the National Audit Office, including the control powers (addressed in § 1 of the National Audit Office Act).

In the course of performing its main function, the National Audit Office may assess the audited entities' internal control, financial management, financial accounting, and financial statements, as well as the legality of their economic activities, including economic transactions; performance with regard to the audited entities' management, organisation, and activities; and the reliability of their information technology systems (§§ 16

<sup>4</sup> Euroopa kohaliku omavalitsuse harta ratifitseerimise seadus. – RT II 1994, 95 (in Estonian).

<sup>5</sup> CRCSCd 15.07.2002, 3-4-1-7-02. – RT III 2002, 22, 251 (in Estonian).

<sup>6</sup> SCEbd 19.04.2005, 3-4-1-1-05. – RT III 2003, 5, 48 (in Estonian).

<sup>7</sup> See SCEbd 3-4-1-1-05 (Note 6).

<sup>8</sup> M. Ernits. – Eesti Vabariigi põhiseadus. Kommenteeritud väljaanne (Note 3), p. 128.

<sup>9</sup> CRCSCd 6.10.1997, 3-4-1-3-97. – RT I 1997, 74, 1268.

<sup>10</sup> V. Olle et al. – Eesti Vabariigi põhiseadus. Kommenteeritud väljaanne (Note 3), p. 664.

<sup>11</sup> Riigikontrolli seadus. – RT I 2002, 21, 117; 2006, 48, 357 (in Estonian).

(2) and (3) of the National Audit Office Act). Section 7 of the National Audit Office Act also specifies the audited entities: in addition to the institutions and persons listed by law, the National Audit Office audits local governments. The law determines the content and scope of the economic control exercised by the National Audit Office (control powers) and the bases for audit activities (procedure). The control powers of the National Audit Office are extended not to the entire scope of local government activities but to a limited set of them.<sup>\*12</sup> Until 1 January 2006, the economic control exercised by the National Audit Office over local governments covered allocations for specific purposes and subsidies granted from the state budget for the immovable and movable property of the state transferred into local governments' possession, and funds allocated for the performance of state functions.

### 3. The necessity of control of local governments

The insufficiency of local governments' control system has been pointed out in many international reports concerning Estonia. An example can be found in the 2001 report of GRECO (Group of States Against Corruption, Council of Europe).<sup>\*13</sup> Amongst other things, it recommended that Estonia review the National Audit Office's activities and strengthen control over local governments. Other methods of strengthening control over local governments were considered in order to solve these problems and attain the goals. These methods include, for example, improving the efficiency of audits commissioned from private auditors, establishing a special auditing institution for external audit of local governments, and strengthening auditing conducted by the audit committee. Thorough analysis led to the conclusion that extension of the National Audit Office's powers was the best solution.<sup>\*14</sup>

The Supreme Court's position concerning control over local governments is based on Article 8 of the European Charter of Local Self-government, under which administrative supervision of local authorities may be exercised only according to such procedures and in such cases as are provided for by the constitution or by statute. Any administrative supervision of the activities of the local authorities shall normally aim only at ensuring compliance with the law and with constitutional principles. Administrative supervision shall be exercised in such a way as to ensure that the intervention of the controlling authority remains in proportion to the importance of the interests it is intended to protect.<sup>\*15</sup>

### 4. The objectives of extending the control powers of the National Audit Office

Extension of the control powers of the National Audit Office to local governments served two main objectives:

- to help strengthen external control over the lawful use of public-sector resources; and
- to help reduce corruption risks and disclose cases of corruption.<sup>\*16</sup>

Both objectives are in line with the main purpose of the National Audit Office — to exercise economic control in order to assure the Riigikogu and the public that the funds of the public sector are being used legally (§ 3 of the National Audit Office Act). It is important to note that the purpose of economic control is not only to identify shortcomings but particularly to give an overview of the actual situation.

The Constitution does not prevent the extension of the National Audit Office's powers by law, because it is not essentially contrary to the Constitution to assign new duties to constitutional institutions in addition to their duties under the Constitution. In assignment of new duties, it should be taken into account that the new duties must not prevent the performance of the main duty or run counter to other constitutional principles. It was therefore concluded that adding the function of economic control over local governments to the duties of an independent constitutional institution does not go against constitutional principles.<sup>\*17</sup>

<sup>12</sup> Letter by the Chancellor of Justice to the Auditor General of 6.09.2004, No. 6-1/04/1154, p. 2.

<sup>13</sup> Available at [http://www.coe.int/t/dg1/Greco/Default\\_en.asp](http://www.coe.int/t/dg1/Greco/Default_en.asp)

<sup>14</sup> Explanatory memorandum to the National Audit Office Act and Local Government Organisation Act Amendment Act, p. 2. Available at <http://web.riigikogu.ee/ems/saros-bin/mgetdoc?login=proov&password=&op=ems&system=ems&server=ragne11&itemid=050950014> (04.11.2007) (in Estonian).

<sup>15</sup> CRCSCd 5.02.1998, 3-4-1-1-98, Chapter II. – RT I 1998, 14, 230 (in Estonian).

<sup>16</sup> See letter of the Chancellor of Justice to the Auditor General of 6.9.2004, No. 6-1/04/1154, p. 2.

<sup>17</sup> *Ibid.*, p. 3.

The shorthand notes from the discussion in the Riigikogu concerning amendment of the National Audit Office Act reveal another issue — the concern of practitioners about the independence of the National Audit Office and doubts as to whether the amendment is going to achieve its intended purpose. It was concluded in the analysis of the issue that no new inspection body or type of inspection will be established for local governments. Instead, the National Audit Office will be able to perform its current duties — of ensuring control of transparency and lawfulness — to a higher standard of quality and in a manner that does not result in a constant risk of legal disputes. The risk of legal disputes implied a ‘grey area’ in assessing the lawfulness of the use of assets of the state and of local governments.<sup>\*18</sup>

Assessments and conclusions of an independent body responsible for external audit should additionally provide the audited entity with a good basis for quality decisions and enhance the reliability of the audited entity in the eyes of third parties.

The National Audit Office’s right to audit local governments also means the latter’s obligation to tolerate control procedures and to co-operate. Such duties can be assigned only by means of a law governing the relations between state and local government.<sup>\*19</sup>

## 5. A look at the debate over the scope of local government control in 1937

There is nothing new in the current discussion. A similar discussion was held over the draft Constitution in 1937.

The National Audit Office was established by a decision of the *ad hoc* Land Council of 27 December 1918. The first Constitution of the Republic of Estonia took the view that control of state agencies’ and enterprises’ economic activities and of implementation of the state budget was a function of the Riigikogu, for which the Riigikogu was to set up the relevant bodies. The Constitution of 1937 inclined the National Audit Office toward executive power.

The draft Constitution provided for the possibility of assigning to the National Audit Office the duty of auditing the economic activities of local governments. At the second reading of the draft Constitution, § 101 (2) of Chapter 10, ‘National Audit Office’, was worded as follows: “Audit of the economic activities of local governments and other public institutions may be assigned to the National Audit Office by law” (translation from the original Estonian).<sup>\*20</sup>

Some arguments **in favour of local government autonomy** from the 26<sup>th</sup> set of minutes of the meeting of the general committee for the Constitution at the first National Assembly, held on 27 May 1937 in the Riigikogu building (discussion of § 101 (2))<sup>\*21</sup>, were set forth as follows (originally in Estonian).

- Kaarel Eenpalu: “We have gone too far with this section. We do respect local governments, but only in our words. What is a local government? A government’s being local means that it determines its budget itself and also supervises its implementation. It would be too far-fetched to assign this supervision to the National Audit Office. We should act against this.”
- Värdi Velner: “Even during Russian times they did not go so far as to impose a national audit, for example, on rural municipalities. Neither can we go so far. Local governments have their own audit committees that exercise control. Nothing has gone wrong with this system so far.”
- Herbert Treial: “If the National Audit Office were to control the economic activities of local governments, this might interfere too much with local government affairs, which is why this committee takes the view that the state can control the economic activities of local governments not from the premise of purposefulness but only on the premise of lawfulness.”

Arguments **for local democracy** were put forth at the same meeting:

- Juhan Kaarlimäe: “Although local governments are audited in many ways, none of the audits are conducted to the end, because each body audits only certain aspects, and such audit is not purposeful.”

<sup>18</sup> Draft National Audit Office Act and Local Government Organisation Act Amendment Act (603 SE, 614 SE), second reading, 10.05.2005. Available at [http://web.riigikogu.ee/ems/stenograms/2005/05/t05051013-03.html#P323\\_94193](http://web.riigikogu.ee/ems/stenograms/2005/05/t05051013-03.html#P323_94193).

<sup>19</sup> L. Lehis. Arvamus Riigikontrolli auditeerimispädevusest seoses kohalike omavalitsustega (Opinion on the Auditing Powers of the National Audit Office with Respect to Local Governments). Tartu 27.08.2004, p. 2.

<sup>20</sup> Estonian State Archives, unit 77, directory 3, item 77a, p. 287.

<sup>21</sup> Estonian State Archives, unit 77, directory 3, item 77a, p. 288.

- Anton Uesson: “The stronger the control of local governments, the better the local government representatives and leaders have managed these governments.”
- Kaarel Eenpalu: “I must say that any abuses that we have had occurred at the time when our local governments were almost completely without supervision. Parliament factions supported them, and where units of these factions existed at the local government level there was no power that could control them. From this we may conclude that local governments had a good life if this was favoured by the central government itself.”

At the meeting of the third committee reviewing the draft Constitution, on 13 April 1937, committee member Ado Anderkopp voiced the following opinion: “The current procedure for auditing local governments is such that a ministry official arrives and goes through the local government’s records without actually being competent enough. It is better to replace this authoritative control by the impartial and competent control powers of the National Audit Office.”<sup>22</sup>

Jüri Marksoo, a member of the third committee reviewing the draft Constitution, opined on the proposal to “also check the bodies’ own finances when checking the state finances” that such a scope of control would be difficult for the National Audit Office because it would imply checking the purposefulness of transactions carried out with local governments’ own funds.<sup>23</sup>

At the committee meeting of 21 April 1937, committee member Herbert Treial said: “At the last meeting, committee member Kohver raised the question of whether it is purposeful to grant the National Audit Office the power to control the purposefulness of the economic activities of local governments. I think the National Audit Office should control only the lawfulness of the economic activities of local governments.”<sup>24</sup> At the same meeting, August Kohver himself adopted the same view: “[...] whether the National Audit Office controls the economic activities of local governments and other public agencies with a view to ensuring the lawfulness or purposefulness of these activities. National audit of these bodies is thinkable only in consideration of lawfulness, not purposefulness, because in the latter case we would restrict the self-governing activities of these bodies.”<sup>25</sup>

The result of the discussion in 1937 was that § 101 (2) was passed in the vote unanimously as proposed:

- Contribution to the audit of the economic activities of local governments and other public institutions with a focus on the use of public finances may be assigned to the National Audit Office by law.<sup>26</sup>

Two angles should be stressed here. Firstly, as now, so in 1937 the extension of powers was unanimously approved. Secondly, in 1937 the debate was over whether the National Audit Office should be given any power to control local governments at all. As a final solution it was decided that the National Audit Office could control the use of public funds by local governments. One should keep in mind the context of those times; while today the National Audit Office may make only advisory proposals, at that time, as Auditor General Karl Soonberg put it, the National Audit Office was a body “also having judicial functions, such as imposing additional payments and repayments”.<sup>27</sup>

## 6. Discussion in the Riigikogu of the scope of local government control

The discussion of 2005 was similar to that of 1937 except that it went one step further — namely, the debate was over whether the National Audit Office should be given the powers to control not only public finances but also local governments’ own finances, and whether granting such powers would impinge on the discretion of local governments.

In the discussion of amendments to the National Audit Office Act in 2005, the debate over the powers of the National Audit Office sprang from § 133 3) of the Constitution, according to which the National Audit Office shall audit the use and disposal of state assets that have been transferred into the control of local governments. This provision was the subject of thorough discussion during the amendment of the National Audit Office Act.

<sup>22</sup> Estonian State Archives, unit 77, directory 3, item 81, p. 111.

<sup>23</sup> Estonian State Archives, unit 77, directory 3, item 81, p. 110.

<sup>24</sup> Estonian State Archives, unit 77, directory 3, item 74, p. 132.

<sup>25</sup> Estonian State Archives, unit 77, directory 3, item 74, p. 133.

<sup>26</sup> Estonian State Archives, unit 77, directory 3, item 77a, p. 300.

<sup>27</sup> Estonian State Archives, unit 77, directory 3, item 81, p. 108.

Minister of Justice Rein Lang summarised the discussion at the Riigikogu session on 13 April 2005.<sup>\*28</sup> The main point at issue was whether the above-mentioned provision restricts the powers of the National Audit Office indeed to only the assets assigned to local governments or whether it should be allowed to give greater control powers to the National Audit Office so as to ensure the lawful and purposeful use of public resources as a whole. The narrow interpretation was no longer considered justified, and any fears concerning the extension of the National Audit Office's powers were largely viewed as groundless.

In the course of the discussion, the Chancellor of Justice took the view that the issue should be viewed in the light of the historically important role of the local governments' guarantee in Estonian society. However, it is important to admit that local governments are a part of public authority whose financial basis is formed of taxes. The constitutional function of the National Audit Office is to identify and disclose any misuse of public funds. A local government is a public authority and, as such, has been created not for the sole purpose of serving people better but to serve people better while enhancing democracy. The state should retain sufficient control mechanisms to achieve these goals<sup>\*29</sup>.

During the discussion of amendments to the National Audit Office Act, member of the Riigikogu Urmas Reinsalu pointed out the philosophical point of departure that taxpayers' money should be fully subject to external control and to auditing via external control. An important aspect of this principle is the legal certainty of those subject to the local government in knowing that their tax money and public services are lawfully handled — i.e., that inhabitants under the jurisdiction of the local government are guaranteed legal certainty. In addition, it also helps to realise the important principle of democracy of state government, one of whose elements is good governance.<sup>\*30</sup>

Local government authorities are often the first and closest point at which people come into contact with the public sector, and they have an impact on people's trust in the state. Therefore, strengthening control over local governments is important with a view to enhancing the legitimacy of the authority of the state. Local government autonomy need not mean absence of control. In addition, the explanatory memorandum to the legal amendment mentions that, because requirements have changed over time, it is reasonable to update the content of the relevant provision of the Constitution, so as to reduce the margin of no control to a minimum in the public sector.<sup>\*31</sup>

In its decision of 19 April 2005, the Supreme Court also took the view that it is admissible to impinge on rights arising from constitutional principles if a constitutional value is protected by the restriction and if the restriction is necessary in a democratic society. Impinging on the principle of local government authority as a general constitutional principle is also admissible if this is justified by the achievement of an important constitutional value.<sup>\*32</sup>

As regards supervision by the National Audit Office, it should be kept in mind that this does not constitute supervision in the traditional sense. The procedure conducted in the course of economic control by the National Audit Office does not result in a mandatory prescription or other immediate sanction or punishing act. The procedure merely results in an audit report containing observations, assessments, and recommendations for the elimination of shortcomings. Public disclosure of misconduct is the main 'sanction'.<sup>\*33</sup>

Therefore, there is not and could not be any essential conflict between those two principles. Rather, the question is one of how to achieve balance between the two important constitutional principles without restricting them unjustly.

The explanatory memorandum to the draft act proposed extending the economic control powers of the National Audit Office to local governments regardless of whether the control covers state or municipal assets. However, the intention was to limit the control of municipal assets to control of lawfulness. As the money always comes ultimately from taxpayers, the efficiency of control should not depend on the user of the money. In practice, there are often problems with distinguishing between national and local affairs.

Member of the Riigikogu Andres Herkel stated in the discussion of the National Audit Act amendment in the Riigikogu that the dispute over whether the National Audit Office's control of local governments is in line with the Constitution has continued for years. It was concluded as a result of the discussion that control cannot cover the purposefulness of policy decisions but only lawfulness and financial audit. At the same time, Herkel

<sup>28</sup> Shorthand notes of the Riigikogu, draft National Audit Office Act and Local Government Organisation Act Amendment Act (603 SE, 614 SE) first reading, 13.04.2005. Available at [http://web.riigikogu.ee/ems/stenograms/2005/04/t05041311-10.html#P204\\_31987](http://web.riigikogu.ee/ems/stenograms/2005/04/t05041311-10.html#P204_31987) (4.11.2007) (in Estonian).

<sup>29</sup> See letter of the Chancellor of Justice to the Auditor General of 6.09.2004, No. 6-1/04/1154;

<sup>30</sup> Draft National Audit Office Act and Local Government Organisation Act Amendment Act (603 SE, 614 SE), third reading, 11.05.2005. Available at [http://web.riigikogu.ee/ems/stenograms/2005/05/t05051114-04.html#P291\\_46209](http://web.riigikogu.ee/ems/stenograms/2005/05/t05051114-04.html#P291_46209) (4.11.2007) (in Estonian).

<sup>31</sup> Explanatory memorandum to the National Audit Office Act and Local Government Organisation Act Amendment Act (Note 15).

<sup>32</sup> SCEbd 3-4-1-1-05 (Note 6).

<sup>33</sup> Speech by R. Lang at the Riigikogu at the first reading of the draft National Audit Office Act and Local Government Organisation Act Amendment Act (29 SE, 614 SE), 13.04.2005 (Note 28).

considered it to be a draft law of European orientation that would help improve the efficiency of control over local governments.<sup>\*34</sup>

Also, Riigikogu member Urmas Reinsalu pointed out the positive attribute that the Riigikogu will have at its disposal, via the co-operation committee of the parliament and National Audit Office, additional information on the activity of local governments in using taxpayers' money.<sup>\*35</sup>

The legislature found that allowing an external inspection body to assess the lawfulness of local government activities while not allowing assessment of the sustainability, efficiency, and effectiveness of local government decisions is in line with the Constitution.

## 7. The National Audit Office as external inspection body for local governments

When it comes to implementing the extended powers of the National Audit Office, it seems clear at first glance how to act under the law. However, several disputes have already arisen in practice about the admissibility of assessing 'grey area' issues: is a formal audit of lawfulness sufficient for protecting local democracy, or should assessment cover whether local governments have indeed proceeded in their activities from the actual objectives of the law, the intent of the legislature, and the legitimate interests and needs of the inhabitants served by the local government?

We can cite an example:

- Can the National Audit Office assess, e.g., the following situations: in a city where roads are in extremely poor condition and need major repairs, a new local government building is erected, or, in the same city, instead of erecting a new building, workers acting on the city's behalf repair only the road leading to the mayor's residence? What kind of assessment can be made in such cases?
- The purpose of the Public Procurement Act<sup>\*36</sup> is to ensure the transparent, purposeful, and sustainable use of local government funds; equal treatment of persons; and efficient use of the existing competition situation in public procurements (§ 1). A key question is how to audit lawfulness while avoiding assessment of the sustainability of the activities of a municipality or rural incorporated area.
- A waste management plan deals with the organisation of waste management, the objectives of improving the efficiency of waste management, and optimisation of waste transport in the municipality or rural incorporated area concerned.<sup>\*37</sup> How can one audit the implementation of the waste disposal plan while avoiding assessment of the effectiveness of the activities of the municipality or rural incorporated area?

It is clear that merely formal control of lawfulness is not sufficient to protect local democracy, as this might not yield any objective or essential information about the local government's activities. The legislature's intention and the actual purpose of a law, as well as the legitimate interests of the inhabitants, also should always be kept in mind in assessments. Only this way can local democracy be essentially ensured without impingement on local government autonomy. This should be the point where democracy is ensured by public control, on the one hand, and the local government's right to independently and finally resolve local issues is not infringed, on the other.

It should be stressed that the chief purpose of economic control is to provide an overview of the actual situation. In addition, the assessments and conclusions of an independent external auditing body should provide the audited entity with a good basis for quality decisions and enhance the reliability of the audited entity in the eyes of third parties.

Therefore, the activity of the National Audit Office is not aimed just at representing the interests of public administration before municipal administration. The National Audit Office considers it equally important to assess whether and how local government issues are related to shortcomings in public administration and to what extent the state takes account of the justified needs of local governments. The principles for actions and reporting of the public sector have been undergoing constant rapid development, which is why the National

<sup>34</sup> Shorthand notes of the Riigikogu, draft National Audit Office Act and Local Government Organisation Act Amendment Act (603 SE, 614 SE) second reading, 10.05.2005 (Note 18).

<sup>35</sup> Shorthand notes of the Riigikogu, draft National Audit Office Act and Local Government Organisation Act Amendment Act (603 SE, 614 SE), third reading, 11.05.2005 (Note 30).

<sup>36</sup> Riigihangete seadus. – RT I 2007, 15, 76 (in Estonian).

<sup>37</sup> Subsection 39 (2) of the Waste Act (Jäätmeseadus. – RT I 2004, 9, 52; 2007, 44, 315 (in Estonian)).

Audit Office plays a major role in supplying the Riigikogu and the public with independent and objective feedback on the effectiveness of the choices made and on any shortcomings identified.

In the discussion of the legal amendment, Minister of Justice Rein Lang set in a positive light the addition to the draft law according to which the National Audit Office may make proposals to the Riigikogu, the Government of the Republic, and the minister, as well as local government bodies, concerning the drafting, amendment, and supplementation of legislation. This right to participate in legal drafting has the primary purpose of eliminating the shortcomings identified in the course of economic control and avoiding such shortcomings in the future. The provision also makes it possible for the National Audit Office to draw attention to potential gaps or shortcomings in legislation preventively, if relevant information is available to it. The National Audit Office has availed itself of this opportunity in connection with issues related to the functions of local governments.<sup>\*38</sup>

## 8. Activities of the National Audit Office in checks of local governments since 1 January 2006

On the basis of the new objectives, the National Audit Office started to exercise control of local governments on 1 January 2006 with respect to the following persons and areas:

- local governments in their possession, use, and disposal of municipal assets;
- foundations and not-for-profit associations in which a local government participates as a founder or member;
- companies controlled by local governments; and
- subsidiaries of such companies.

In these areas, the National Audit Office may assess the following aspects of the audited entities:

- internal control, financial management, financial accounting, and financial statements;
- the legality of their economic activities, including financial transactions; and
- the reliability of their information systems.

It should be pointed out here that in its activities the National Audit Office takes into account one of the main principles of local government organisation — the right of local governments to independently and finally resolve and manage local issues — which is why the control powers of the National Audit Office do not extend to assessing the effectiveness of local government management, organisation, and activities.

In addition, the National Audit Office continues to examine the use of immovable and movable property of the state that has been transferred into the possession of local governments, allocations for specific purposes and subsidies granted from the state budget, and funds allocated for the performance of state functions (including assessment of the effectiveness of the assets' use).

A special audit department was set up in the National Audit Office for these functions; 13 auditors currently work in this department. The department began its work on 1 January 2006. Key National Audit Office objectives for 2006 were to launch the department and determine its structure and responsibilities, on the one hand, and to launch actual auditing activities, on the other. According to the National Audit Office Act, the National Audit Office shall decide independently on the conduct of audits and the time and nature thereof (§ 37) and is committed to conducting audits impartially, in line with applicable law and internationally accepted auditing standards.

Due to the large number of entities within the scope of auditing and the limited resources of the National Audit Office, entities for auditing are selected on the basis of analysis of the information available to the National Audit Office and upon identification of areas of priority with respect to the efficient functioning of state and municipal administration and the related risks.

As regards local government audits, the National Audit Office has considered it necessary to apply the following types of audit especially:

- general or institutional audits of local governments or their units, their financial management, and their asset management and internal control systems; and
- subject-specific audits.

<sup>38</sup> Shorthand notes of the Riigikogu, draft National Audit Office Act and Local Government Organisation Act Amendment Act (603 SE, 614 SE), first reading, 13.04.2005 (Note 28).

The main purpose of **general audits** is to assess whether the activities of a local government and its financial and asset management are lawful and whether efficient internal control systems are in place. Before the end of the department's second year of activity, eleven cities and rural municipalities had been audited. The main problems, which largely represent the general problems of all local governments, are as follows:

- the internal control systems of all audited local governments need major improvements of efficiency;
- information is not disclosed in the required scope and manner;
- established procedures are not followed or are outdated; and
- budgeting and implementation of the budget, as well as financial transactions, are not always in line with the law.<sup>39</sup>

The purpose of **subject-specific audits** is to assess the lawfulness of the management of a specific area of activities by all or a certain group of local governments. The areas to be audited are likely to be selected on the basis of a risk analysis from among the following areas of local government operations: management of fixed assets, granting of subsidies, organisation of public procurements, issue of activity licences, management of assets for a specific purpose transferred by the state to the ownership of local governments free of charge, use of support received from European Union Structural Fund programmes, and funding of the activities of the local government. Four such audits have been completed in the second year of the department's activity, in which the following problems were identified:

- the overall level of accounting is poor, and there are material shortcomings in financial statements, the latter also not being readily available to the public;
- planning of investments requires major improvements with a view to ensuring continuous development;
- there is no reliable and comparable information about the actual amount of personnel costs; and
- most local governments lack the capacity to handle IT and 'information society' issues.

Correctness and transparency in local government activities are not only formally important. It is clear that, by applying a balanced and well-considered approach, the National Audit Office can be of help to local governments, helping them ensure the lawful use of the funds at their disposal and also transparent and efficient administration, thus strengthening local democracy.

In performing its functions, the National Audit Office endeavours to be a source of impartial information and feedback for the public and the Riigikogu but also to help develop and improve the administrative arrangements and internal control systems of local governments.

<sup>39</sup> All audit reports of the National Audit Office are available in Estonian at <http://www.riigikontroll.ee/>.