



## **The Percentage designation based on the Hungarian Model: can it make a difference in Moldova?**

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## Table of Contents

Summary .....	3
Introduction .....	3
Chapter 1. Theoretical and legal considerations of percentage designation .....	4
1.1. What is percentage designation? .....	4
1.2. How it appeared and evolved? .....	4
1.3. What is the aim of the percentage designation?.....	5
Chapter 2. Percentage philanthropy in Hungary .....	6
2.1. Background .....	6
2.2. Substantive aspects.....	6
2.3. Administrative procedures and burden .....	9
2.4. Effects of the percentage designation in Hungary.....	11
Chapter 3. Implications of the percentage mechanism for the Republic of Moldova .....	14
3.1. The potential administrative costs.....	14
3.2. The potential impact on national / local budgets.....	15
3.3. Policy options: Risks vs. Opportunities .....	16
3.4. Potential impact of the percentage mechanism for Moldova.....	17
Recommendations .....	19
Bibliography .....	21

## Summary

This Research analyzes the percentage designation model in Hungary and examines its feasibility for the Republic of Moldova. It analyses the evolution of the “1% law” in Hungary, the implementation mechanism, policy aspects, and its effects on the Hungarian citizens and NGOs. Based on the findings, it argues that the implementation of the percentage mechanism in Moldova is feasible and provides corresponding recommendations for national authorities and Moldovan NGOs.

## Introduction

This research was developed in the course of the Research Fellow Program conducted at the European Center for Not-for-Profit Law (ECNL) during the summer of 2012. It seeks to analyze the percentage designation model in Hungary and examine its feasibility for the Republic of Moldova. The paper is structured into three chapters.

The first chapter explores the concept of the percentage designation. It considers the way in which the percentage appeared in Western European countries and how it evolved in Central and East European Countries. Subsequently, it provides an overview of countries that managed to successfully implement the percentage mechanism.

The second chapter analyses how the percentage mechanism functions in Hungary. Following an overview of the adoption of the 1% percent law in Hungary, it looks into the substantive and procedural aspects of the law. Subsequently, the effects of the legislation are examined, compared to the envisaged rationales. The chapter also provides a case study that illustrates the benefits of the percentage legislation for NGOs in Hungary.

The third Chapter examines the feasibility of the percentage mechanism for the Republic of Moldova. It begins by considering the potential costs related to the introduction and administration of this mechanism based on the experience of the Hungarian Tax Authority. The second section seeks to respond to budget impact concerns raised by the national authorities. In the third section the policy implications are being examined, seeking also to respond to particular questions and concerns raised by various experts at national level. Subsequently, the chapter provides an overview of the envisaged impact of the percentage mechanism for the Republic of Moldova.

The paper provides recommendations for national authorities and civil society organizations in view of the upcoming reform to develop and implement percentage mechanism in Moldova.

This findings and recommendations of this paper are based on a variety of methodological approaches. A comprehensive desk review on implementation of the Percentage Law was conducted before the fellow’s arrival to Budapest and during the week at ECNL. The desk research included thorough examination of relevant legal framework, studies, reports, statistics, and opinion polls. With the support of ECNL team, the fellow developed and examined the results of a questionnaire on Hungarian legislation that was distributed by ECNL among

Hungarian stakeholders. In addition, meetings with relevant state and non-state actors were conducted in Budapest. The list of NGOs is included in Annex 1 of the paper.

## Chapter 1. Theoretical and legal considerations of percentage designation

This Chapter will explore the concept of the percentage designation. It will consider the way in which the percentage appeared in Western European countries and how it evolved in Central and East European Countries. Subsequently, it will provide an overview of countries that managed to successfully implement the percentage mechanism.

### 1.1. What is percentage designation?

The percentage designation is a special form of indirect state support. Under this mechanism, individuals and in some countries also corporate taxpayers are conferred the right to decide how to use a certain percentage of their tax. Taxpayers may decide to transfer this portion of the tax to a qualifying organization or beneficiary as defined by law (either a separate law or the tax law). If the taxpayer(s) decide not to transfer the funds to one of these beneficiaries, the funds will be channeled into the overall public budget and used as determined by the Annual Budget Law of the National Parliament.

### 1.2. How it appeared and evolved?

The concept originates in Western Europe, pursuant to attempts to resolve dilemmas of church financing after the separation of state and church. Legislative efforts in European countries to separate the powers of the state from the powers of the church started following the French revolution in 1789 and lasted until the middle of the 20th century. Consequently, the “percentage legislation” essentially has been serving the purpose of a specific, non-political way of financing the Catholic Church (and eventually, other churches). In a few countries, such as Spain and Italy, an additional objective has been to provide some citizen allocated funds to finance state-determined objectives of public interest. In a way, this latter option can be regarded as a “concession” made to provide a choice to non-religious taxpayers.

In the case of CEE, the intent of the laws to support the so-called “civil sphere”, i.e. nonprofit, non-governmental organizations (NGOs) has been clearly articulated. Political, economic, social and cultural factors all contributed to the creation of this distinct legal product<sup>1</sup>.

This mechanism was introduced for the first time in **Hungary** in 1996. **Slovenia, Slovakia, Lithuania, Poland and Romania** followed the example. In Slovakia the law was amended in 2004 to permit tax designations not only by physical taxpayers, but also by businesses. The concept of percentage mechanism was reviewed, but not adopted upon in-depth assessment of its possible impact in **Bulgaria, Georgia, Estonia and Macedonia**. The mechanism is currently being reviewed in **Ukraine**<sup>2</sup>.

<sup>1</sup> Nilda Bullain: Percentage philanthropy and law. NIOK and ECNL, 2004.

<sup>2</sup> ECNL (2012). Guidelines on policy assessment for introducing the percentage mechanism. (under publication)

### 1.3. What is the aim of the percentage designation?

While the general goal of the percentage mechanism is advancement of civil society through support of its organizations, there is a range of specific reasons governments and NGOs have used in campaigning for its adoption.

One rationale is that the possibility that tax-paying citizens make autonomous decisions on the use of a portion of their income tax, thereby exercising direct democracy.

Another rationale is that of civil society development. This mechanism can play a role in strengthening civil society by (a) providing new resources to the NGOs, (b) raising awareness about NGOs, and (c) increasing the skills of NGOs in communication and community outreach. In light of this argument, the mechanism actually helps educate the general public about the role and importance of NGOs and at the same time it motivates NGOs to communicate with the public.

A third rationale is that of development of a philanthropic culture. This focuses on the importance of citizen support to NGO endeavors. According to those emphasizing this rationale, in transition societies there is no tradition of philanthropy (private giving) and this mechanism may be a good first step in developing such culture, as it encourages the individuals to think about reasons for supporting an NGO. In addition, it serves as an indicator of the level of public support to NGOs.

A fourth rationale is “government outsourcing”, in that the method can serve the purpose of providing decentralized and depoliticized government support to activities that benefit the public. According to the arguments of the “government outsourcing” rationale, because the beneficiary organizations are conducting public benefit activities the government is subsidizing important public tasks, but in a decentralized and depoliticized way, which is a much-needed alternative to centralized and bureaucratic decision making.<sup>3</sup>

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<sup>3</sup> *ibid.*

## Chapter 2. Percentage philanthropy in Hungary

This chapter will analyze how the percentage mechanism functions in Hungary. It will consider the legislation and will look into substantive and procedural aspects of the law. Subsequently, the effects of the legislation will be examined, compared to the envisaged rationales, described in the previous chapter.

### 2.1. Background

In Hungary the initial idea of the “1% Law” was brought into the political debate in the context of church financing, when in the early nineties the restitution of churches required a solution for their public support. In 1991, liberal politicians proposed abandoning direct state support to churches in favour of a scheme similar to the Italian and Spanish models, whereby a portion of tax revenues was designated by citizens towards churches. At that time, the Hungarian Parliament was not ready to make a decision on the proposal, but the idea of tax income redirected to finance churches was included in the programs of parties that came to government in 1994.

Another dimension to the political debate concerned financing of civil society organizations. In the post communist revival of civil society, each successive government in Hungary stressed their genuine commitment to the strengthening of this sector. Consequently, the political debate extended beyond the separation of church and state and sought to address issues related to governance, democratization, civil society development.

In Hungary, the provision that individual taxpayers have the right to designate a determined portion of their taxes paid, which will be transferred by the tax authority was introduced in 1997. It states that the exact portion of tax, the potential beneficiary(ies) and the procedure for transfer will be determined by a separate law. This separate law is Act CXXVI of 1996, on the Use of a Specified Portion of Personal Income Tax According to the Designation of the Taxpayer, commonly referred to as the “1% Law.” The use of the term “1% Law” is really only applicable in Hungary, as it is the only country that has a separate law containing all essential substantive and procedural conditions regarding percentage designations. Nevertheless, the term “1% or 2% Law” is commonly used as a general expression in other CEE countries although “1% provision” would perhaps be a more accurate term. <sup>4</sup>

### 2.2. Substantive aspects

- Who are entitled to designate a portion of tax?

Individuals who are obliged to file tax returns and pay taxes under the personal income tax law are entitled to make a tax percentage designation, provided that they paid the tax in due time or received a payment extension or a permission from the tax authority to pay it in installments before the deadline and fulfilled their payment obligation within the new deadlines. This includes self-employed small entrepreneurs and agricultural farmers as well. Usually “individual

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<sup>4</sup> Nilda Bullain: Percentage philanthropy and law. NIOK and ECNL, 2004

taxpayers” include all residents (as opposed to citizens only), and therefore, those foreign nationals who have permanent residency in the country and pay taxes under the domestic tax law are also entitled to make designations.

- Who are entitled to receive the designated amounts?

In Hungary, individual taxpayers – natural persons – may designate 1% of their income taxes paid to a qualifying NGO and another 1% to a church. Alternatively there is a list of public institutions<sup>5</sup> to contribute to instead of an NGO; while as an alternative to a church there is a special national priority objective named each year<sup>6</sup>. Taxpayers may make the designations on special forms enclosed in the tax return or in case they submit their tax report online, fill it in on the Internet. The tax authority transfers the amounts designated after the beneficiary proves its entitlement, and the designators remain anonymous.

- What are the criteria for entitlement for those kinds of organizations?

Non-governmental organizations must fulfill certain requirements in order to gain access to the percentage designations.

**1. Public benefit activity.** The beneficiary NGO does not need to have public benefit status but it needs to conduct public benefit activities without interruption from at least one year prior to the first day of the year of the designation.

**2. Previous operation.** The law also requires that the beneficiary NGO shall be registered at least two year prior to the first day of the year of the designation. The criteria of two years is reduced to one year in case of public foundations and those public benefit associations/ foundations which undertake their activity based on a contract with a state institution or a local government.

**3. Lack of public debt.** Further condition is that the beneficiary NGO may not have a public debt for which it did not receive payment extension or permission to pay it installments.

**4. Hungarian registered office.** The beneficiary NGO shall have its registered office in Hungary.

**5. Beneficiaries.** The beneficiary NGO must be operating in the interest of the Hungarian community or Hungarians living abroad.

- Who decides on the entitlement? Is there a need to have a register of the potential beneficiary organizations?

In Hungary, it is the tax authority that makes a decision each year on the entitlement of NGOs to whom taxpayers designated 1% of their taxes. NGOs do not need to be entered in a separate register in order to be entitled to the 1% designations. The NGO’s qualification to receive designations is determined only after the designations have been made.

- How many beneficiaries may one taxpayer designate to?

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<sup>5</sup> E.g., Hungarian Academy of Sciences, Hungarian State Opera, National Cooperation Fund, Hungarian Széchenyi Library

<sup>6</sup> In 2011 the 1% could be dedicated to the National Talent Program.

Taxpayers may effectively designate only to one organization, e.g. an NGO and/or a church.

- What can the designated money be used for?

In general terms, designations should be used for the accomplishment of the mission-related public benefit activities of the beneficiary NGO. Under the Hungarian Law, operational and maintenance costs may be covered from the designated amount. However, the total amount of such costs shall not be more than 50% of the amount utilized from the designated amount in the subject year. The Law specifically includes that salaries, office rent, public utility fees, postal costs, internet and phone bills may be considered as operational costs. Recipients can retain the designated amounts for later use but it shall not be more than 3 years. The fact, the objective, the term and the amount of an eventual reserve shall be reported to the tax authority as part of its reporting obligation explained below. In case the tax authority recognizes that the beneficiary NGO exceeds the term of 3 years it orders the organization to repay the amount which was not used for public benefit activity during the term of the reserve.

- What are the reporting requirements for the beneficiaries?

The beneficiary NGOs are obliged to report to the tax authority on the usage of the designation within two years after the designation was transferred to the beneficiary NGO, until the 31st of May. The reporting obligation is fulfilled by submitting a specific tax authority form which includes the amounts of the mission related and the operational costs and the details of the reserve. In case the tax authority establishes that the NGO

- 1) failed to submit the report; or
- 2) provided false data; or
- 3) provided a miscounted data and did not make up the mistake

it decides to exclude the beneficiary NGO to receive designations in the next designation year.

According to the Law the reports are forwarded to the Ministry responsible for civil society relations which shall publish them on its thematic website for NGOs. In addition, the beneficiary NGOs shall disclose the report on their own website as well.

- How are disputes settled?

In the Hungarian experience disputes tend to cluster around three areas. One concerns beneficiary NGOs who miss the deadline to prove entitlement to designations. According to the 1% Law the tax authority sends a letter until the 1st of September and calls upon the beneficiary NGOs to certify that they are eligible to receive the designations. A term of 30 days shall be provided to comply with such requirement. In case the beneficiary NGO fails to submit the required documents within 30 days through no fault of his own it is entitled to submit an application for extension. Otherwise, the NGO loses all designations.

Another problem concerned situations where the tax authority deemed an NGO ineligible to receive designated funds, and the NGO disagreed. In such cases, an NGO could initiate an appeal to the competent court against the written ruling of the tax authority. The court may decide either to uphold or reject the tax authority's ruling within 15 days in the course of an out-of-court proceeding.

A third area of potential dispute is between the tax authority and the taxpayer. There is no special rule concerning this issue in the 1% Law. If the tax authority finds a taxpayer's designation invalid, it issues a resolution and sends a notification to the taxpayer, against which the taxpayer may appeal under the standard procedures of the Administrative Procedure Act.

- What happens if an organization does not comply with transparency and accountability requirements?

In this case the Tax Authority publishes on its web site the list of organizations which were excluded from the 1% designation as they either 1) failed to submit the report; or 2) provided false data; or 3) provided a miscounted data and did not make up the mistake. In such cases, the respective NGO(s) are not eligible for 1% designation during the following calendar year. According to the Tax Authority, this sanction was applied to 1030 NGOs related to the year of 2012. Additional sanctions include the return of provided funds, fines.

### 2.3. Administrative procedures and burden

- How and when is the designation made? Are designations anonymous?

The 1% designation form shall be submitted to the tax authority until the deadline of the tax return; this is a forfeit deadline so it is not possible to submit an application for extension. The designations shall be made on a separate form which includes the name and tax number of the taxpayer and the tax numbers of the beneficiary NGO and church. The tax return and the designation forms may be forwarded to the tax authority directly by the taxpayer or via the employer along with the tax return (see the details below). It may be submitted in person, by post or via the governmental online citizen portal.

The data on the designation form are considered to be confidential tax information therefore the tax authority shall take measures to ensure their protection. Irrespectively of the method of submission the tax authority separates the information on the taxpayer and the beneficiary NGO, In case the tax return and the designation form are submitted on paper the tax authority puts code on the envelope and the designation form and separates the information of the designation form on the taxpayer and the beneficiary NGO in a way that the same people will not have access to both information. In case the tax return and the designation form are submitted electronically the tax authority first separates the designation form from the tax return and marks it with a code. While processing the designation form, the tax authority also separates the information on the taxpayer and the beneficiary NGO. The tax authority may provide information on the designation form only in the following specific cases:

- 1) in case a legal proceeding was initiated in relation to the designation form, information may be provided to the people authorized in the legal proceeding;
- 2) to the taxpayer related to their own data and the content of his/her designation form;
- 3) to the beneficiary NGO about the amount designated to the organization.

- What data must taxpayers provide in order to designate effectively?

The tax identification number (TIN) of the beneficiary – is necessary to make an effective designation. In addition, the taxpayer has to indicate his or her own name and TIN number on the designation form.

- To what extent does the government provide the required information?

In Hungary, the Government provides a list of the names and technical numbers (TIN) only for churches (around 90 entries in 2012). An NGO, Nonprofit Information and Training Center Foundation (NIOK), maintains an online database of those NGOs which would like to receive percentage designations (<http://nonprofit.hu/?q=niok/organization-search>). The NGOs voluntarily agree to be part of the database and keep the information updated on the website (basic data of the organization, scope of activity, management and financial data, income from 1% in the previous years). At present, the database contains almost 13,000 organizations. It is part of a comprehensive service that provides, among other things, a search function, and helps taxpayers in finding an NGO to support.

- What are the procedures for those taxpayers who submit their tax return via their employers?

In Hungary, when the employer files a tax report on behalf of the employee, the employee may hand a sealed envelope containing the designation form/s to the employer. This envelope has to bear the signature of the employee over the seal and shall be handed over to the employer at the latest 10 days before the deadline of submitting the tax return. The employer shall prepare a list of these employees and send it along with the envelopes and the tax return to the tax authority. In case the employee fails to dedicate its 1% through the above method she/he is still entitled to fill out the designation form and send it to the tax authority directly but not later than the deadline of the tax return.

- What are the procedural requirements for the tax authority and for the NGOs?

In Hungary, the tax authority must check the entitlement of each NGO named as a beneficiary. This is a burdensome and time-consuming process. The tax authority sends a notification to beneficiaries by 1 September of a given year. In this letter, the tax authority indicates the amount the beneficiary will be entitled to receive and calls for proof of the entitlement. NGOs have 30 days to prove that they satisfy all the legal conditions. Upon successful verification, the tax authority is obliged to transfer the funds within 30 days but not later than the 15<sup>th</sup> of December of the given year.

- What are the related costs for the implementation of the designation mechanism?

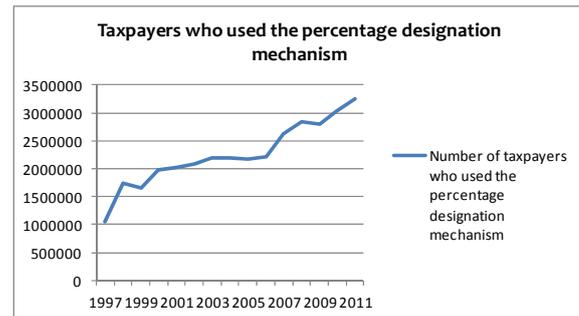
There is no separate unit responsible for the implementation of the designation scheme. According to the Tax Authority, approximately 15 persons at the central level are mostly involved during the period of July-August, when the entity is processing the designations, working on inspection of eligibility, and preparing the notifications that shall be sent to beneficiary NGOs by 1 September of each calendar year. In addition, the Tax Authority has 1 specialized expert dealing specifically with the percentage mechanism in each of its 23 territorial offices. Among the most pressing difficulties to the administration of the 1% mechanism, the Tax Authority mentioned the human personnel involved in data processing, particularly the designations submitted in printed form. To make the process faster, the Tax Authority suggested the extensive use of online and electronic submission of designation, in this way reducing the burden of manual data processing by the staff.

## 2.4. Effects of the percentage designation in Hungary

This section will seek to examine the effects of the percentage designation mechanism based on the policy rationales provided in the previous chapter: (i) taxpayer self-determination; (ii) civil society development; (iii) development of a philanthropic culture; (iv) government outsourcing .

To what extent did the percentage designation increase the taxpayer self-determination? In order to answer this question it is important to consider the dynamics of taxpayers who used the percentage designation over the last decade. The findings are illustrated in the graph below which shows the total number of people designated their 1% to CSOs and churches:

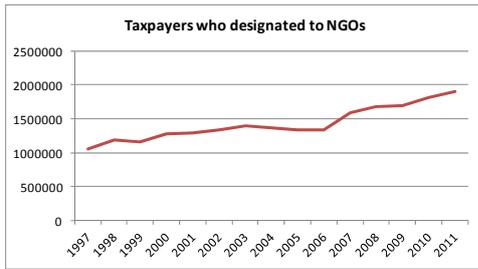
The comparative analysis of data from 1997, the year when the mechanism was first introduced in Hungary, points to a significant and steady increase in the number of taxpayers who decided to take advantage of the right to decide on a certain percentage of the public budget. Consequently, the percentage designation mechanism has had an important contribution to increasing taxpayers' awareness and participation.



Is there room for more? According to the Tax authority from Hungary, the total number of taxpayers is approximately 4,500,000.00. A comparative analysis of the total number of taxpayers and the number which actually used this right in 2011, namely 3,253,477 persons, points to a share of 72.3% of eligible taxpayers who used the designation. Consequently, in theory 27.7% could still use the designation mechanism.

An important question is to consider the extent to which the percentage mechanism has contributed to raising awareness about the civil sector among the general public, which is a fundamental element in the development of civil society. The relevance and strength of voluntary organizations depends largely on the level of recognition and support they receive from the public. Due in part to the simple fact that information about this opportunity is delivered to every taxpayer, the 1% provision has the potential to raise awareness about these organizations in almost every household in the country. This is an unprecedented opportunity and probably one of the biggest benefits of the law. It takes decades of education and several generations to change culture and attitudes in a society. The percentage law offers a unique chance to accelerate such change in relation to nonprofit organizations and their importance to the lives of people.

Another question to consider is the extent to which the percentage designation has contributed to raising resources for the non-profit sector. For this purpose, a comparative analysis of available statistical data in Hungary has been performed, considering the dynamics regarding the number of taxpayers who designated their 1% specifically to NGOs. The findings are presented in the following diagram:

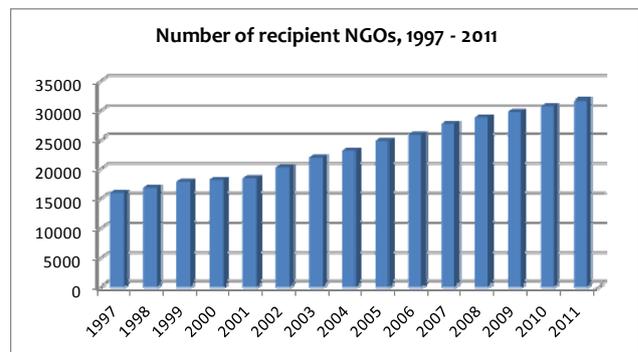


As reflected in this graph, during 1997-2011 there was a significant increase in the number of taxpayers who designated their 1% of income tax to NGOs, increasing from 1,058,362 in 1997 to 1,906,046 in 2011, which represents approximately 42.4% of the total number of taxpayers. Arguably, there is room for further improvement, since there are still almost 58% of

taxpayers who did not yet designate for NGOs.

To what extent has the 1% Law helped increase the responsiveness, transparency and accountability of the NGO sector? One way of examining this question is to analyse the dynamics of beneficiary NGOs.

As reflected in the diagram, the number of beneficiary NGO has practically doubled, increasing from 15949 in 1997 to 31625 in 2011. The previous section showed that the law subjects NGOs to reporting requirements. Consequently, the law helped to increase the transparency of NGOs and reduced possibilities for the misuse of funds. In order to receive the taxpayers' designations NGOs have to spare efforts to convince citizens, which strengthened communication between them and constituents. By receiving contributions from their stakeholders, NGOs became not just accountable by law, but also directly accountable to taxpayers regarding the expenditure of funds.



It would be important to consider the share from 1% allocations within the total budget of various NGOs. Discussions with Hungarian NGOs showed that this share may vary depending on several subjective and objective factors, including the visibility of the organization, communication with the taxpayers, mission statement and activities, quality of their work. In case of one of the top recipients of the percentage designation, the share represents 80-85%. In the case of a Local School Foundation – approximately 20%. For other organizations, the share is less than 5%. Discussions with 1% recipients showed that while the 1% income did not represent a major source of funding for the sector as a whole (less than 1% of the total income of the sector), it has played an important developmental role in the composition of the sector. It has increased access to unrestricted funding and channeled public support for organizations that would otherwise have little or no chance to gain such access.

According to an earlier ECNL study, the mixed nature of the percentage mechanism, however, makes it limited in its potential to develop a philanthropic culture. The main reason is, that it “costs nothing” to the donor except for the time and effort needed to make the designation. If we regard philanthropy as some form of private investment in the public good involving a personal stake, there will be a clear tension between treating the designation arrangement as a tax allocation and treating it as a form of philanthropy. Taxes as such are not considered philanthropy but a civic obligation and therefore not a voluntary choice of the individual.

#### **Case study:**

##### **Rex Dog Shelter Foundation**

Rex is one of the top 5 recipients of the designation mechanism. It is one of the first organizations that started to plan 1% campaign media campaigns in a professional manner and to work intensively with the Media to this end. While the organization is primarily providing shelter for abused dogs, it has also created quite a large animal shelter called “animal island”. Consequently, the organization is known for its 4 brands: (i) “Bloody Reality” Shelter for abused dogs, (ii) the “Animal Island”; (iii) the Rescue Team and (iv) the real animal world.

The first conscious decision was to simplify their message. In their mass communications the foundation continued to use dogs to keep their message simple. The campaigns are calling on the guilt feeling of the audience to call them to action – i.e. giving their 1% for this cause – so most campaigns are shocking in their image.

The campaigns were using a mix of approaches including TV ads, leaflets, billboards, internet, letters sent by post. The primary target audience were people dedicated or interested in animal protection, but also owners of companion animals or future owners. In its 2012 percentage campaign, the organization sent out 1 million posted letters to citizens, out of which 789,000 addressees are from Budapest. The organization is conducting constant research, seeking to identify the profile of their donors.

The income of Rex has been increasing rapidly each year. Currently 80-85% of the foundation’s budget represents revenues from 1% designations. The organization does not have any project funding from the government. The foundation has approximately 10,000 donors per year.

## Chapter 3. Implications of the percentage mechanism for the Republic of Moldova

The previous chapter showed that the percentage designation mechanism in Hungary had a positive effect from at least several perspectives.

This chapter will consider whether it is feasible to introduce the percentage mechanism in Moldova. Particularly, it will examine the potential costs related to the implementation of the percentage mechanism and the potential benefits. Due attention will be paid to the questions raised by Ministry of Finance and earlier studies commissioned and carried out by non-state actors. Subsequently, the chapter will consider the envisaged impact of the percentage mechanism for the Republic of Moldova.

### 3.1. The potential administrative costs

While it is difficult to provide a comprehensive assessment of the costs related to establishment and maintenance of the percentage designation mechanism, the Hungarian example is suggestive of the financial implications.

The introduction of the scheme would not necessarily imply the establishment of a separate Unit within the Main State Tax Inspectorate of the Republic of Moldova. Instead, it might require dedicating trained personnel during a specific time-frame to process the designations to NGOs. The experience from Hungary showed that it may require one month to finalise this task. In addition, administration of the mechanism might also require one assigned expert in each of the Territorial Offices of the Tax Inspectorate.

The number of personnel involved in the processing of designation will depend to a great extent on the number of potential designations and recipients. In the long run, the experience from Hungary points that the number of people who designate usually does not exceed 40% of taxpayers. Assessing number of potential beneficiaries it is important to keep in mind that there are approximately 9000 NGOs in Moldova, and only 25% of NGOs are active, which makes approximately 2250 NGOs. The number of potential recipients will depend on the eligibility criteria established for potential beneficiaries.

The establishment of the mechanism will also require significant capacity building efforts and expertise. That will involve elaboration and/or amendment of related norms, internal regulations, guidelines. The experience from Hungary showed that guidelines for taxpayers shall be simple and accessible. Guidelines for NGOs shall include eligible costs, reporting requirements, and specific pre-award requirements, such as lack of debts to state budget or other creditors.

Overall, assessing the administrative burden of the mechanism, it is important to keep in mind that in Hungary 15 persons within the Central Tax authorities and per one expert in each territorial administrative unit manage to process almost 2 million designations to approximately 31 thousand NGOs. In Moldova, these amounts will be significantly less, consequently, the number of corresponding administrative personnel may be lower.

### 3.2. The potential impact on national / local budgets

This section will consider implications of the percentage mechanism for the state budget. It will use the analytical framework provided by the Moldovan Ministry of Finance in a study that seeks to assess the feasibility of the percentage mechanism.

In Moldova the income taxes form the budget of the territorial administrative units (TAU). Therefore, it is important to consider the impact of the percentage mechanism on local budgets.

The Ministry of Finance recently collected data for the first draft of the assessment report on possible introduction of the percentage law and its impact on local budgets. According to the study, in the eventual scenario where 22% of taxpayers designate 2% for NGOs, the aggregate losses of the TAU will amount to 9,627,000.00 MDL (the equivalent of 603,960.00 EUR).

While it is true that this may be a sensitive subject for local authorities, they should also consider the contribution of NGOs to local development. In assessing the “losses” it would be important to consider that there is a myriad of NGOs all over the country that contribute significantly to community mobilization, development of human capital, education, social inclusion of people with disabilities. national and local NGOs make a tangible contribution to strengthening the educational system (such as the Associations of Parents and Teachers), community development (such as the network of “Contact” centers), Youth mobilization (such as the Youth Resource Centers or Local Youth Councils), etc. One should not underestimate the economic potential of NGOs through their role as employers. In addition, NGOs are mentioned as vital partners in the National Decentralization Strategy and other policy documents.

The experience from Hungary points to the fact that people tend to donate to local NGOs who are implementing activities for public benefit in particular communities. Discussion with a local School Foundation pointed that 15% of their annual budget comes from 1% designation<sup>7</sup>. However, as seen in the case of Rex Foundation (case study described above), people also tend to support national NGOs work on children’s and animals’ rights. This means that taxpayers from a particular TAU will have the right to designate a certain portion of their income tax to NGOs who are not necessarily working to in that particular community or territorial administrative unit. In such cases, national authorities in Moldova may consider a scheme that would compensate the respective local the budgets.

The study also points that draft objectives of the fiscal policy for the medium term 2011-2013 stipulate the reintroduction by 2012 of income tax for businesses in the amount of 10%, which will bring significant changes in the structure of BATU revenues, thus increasing the eventual losses from certain voluntary transfers in favor of NGOs.

Considered from a different perspective, this argument can be seen as an opportunity to set up the percentage mechanism. The reintroduction of the income tax for businesses will generate additional resources to the local budgets, hence compensate the potential losses.

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<sup>7</sup> Interview with Móríc Zsigmond High School Foundation, 21 August 2012

In addition, the study notes that in most cases the NGOs' activity is concentrated on solving secondary issues, with a reduced level of importance for the entire society, being focused on socially narrow groups (homosexuals, drug addicts, prostitutes, stray, abandoned animals, sick people etc.).

The above-mentioned arguments do not stand either, due to a number of reasons. Evidence-based data shows that almost half of Moldovan NGOs are working either in the social area, or education. Every tenth NGO is active in the area of human rights, while 7.4% - in the area of youth. The environment represents a preoccupation for 6.5% of NGOs, and 4.3% work in the area of economic development<sup>8</sup>. In addition, as seen from the Hungarian model, only NGOs who conduct activities for public benefit are eligible recipients of the percentage designation mechanism. Not the least, this mechanism represents a right, not obligation. Therefore it should be regarded as an opportunity for the citizens to assess the results of NGOs and based on those assessments to decide whether to allocate a tiny portion of their income to sustain and uphold those results.

### 3.3. Policy options: Risks vs. Opportunities

This section will consider various policy options for the Republic of Moldova. It will look into legitimate questions, concerns and potential risks raised by non — state local experts.

A recent study on fiscal mechanisms of stimulating philanthropy raises a number of questions and risks related to the perspective of introducing the percentage designation mechanism in Moldova. Specific questions include: How efficiently will the allocated means be used by NGOs? To what extent can the state trust these NGOs? Should there be a list of eligible NGOs? Will the usage of funds be monitored? How? The paper further argues that such a mechanism would negatively affect the philanthropic culture, since persons who already designated (1% or 2%) will consider that he/she already made a donation to NGOs. In this light of thought, the study concludes that the impact of the percentage designation mechanism would have a negative effect for NGOs and for philanthropy<sup>9</sup>.

While the study raises legitimate questions, it does not consider the models that exist in Hungary and other countries. A careful examination points that introduction of the mechanism can actually transform these concerns into opportunities.

How efficiently will the allocated means be used by NGOs? To what extent can the state trust these NGOs? Will the usage of funds be monitored? How? As seen from the Hungarian model, recipients are bound by a list of eligible expenses. Disclosure and reporting requirements are in place to ensure transparency of funds. This enables the Tax Authorities to check the accuracy of reports. In case of misuse of funds, specific sanctions should be provided by law and applied, such as – interdiction to benefit from percentage designation mechanism, fines, etc. The transparency and disclosure requirements also enable the taxpayers to check how the funds

<sup>8</sup> PNUD (2007). Studiu privind Dezvoltarea Organizațiilor Neguvernamentale din Republica Moldova, pp. 7-13

<sup>9</sup> [http://www.expert-grup.org/download.php?pathu=library\\_upld/d463.pdf](http://www.expert-grup.org/download.php?pathu=library_upld/d463.pdf), p. 21

provided by them were spent in order to decide whether to designate to a particular NGO in the future. This also contributes to developing a culture of associative democracy among citizens.

Should there be a list of eligible NGOs? In Hungary the organizations do not necessarily have to have a public benefit status, but must implement activities that contribute to public benefit. In other countries, such as Lithuania and Poland, contributions can be made only to registered public benefit organizations. In case of the Republic of Moldova, there might be two options. The first would be to limit eligibility only to NGOs who have the public benefit status. This may, however, prevent access to these funds of community based NGOs who would spare too much effort to apply and acquire the public benefit status. Another option may be to develop and adopt a list of activities that can be considered for public benefit, that will serve as a criteria for assessing eligibility of recipients, which may correspond to the list of public benefit activities, provided in Article 30 of the Law on Civil Associations<sup>10</sup>.

Finally, while there is some weight in the argument that introduction of the percentage designation mechanism may alter the general philanthropic environment in the country, such adverse effects can be prevented through proper awareness raising activities and adequate policies. The Government should understand and treat this mechanism as it is – a form of indirect public support, not a form of philanthropy. Indeed, this mechanism does not fully satisfy demands for both public and private support to the sector. Therefore, this mechanism should not be eventually treated as a trade-off for abolishing traditional tax incentives. Tax deductible donations should be preserved along with the percentage designation. NGOs should undertake corresponding awareness activities among tax-payers.

### **3.4. Potential impact of the percentage mechanism for Moldova**

The percentage designation mechanism will have at least six positive effects on the Moldovan society.

First, it will strengthen taxpayer control over the public money. By giving them an opportunity to designate a percentage of their taxes, it makes people conscious of the fact that taxpayers may actually have a say in how their taxes are being used. This kind of “taxpayer consciousness” is still generally weak in Moldova.

Second, it will increase citizens’ participation. Citizens who pay taxes will be enabled to make autonomous decisions on the use of a portion of their income tax, thereby exercising direct democracy.

Third, it will help in raising awareness about the civil sector among the general public, which is a critical element in the development of civil society. The relevance and strength of voluntary organizations depends largely on the level of recognition and support they receive from the public. Due in part to the simple fact that information about this opportunity is delivered to every taxpayer, the 1% provision has the potential to raise awareness about these organizations in almost every household in the country.

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<sup>10</sup> <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=325424>

Fourth, it will help increase the responsiveness, transparency and accountability of the NGO sector. Efforts by NGOs to convince citizens that they should support them will strengthen communication between the nonprofit sector and society. By receiving contributions from their stakeholders, NGOs will become directly accountable to them in terms of how funds were spent. In addition, because the NGOs shall be subjected to reporting requirements, their transparency will increase, reducing possibilities for the misuse of funds.

Fifth, it will encourage philanthropic thinking in the Moldovan society. By designating to NGOs, citizens will become more aware of specific causes for public benefit. This will pave the basis for donating to address issues that are important for the society.

Sixth, it will provide alternative financial resources for the nonprofit sector. While the percentage income does not represent a major source of funding for the sector as a whole, it can play an important developmental role in the composition of the sector. It will increase access to unrestricted funding and channel public support for organizations that would otherwise have little or no chance to gain such access.

## Recommendations

The previous section has pointed that the introduction of the percentage designation mechanism in Moldova would have positive effects on the Moldovan society. In light of the above, this section will seek to provide specific recommendations that may assist preparation and implementation of the percentage designation mechanism in Moldova.

Key policy **recommendations for National Authorities** include the following:

- Deciding on the subjects that could designate, national authorities may consider applying the mechanism to both individuals (as in Hungary), but also to corporate businesses (such as in Slovakia). In such a case, due consideration should be given to considering conflict of interest and ensuring that companies may not end up setting up their own foundations that will receive percentage allocations<sup>11</sup>.
- In order to provide to the public a myriad of choices, Moldovan authorities might consider introducing a mixed approach to the percentage designation. Taxpayers could be provided the right to choose between allocate 2% of their income tax to NGOs or to the implementation of a national priority. This approach will strengthen taxpayer awareness of both NGOs and national development priorities.
- The eligibility criteria should not necessarily be limited to public benefit status, because this might disproportionately prevent community based NGOs to access these funds. It is recommended to limit eligibility to NGOs that are registered in Moldova and conduct activities that contribute to public benefit. Illustrative activities that are considered for public benefit are provided in Article 30 of the Law no. 837 on Civil Associations, approved by the Moldovan Parliament on 17 May 1996, with subsequent amendments.
- The procedures to comply with should be simple and clear. The Ministry of Finance and Moldova Tax Authority should develop clear regulations for taxpayers, explaining the designation procedure and deadline, and ensuring that designations can be done anonymously and easily. Clear guidance should be provided to NGOs regarding eligibility, disclosure, reporting requirements, disputes settlements, etc.
- There might be various ways to address the potential implications and effects on local budgets, particularly in cases where taxpayers designate to national NGOs or to NGOs registered in other TAUs. One approach would be to establish a compensation scheme whereby the amounts corresponding to designations which made to national NGOs or NGOs located in other TAUs will be compensated from the national budget.

Taking into consideration the Hungarian experience, a number of recommendations can be drawn up **for NGOs**, including the following:

- NGOs should strengthen their communication with constituents. This implies a significant shift in intervention approaches, because NGOs will have to bring convincing arguments that might determine taxpayers to designate for them. This will require a shift from

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<sup>11</sup> ECNL (2012). Guidelines on policy assessment for introducing the percentage mechanism. (under publication)

activities to results and effects that NGOs interventions have at community and/or national level.

- NGOs should seek to diversify their outreach methods and tools. This includes effective use of social media, increased presence in the national and local media, but also increased physical presence at community level. NGOs should actively engage the media in awareness process, which might be a costly effort. Therefore, it would be important to prepare in advance, educating media about the impact and their important role in the process.
- NGOs should strengthen their transparency and disclosure systems. This involves due diligence financial procedures in place, recruitment procedures, transparency in terms of donors, amounts, purposes of expenditures, cost-effectiveness.

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## Annex 1. List of interviewed stakeholders in Budapest, Hungary

Organization / Institution	Interviewed representative(s)
European Centre for Not-for-Profit-Law (ECNL)	Katerina Hadzi - Miceva Evans Hanna Asipovich Eszter Hartay
National Tax and Customs Administration (NAV)	Irma Borsiné Bézi
Móricz Zsigmond High School Foundation	Zoltán Somodi
Administration Agency of the National Cooperation Fund	Anikó Major
Rex Dog Shelter Foundation	Haba Gábor
National Coalition of the Big Families	Hajnalka Székely
NESsT	Anna Horváth
Hungarian Civil Liberties Union	Balazs Denes