A SUPPORTIVE FINANCING FRAMEWORK FOR SOCIAL ECONOMY ORGANIZATIONS

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I. INTRODUCTION

Social economy organizations (SEOs) have played a vital role in the establishment of stable models of democracies after the political transformations that have occurred in Central and Eastern Europe (CEE). They have not only successfully served as vehicles for expressing and representing citizens’ needs but they have also been addressing the immediate needs of their stakeholders by directly engaging in service provision or lobbying for change in government policies. Recognizing the potential of these organizations and their contribution to the public good, governments in the transitional countries have launched legislative reforms to facilitate their existence and operations and to regulate their relationship with the stakeholders so as to ensure their sustainability. Nevertheless, these organizations still face many challenges pertinent to the financial aspects of their sustainability. This is true especially for countries in South-East Europe where foreign donors are a predominant source of funding, while the mechanisms for government support remain underdeveloped and non-transparent.

The paper will review the basic regulatory framework that supports the financial viability of the sector in the countries of the region. It will provide a brief comparative overview of the legislation governing the public benefit status, which is a conceptual prerequisite for state support in most countries of the European Union (EU).

Further, the paper will provide an overview of the concepts regarding the three major revenue sources for financial sustainability and will introduce country specific examples to show how each source benefits SEOs:

- It will address legal and fiscal framework issues that affect SEO ability to engage in income generating activities;
- It will provide a brief overview of the forms of direct government support and outline innovative sources of public support; and
- It will highlight the issues pertinent to the development of philanthropy by focusing on the tax treatment of incentives for philanthropic initiatives from businesses and individuals, as well as volunteerism.

By providing a general overview of the existing mechanisms that support SEO viability and outlining the successes and challenges of best regional examples the paper aims to convey the message that no one mechanism will serve as panacea to the sustainability problem if introduced independently from the others. It is necessary for governments and SEOs to partner in the development of policies that can outline the most desirable approach to enhance financial sustainability of the sector.

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II. FRAMEWORK LAWS AS A BASIC FACTOR FOR SUSTAINABILITY

An enabling environment for SEOs’ sustainability presupposes (1) the right of the citizens to associate freely in order to achieve common interests and needs, and (2) clear and well defined rules that support SEO viability and functioning. To create conditions for SEO operations the legal framework should contain rules, which regulate the basic lifecycle of SEOs from registration to dissolution, including the type of activities they can engage in and their governance structure.

The provisions regarding registration and dissolution are important for the overall sustainability of SEOs. They set a protective framework for SEOs’ activities and limit the ability of governments to interfere with their basic rights: to be established and operate freely. Framework laws should determine basic rules for SEOs seeking to obtain legal entity status, but should not restrict informal activities of unregistered organizations. Mandatory registration contradicts the nature of citizens association and inhibits the ability of citizens to perform ad-hoc or informal activities that benefit their local communities. The non-mandatory registration requirement is also in line with the internationally promoted freedom of association as a basic constitutional right of citizens.

To limit arbitrary government decision-making, most of the countries have adopted rules that introduce a straightforward registration process, require basic documents (act of establishment, governing document and application form) and define narrowly the grounds for refusal. Although, the majority of CEE countries have adopted acceptable grounds for refusal of registration (incomplete submissions, basic legal requirements not satisfied, or illegal activities), some laws still contain vague terms, which can be subject to discretion. For example, under the Croatian Law on Foundations if the activities are seen as “immoral” or the registration authority finds that the purpose “lacks seriousness” it will refuse registration. Limiting grounds for involuntary termination is also an important factor that contributes to the creation of a favorable environment where SEOs can operate without the fear of discretionary government intervention. Even though laws throughout the region have adopted strict provisions for determining the cases of involuntary termination, some still tend to cause problems. For example, Slovenia allows the responsible ministry to dissolve a foundation if it decides that the changed circumstances make the continuation of the foundation unnecessary. This provision is problematic, as it gives registration officials a great deal of discretion as to whether to dissolve an organization.

Apart from the registration and dissolution provisions, laws also set basic guidance as to the governing structure of the organizational forms to facilitate and promote accountability and good governance. Unfortunately, some framework laws in the region are vague or silent about governance structures, and even if the basic governing bodies are prescribed, their roles are not clearly defined. This results in poor accountability and transparency of SEOs, thus leading to weak public image which

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2 For the purposes of this paper, SEOs would refer to the basic forms of nonprofit, non-governmental organizations in the region: associations and foundations. The term will also embrace other legal forms that exist under country framework legislation, such as public benefit companies in Czech Republic.

3 For a detailed analysis of country specific frameworks see “Overview of NPO Legislation in Central And East Europe”, by Douglas Rutzen, Michael Durham and David Moore (www.icnl.org)

4 E.g., the obligation for mandatory registration was challenged before the Constitutional Court in Croatia, and as a result Croatia abolished this requirement. For further information see “Croatian Constitutional Court Strikes Down a Number of Provisions in the Law on Associations” IJNL, Vol.2. issue 3, at (http://www.icnl.org/journal/vol2iss3/en_croatia1.htm)

5 See supra fn.3.

impacts the ability of SEOs to mobilize financial or other support from the government, individuals and business.

Most importantly SEOs are greatly affected by the way framework laws regulate the type of activities they can engage in. There are two key issues that are usually part of framework laws and which are regarded when discussing the financial viability of SEO (1) the permissibility of SEOs to engage in income-generating activities and (2) the public benefit status as a prerequisite for state support. For example, when the Government of Czech Republic introduced the mechanism for endowments, it realized it needed to revise its basic Law on Foundations to make this instrument effective.\(^7\) Furthermore, when introducing the percentage mechanism Poland and Lithuania also addressed the issue of public benefit organizations in order to make the percentage designation system implementable.

The legal framework and the sustainability issues pertinent to the ability of SEOs to engage in income-generating activities will be discussed in detail under section III.1 below. However, it is already important to emphasize at this point that according to the John Hopkins Comparative Research Project (John Hopkins Survey), 53% of the SEO income in the surveyed countries is generated through fees for services, economic activities, investments and other income generating activities.\(^8\) It is therefore crucial for the viability of SEOs that states revisit their policies and improve framework laws to support engagement in activities which enable SEOs to sustain their statutory purposes.

### II.1. Public Benefit Status

The public benefit status if fundamental to the SEO sustainability because most countries in the region treat this status as a conceptual prerequisite to granting tax benefits or other types of state support. For example, France, Germany and Hungary allow only public benefit organizations to receive tax-deductible donations. In some countries, such as Croatia, there may be no explicit status defined in the law, but tax benefits are nevertheless only linked to public benefit purposes. Even foreign donors (e.g., multinational corporations) sometimes base their donation policy on the precondition that SEOs have received a public benefit status or its equivalent.

The public benefit status essentially distinguishes between organizations that are established for the mutual interest of the members, such as sailing clubs, from those whose activities benefit a larger community. Countries generally list the type of activities that are considered of public benefit and prescribe the criteria to further define the status. For example, in the Netherlands and in Poland public benefit SEOs are those that operate principally for public benefit purposes and provide services to a larger and undefined group of beneficiaries. Public benefit status can be conferred on SEOs either through provisions included in framework legislation (Bulgaria, Romania), in separate public benefit legislation (Hungary, Lithuania, Poland, Latvia), but also implicitly through provisions in tax or other laws (Croatia as well as most Western European countries). While organizations that receive public benefit status are entitled to more benefits than others, in turn they are subject to greater supervision by the government and have to comply with stricter rules on accountability. The purpose of this scrutiny is

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\(^7\) In general, the amendments removed the prohibition on investment of assets from endowments, and provided various mechanisms and rules for managing endowments. See also below, section III.2.1.2

\(^8\) The study included 16 advanced industrialized countries, 14 developing countries from Africa, Asia and Latin America, and 5 countries from Central and Eastern Europe, including the Czech Republic, Hungary, Poland, Romania and Slovakia. See “Global Civil Society: An Overview,” Lester M. Salamon, the John Hopkins Comparative Nonprofit Sector Project, 2003 (www.jhu.edu/~ccss).
to protect the public from possible fraud and ensure that the benefits these organizations get are not wrongfully used.

Governments generally decide to provide special benefits to public benefit organizations because such organizations serve more effectively the needs of local communities and society as a whole. By addressing social needs they complement or supplement obligations of the state or provide services that are under-supplied. They often identify and respond to social needs faster than governments and are capable of delivering services more efficiently and directly. In addition, governments have an interest to support public benefit SEOs because in the provision of their services they raise additional funds, thus saving state money and mobilizing larger community support.

The benefits granted to public benefit SEOs generally come in form of profit tax exemptions, exemptions from property, gift or inheritance taxes, customs duties exemptions, tax benefits to donors, preferred status for government funding and contracting or use of public property.\(^9\)

\(^9\) For more on the theories that justify the supporting to public benefit organizations see “Public Benefit Status and Not-For-Profit Organizations,” by the International Center for Not-for-Profit Law, Regulating Civil Society Conference, Hungary - May, 1996

In conclusion, SEO legal framework issues are not only a precondition for SEO ability to be established, but they also have an impact on the democracy and governance of SEOs and on the activities they can engage in. By setting the basic framework to allow SEOs to generate own income and by distinguishing the organizations the serve the public good, the framework laws serve as important and integral part of all public policies affecting the financial sustainability of SEOs.
III. SOURCES FOR FINANCIAL SUSTAINABILITY

Generally, there are 3 main sources of revenue available to SEOs:
- Government funding (central and local level);
- Income generating activities: fees for services, sales, membership fees, rents, investments, business ventures; and
- Philanthropy (financial donations and in-kind support from volunteers).

As noted above, according to the John Hopkins Survey, economic activities constitute the largest source of revenue (53%), in comparison to government funding (35%) and philanthropy (12%).

The relative importance of all three sources varies among countries and regions and not one approach taken independently will alleviate the sustainability problem. Each country should assess what is a strategic priority depending on local circumstances. E.g., the Government of Hungary decided that it would need to increase the level of government support, comparing to other policy alternatives. Consequently, in its strategy from 2002 it adopted this goal by setting a target of doubling the level of government support by the end of its term. To support this aim, it created the National Civil Fund as a grant mechanism, which distributes funds for operational costs to nonprofits. As a result, the funding allocated through various public mechanisms in Hungary exceeded 40% by 2005. The Czech Republic created a mechanism to support the creation of endowments, which helped bolster the creation and operation of indigenous foundations.

On the other hand, ensuring diversified funding resources is important to support the existence and to foster the flourishing of different types of organizations based on their activity. Specifically, not all SEOs benefit from one resource revenue. However, some sources dominate over the others depending on the field of activity. The John Hopkins Survey illustrates that, on the global level, SEOs active in the health and social service fields benefit the most from government funding. SEOs engaged in culture, education, regional development, environment and advocacy rely mostly on economic activities, while religious organizations and those involved in international development receive most of the funds through philanthropic giving.

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<th>Government funding</th>
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<td>Social services</td>
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* Social service: 44% gov’t funding, 37% economic activities, 19% philanthropy
* * Environment: 42% ec. activities, 30% gov’t funding, 28% philanthropy

10 See supra fn. 8
11 Id.
All resources complement each other. For example, the ability of environmental SEOs to engage in income-generating activities and to raise funds through philanthropic initiatives increases their income, which in turn matches the support from the government. This is especially important for the government in cases where it contracts out tasks to SEOs to help implement state policies or deliver services.

While this division is relative and the share of each source to SEO sustainability differs from country to country, and also across regions, it contributes to the understanding that it is crucial for governments to recognize the significance of promoting different sources of funding and to remove the obstacles to financial maturity of civil society.

### III.1. Income Generating Activities

An important factor that helps measure the supportiveness of the legal environment towards SEOs’ viability is the permissibility of SEOs to engage in income-generating activities. SEOs may generate income from membership fees, sales, fees from services, investments or renting property.

Income generating activities are considered the most important resource of SEO financing, particularly in those countries where support from foreign donations is declining, private philanthropy has not developed to the point where it is sufficient to support the activities of the sector and where the mechanisms of public funding are opaque. Allowing SEOs to generate income could lead to an increased level of effectiveness in program implementation and to better quality and more diverse services. For example, charging fees for services and products raises the expectation of beneficiaries to receive a higher quality of service. This triggers the institutional mindset of SEOs, who become more aware about the need they aim to address and the value of services they provide to their beneficiaries. In addition, the ability to engage in income generating activities encourages SEOs to consider services that they could not otherwise provide for through other funding sources. Finally, the ability of beneficiaries to choose the service provider raises competition among SEOs, which leads to better quality of services and enhances the effectiveness of their work.

State policies and the favorable legal environment play an important role in the ability of SEOs to generate income from economic activities to support their nonprofit purposes. Economic activities may be considered as “regularly pursued trade or business involving the sale of goods or services.” Since economic activities involve a financial or market-type transaction and serve an economic purpose, states have adopted safeguards against misuse of this opportunity. Most fundamental is the non-distribution principle, which essentially ensures that such income is not distributed to the members or associates of the organization. In addition, the income should be used to support statutory purposes.

Most countries have set additional criteria that determine the ability of SEOs to engage in economic activities. Croatia allows SEOs’ engagement in economic activities to the extent it is necessary and only in those activities, which are enumerated in the statute so that the registration authority could review their legitimacy in advance. However, the lack of clear criteria regarding what is considered to be an economic activity is one of the problems in implementing this provision. Further, country specific legislation differs regarding the extent to which SEOs are allowed to engage in economic activities. Bosnia, Bulgaria, Romania, and Slovenia permit only activities related to the

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12 See “Economic Activities by NGOs and Charging Fees for Statutory Services” (on file with ECNL)
mission of the organization (for example, in case of a SEOs helping people with disabilities such would be selling a publication on the issue), while in Albania the economic activity must “conform” to the purposes of the organization, which may allow activities that are consistent with, but not necessarily related to the statutory purposes.\(^\text{14}\) However, the income from unrelated activities should also be used to support the statutory activities.

Of all CEE countries, it is only in Macedonia that SEOs cannot engage directly in economic activities and are required to establish a subsidiary (e.g., a limited liability company) if they want to do so. Under the current judicial interpretation of the law, educational SEOs cannot sell a book to help cover printing costs. In practice, SEOs engage in economic activities regardless of this prohibition, which undermines the rule of law. In addition, these activities are unregulated and as a practical matter untaxed, even if the activities are unrelated to the organization’s mission.\(^\text{15}\)

Another important issue associated with the economic activities is the tax treatment of the income from such activities. Tax exemptions are generally considered as an indirect form of government support to SEOs, and thus are distinguished from the permissibility of SEOs to engage in economic activities, which is addressed in framework laws. (The tax treatment of economic activities will be addressed in detail below under section III.2.2.)

SEO ability to generate such income and implement the activities effectively is also dependent on their capacity to develop services that can generate such funds, to create self-financing business models or utilize skills necessary to sustain such activities. One approach, which appeared as an answer to the latter needs, is the establishment of social enterprises. Social enterprises are business ventures with primarily social objectives whose income is reinvested for community purposes.\(^\text{16}\) Social enterprise projects seek to empower SEOs to operate income-generating ventures and to make a social impact.\(^\text{17}\) The UK government recognized that “by using business solutions to achieve public good (...) social enterprises have a distinct and valuable role to play in helping create a strong, sustainable and socially inclusive economy.”\(^\text{18}\) In 2002, it launched a three-year strategy to support these initiatives by setting the following three outcomes: creating an enabling environment for social enterprise, making social enterprises better businesses and establishing the value of social enterprise. The potential impact of social enterprises on economic and community development has triggered some countries, such as Slovakia and Hungary to adopt similar models.

In addition, income from investment also provides an essential source of revenue for SEOs and many countries impose additional requirements and limitations on the distribution and the accumulation of capital to ensure that such income is spent in pursuance of their objectives. Slovenia and Macedonia generally treat almost all investment income as taxable, while Hungary and Poland provide exemptions for public benefit organizations.

Importantly, when considering the opportunities of the mechanisms for income-generation as a financial resource for SEOs, it is important to take into consideration the local economic situation and trust in the quality of SEO services, as factors which also determine its potential. Clearly, the economy

\(^{14}\) Supra fn.3  
\(^{15}\) The Macedonian Ministry of Justice is currently drafting amendments, which will remove this prohibition.  
\(^{16}\) Although it has to be clarified that social enterprise is not a legal form. In fact it can take up any legal form, nonprofit or even for-profit, that exists in the country.  
\(^{17}\) See “Laws and Other Mechanisms for Promoting NGO Financial Sustainability” by David Moore, in USAID 2004 Sustainability Index for Central and Eastern Europe and Euroasia (www.usaid.gov)  
must be strong enough to support SEO self-financing efforts. It is also important to assess the stage of development of the sector in order to determine the most appropriate strategies that will enable SEOs to utilize various opportunities.

III. 2. Government Funding

Governments support financially SEOs by (1) allocating resources directly from the state budget line, or (2) indirectly, by granting benefits to SEOs. In the latter scenario the government is reducing the amount of finances that it would have otherwise collected. In addition, some CEE countries have adopted the percentage mechanism, which goes beyond the traditional forms of government support. Recent data shows that the amount of government funds available to SEOs in Western Europe varies from 29% in Sweden and 35% in Norway to up to 77% in Belgium and Ireland. In CEE the government funding ranges between 20 and 30% on average.\(^{19}\)

The interest of the government to support SEOs through government funding mechanisms cannot be measured only by the amount of funding that it makes available to SEOs. The rules that regulate the distribution and monitoring of the use of funds should also be considered. Specifically, SEOs around the South-East Europe have difficulties accessing government funding mainly because implementation of the funding mechanisms is not transparent, it lacks professionalism in grant-making, there are no clear criteria and the decisions as to who can receive grants are politicized. In addition, there is no effective monitoring mechanism to oversee the use of funds and ensure accountability by the SEOs that have received them. For example, a recent research in Macedonia revealed that the government distributes annually 3.5 million euros from various budget allocations; however only a limited number of SEOs benefit from these funds because of the opaque procedures. Therefore, when discussing government funding mechanisms it is also relevant to consider the implementation aspects, which determine the effectiveness of the system.

III.2.1. Direct Funding

Government funding can be distributed through several traditional forms: subsidies, grants, procurement, per capita fees or vouchers. These funds can be distributed from central level budget (through the parliament, ministries, lotteries, privatization proceeds, public funds and foundations) or through budgets of local governments.\(^{20}\)

**III.2.1.1 Forms of Direct Support**

From the mechanisms of government funding, *subsidies* and *grants* are the most common form throughout the CEE region. In our terminology subsidies serve as general support to the SEO activities, they are not linked to a specific project and can be used to cover general operating expenses, while grants are allocated to support the implementation of a given project which falls within the government’s programs. Subsidies are generally distributed to SEOs whose contribution to governmental policy implementation is considerable and may therefore serve as a general indicator of

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\(^{19}\) Supra fn.8  
\(^{20}\) For a more detailed overview see “A Comparative Analysis of European Policies and Practices of NGO/Government Cooperation” Nilda Bullain and Radost Toftisova, European Center for Not-for-Profit Law, 2004 (www.ecnl.org)
the public sector’s recognition of civil society. They are prescribed by law and distributed by the authority which is dealing with the issue. Funding through subsidies is usually given to major international agencies (such as the Red Cross), national interest representation groups (such as Associations of Pensioners), major service-providing organizations, and very few advocacy organizations. Grants, on the other hand, are awarded through an open tender-type application process and can provide funding for the delivery of social services (Germany, Croatia, UK) or the implementation of programs from the country’s international development aid obligations (Sweden, Denmark, Germany).

The procurement mechanism regulates the government purchase of goods and services delivered by the SEOs. The challenge of this mechanism is that SEOs generally bid together with other service providers (such as businesses) and they are unable to meet technical requirements (e.g., collateral) or achieve the high standards (e.g., quality assurance system) usually set by governments. Some countries have amended their legislation to remove the prohibition on SEO participation in procurement procedures (Bulgaria). Others have created specific mechanisms, such as the public benefit contract in Hungary. Generally, SEOs engaged in social service delivery are most likely to benefit from this mechanism.

Third party payment schemes common in Western Europe, such as per capita fees and vouchers are not widespread in CEE as yet but have proved to be useful mechanisms of public support mainly for social service delivery SEOs. Per capita fees or normative support system, which is common in Hungary, essentially means that SEOs seek reimbursement from the government based on the volume of services they have provided. SEOs that deliver services in areas such as healthcare or education are the beneficiaries of this system. The voucher mechanism, which was introduced in the Czech Republic, allows municipalities to provide vouchers for the services that fall within their obligation and leave the decision to the citizens to choose their provider. Aside from the fact that these two mechanisms are a form of financial support, they also prompt SEOs to compete with service providers from other sectors (public and private), which eventually contribute to higher quality of service delivery and increased accountability.

### III.2.1.2. Sources of Direct Support

Of all regional examples of sources of public support it is worth emphasizing two models: (1) the use of privatization proceeds and (2) the creation of a public fund for support of civil society. Both are important because they have been introduced as a result of concerted government effort to strengthen the third sector through adopting innovative instruments. The former has proven to be generally successful, while the effects of the latter are yet to be assessed.

The distribution of privatization proceeds to foundations was introduced in the Czech Republic as a result of the privatization of state-run enterprises. The Czech Government allocated 1% of these privatization proceeds to a Foundation Investment Fund, which then re-distributed the funds to local foundations in the forms of endowments. The purpose of this mechanism was to enhance building of endowments as a secure resource base for SEOs. Foundations must keep the endowment within a certain legally prescribed minimum, but may use it to pursue investment opportunities to achieve their

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21 Id.  
22 Id.  
23 Id.  
24 The law in Czech Republic differentiates between foundations with endowment and non-endowed foundations. The regular foundations must maintain an endowment with minimum values of approximately 16,000 euros.
statutory goals. In 2002, 27 million euros were distributed to 64 foundations, which at that time represented one-third of all foundations in the country. Following the introduction of this mechanism, the government introduced changes in the legal and tax system to create rules for good management of the endowments and to enhance the ability of foundations to maximize their potential. The amendments introduced several investment possibilities as they provided for a wide range of investment instruments for foundations, they introduced rules for safe investing, the possibility for professional management of endowments by financial institutions, tax-free capital gains, and an easier registration procedure. Currently, 375 foundations are registered in the Czech Republic, with the value of their endowments exceeding over 80 million euros. This instrument also led to improved cooperation among foundations, which pooled their endowments to establish a joint investment portfolio designed specifically for this purpose.

In 2003, the Hungarian Government established the National Civil Fund with the aim to provide a mechanism for institutional support to SEOs. Essentially, the National Civil Fund supplements the mechanism of percentage allocation (see below III.2.3) in that the government matches the amount of funds that are designated to SEOs through the percentage system. 60% of the resources of the National Civil Fund are allocated to SEOs to support operational costs. In addition, funds from this source also support development programs (research, education, international representation). Elected SEO representatives sit on all committees which are deciding on the distribution of the funds. In the first year a total of 28 million euros were distributed to support the operational costs of over 3,500 organizations.

The introduction of the National Civil Fund was accompanied by great enthusiasm from SEOs. However, the first year of distribution of the funds faced many challenges, which raised concerns over its real effect. This was due to the lack of carefully planned implementation mechanisms on the side of the government. It revealed that in conceptualizing the National Civil Fund the Government did not consider a concrete overall strategy to develop the sector. Even the uniquely designed SEO participation in decision-making raised controversies over conflict of interest issues.

Specifically, the implementation of the National Civil Fund was based on application requirements which appeared to be too burdensome and strict. As a result of complicated and not clearly drafted application forms, between 70-90% of the applications were rejected. The responsible Ministry for overseeing the distribution needed to intervene to allow for a broader interpretation of the strict formal requirements so as to permit for a higher number of applications to be considered. Consequently, the decision on the distribution of the funds came later than expected, leaving SEOs with only a month to spend the allocated funds, which originally were designed to cover costs for over a year. On the other side, the substantive requirements were rather broad and with no strategic focus. Thus, it is questionable whether the implementation of the National Civil Fund indeed supported SEOs to reform and strengthen institutionally. Although, the funding potential of this mechanism is considerable, its impact on general financial sustainability in the longer term will largely depend on the willingness of the government and the Governing Council of the Fund to learn from the challenges in the first year and try to revisit the goals they have set to achieve in order to improve the effectiveness of the system.

25 For the potentials of the endowments to support sustainability of the sector see “Endowments and Sustainability”, by Robert Thomas, SEAL Winter 2003
27 Id.
28 See “USAID 2004 Sustainability Index for Central and Eastern Europe and Euroasia” (www.usaid.gov)
III.2.2. Indirect Forms of Support

Indirect support most often appears in the form of tax benefits, use of municipal property or providing services by reduced costs. The support is considered “indirect” because rather than distributing public funds, governments do not collect the revenue that they would be entitled to. The indirect support is mostly associated with the implementation of the activities of the organization. Therefore the legal framework issues discussed under section II above, namely the permissibility of economic activities and public benefit status are important considerations that are regarded by governments in shaping their policies on indirect support.

The issue of tax benefits is emphasized as the most important because it is directly connected to amount of generated income that SEOs can utilize in pursuing their objectives. Tax benefits can appear in the form of exemption of certain types of income from profit tax. Almost all countries exempt from taxation the income from membership fees, grants and donations. There is also a general consensus that all SEOs, regardless of whether they serve mutual or public benefit purpose should be exempted in this case. However, in some countries, such as Bulgaria, mutual benefit organizations are subject to tax on donations.29 In addition, tax benefits are also associated with income from investments, real estate and customs. Further, the VAT treatment of SEO activities is an important consideration in discussions on SEO financial viability and ability to operate. For example, the Macedonian VAT Law provides a VAT exemption only for services and supplies of goods by institutions for social welfare and not to SEOs. This poses a serious burden on the ability of SEOs to financially manage social service activities.30 Even the 6th Directive of the European Commission on VAT does not provide clear guidance on how to treat SEOs, and therefore the rules in the new member states vary as well.

The ability of SEOs to utilize the income from economic activities is not unlimited and is subject to taxation. The tax treatment differs from country to country. Some look at the destination of the income, i.e., the purposes for which funds derived from economic activity are put to use. Consequently, if the income is used to promote public benefit purposes then it will not be taxed (Poland). Another approach is to exempt income from economic activities only when it results from activities related to the purpose of the organization (e.g., in Latvia income from unrelated activities is taxed). Some countries, such as Czech Republic, Serbia and Montenegro have introduced a tax exemption cap, so they would only tax income that exceeds a certain threshold. Finally, some countries, fully tax SEOs (Albania, Bulgaria, Slovenia). 31

III.2.3 Percentage Mechanism

The percentage mechanism is a relatively new example of state support to SEOs. It was first introduced in Hungary in 1997 and although several countries in the region have gladly embraced it, its effect is still disputable. The percentage mechanism is a form of tax allocation as it allows taxpayers to designate a portion of their paid tax to a specific organization. After Hungary introduced the so-called

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29 See “Survey of Tax Laws Affecting NGOs in CEE, 2nd edition, ICNL (www.icnl.org)
30 In Serbia, the VAT Law required SEOs to pay VAT on the import of humanitarian goods and claim a rebate. Due to the lack of financial resources to pay the VAT, custom officials often ship back the donated goods. As a result of joint efforts by domestic and international NGOs, the government amended the law in July 2005 to exempt the import of humanitarian goods from VAT. For more see: www.ecnl.org
31 Supra fn. 29
“1% Law”, Lithuania, Poland, Slovakia and most recently Romania have adopted similar legislation. In addition, based on the CEE experience a local municipality in Japan has also introduced this mechanism.

Hungary is the only country that has witnessed over 7 years of implementation of this law so that one would be able to draw actual learning points from its experience. However, the implementation of the laws in Hungary as well as the other countries has sent signals that require cautious examination by the new wave of countries (such as the Czech Republic, Ukraine, Georgia and Macedonia) that consider implementing such mechanism.

Generally, there are two key objectives behind introducing this mechanism: (1) increasing the pool of resources available to SEOs and (2) helping to develop philanthropic culture among taxpayers. The level to which these objectives were met is difficult to assess, however, its potential impact on the sustainability of the sector is questionable.

There are several concerns expressed by policy makers, SEOs and experts in terms of the capacity of this mechanism to increase resources. First, this mechanism can be utilized only by taxpayers, and in addition, only by individual taxpayers (expect Slovakia where companies can also designate the percentage). Therefore, the potential group of “donors” is limited. Although all taxpayers can designate the funds with no cost for themselves (as they are basically re-allocating the tax amount that they would otherwise need to pay to the government) only 35% in Hungary use this opportunity. The same figure was true for Slovakia during the first year of implementation. In the second year, Slovakia increased the percentage from 1 to 2% and also allowed companies to designate. As a result around 42% of the individuals and almost 94% of companies re-allocated the 2%. However, in countries like Georgia or Macedonia where the population is small, the number of taxpayers is small, the culture of paying taxes is still developing and the income tax rate is also low, this mechanism might not bring the amount of resources that is worth investing in.

The second limitation of the mechanism is that it allows only a minimum amount, either 1 or 2% to be designated. Contrary to philanthropic giving, the “percentage cake” available to the SEOs has a given size and cannot be increased. Consequently, it is not only that the amount of available funding is limited, but also the receipt of a larger portion by one SEO reduces the amount available to others. At the end only a small cluster of organizations (e.g. those who run the best marketing campaigns) really benefit from the mechanism. In addition, the overall amount may be quite small compared to other sources of revenue as the economy develops. In Hungary, for example, funds flowing from this mechanism have been estimated to be less than one percent of the total revenue of the SEO sector.

The effect of the mechanism on philanthropy cannot be easily assessed, as there are no comprehensive research results, which can show whether it achieves its second objective. It is important to note that the mechanism was originally perceived as a mechanism for philanthropy; consequently some refer to it as “percentage philanthropy”. This led to a misperception of the mechanism by both the public and the government. While the mechanism has increased the level of awareness about the importance of civil society among citizens, it has not necessarily resulted in increased financial contributions by individuals (specifically, the percentage of private contributions by individuals in Hungary has been declining). On the contrary, according to some accounts, this mechanism might have

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32 For a detailed overview of the percentage mechanisms in each of the countries see “Percentage Philanthropy and Law”, by Nilda Bullain, European Center for Not-for-Profit Law at www.ecnl.org and www.onepercent.hu

33 Id. Also for discussion on the philanthropic nature of mechanism see “The Percentage System in Central and Eastern Europe: Will It Benefit Civil Society?” by Kuba Wygnanski, SEAL Autumn 2004

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created a feeling in some individuals that they have done their share in society by “giving” a percentage of their taxes and there is no need to give more.

Of most concern, however, is that the introduction of this mechanism has resulted in the abolishment of traditional incentives for philanthropy such as tax deductions in Slovakia and Lithuania. SEOs in Poland were successful in lobbying the government to postpone the decision on whether or not to abolish tax incentives after the mechanism was introduced. Although tax incentives are not prime motive behind philanthropic giving, the example of Slovakia shows that they should not be underestimated. Specifically, even though almost all companies and a high number of individuals decided to designate the 2%, the amount of funding that was distributed to the SEOs was still less than the amount that SEOs had received through traditional philanthropic forms.34 In Czech Republic, where the government is currently considering adopting percentage legislation, SEOs also face the threat that the tax deductions will be abolished in exchange for introducing this mechanism.

Despite the challenges in implementation, this mechanism does have certain advantages for the SEOs, the taxpayers and the government. Specifically, it has proven to be a good resource for local and smaller SEOs, because they relate more closely to their local communities and it is easier for them to mobilize local support. However, in terms of the actual amount of funds it has bigger impact on the larger and service oriented SEOs who are better skilled to communicate and reach out to the taxpayers. The mechanism also creates competition among SEOs and other beneficiaries, thus contributing to their professionalism, better communication with stakeholders and improved image. In terms of taxpayers the percentage laws gives them a possibility to decide on how certain percentage of tax money is spent, thus decentralizing and de-politicizing the decision making process, increases awareness about importance of civil society and sends signals about needs they find important to be supported. The governments also benefit because they are able to monitor the needs of the society. In addition, it should not be forgotten that portion of the designated funds do return to the state budget in the process of their spending, specifically through the VAT.

Although the percentage mechanism seems to be gaining popularity in countries of CEE, the lessons from implementation in the existing countries should not be ignored. These examples reveal that even if SEOs and governments estimate that the mechanism can significantly contribute to the sustainability of the sector, all factors should be considered in its conceptualization. Most importantly, they illustrate that should this mechanism be introduced, it ought to complement and not replace other existing mechanisms, as it will not be the remedy for the financial viability problem.

III. 3. Philanthropy

Although according to the global study the share of philanthropy is relatively small in the income of the nonprofit sector (12%), it is of central importance for social and economic development in transition societies. The level of philanthropy is an indicator of domestic social support to SEOs, which is seriously needed in an environment where SEOs have been largely supported by foreign funding. In addition, it is an indispensable source for certain types of organizations, such as advocacy organizations, who generally would be less likely to receive support from government sources due to the types of activities they engage in. Support through philanthropy can take the form of monetary or in-kind contributions. In both cases public policies and legal framework play an important role.

34 See: www.rozhodni.sk
(1) Governments aim to promote or support philanthropy by creating **tax incentives** in the form of tax deductions or tax credits\(^\text{35}\). By allowing individuals and corporations to receive a reduction in taxes in return for contributions to SEOs, governments empower them to commit resources to goals, which are of common importance. The example of Slovakia, where the relationship with the percentage law indicated that funding from private donations constituted a significant portion of sectoral revenue, shows that the importance of this form of support should not be easily disregarded. While tax benefits are not the primary motivation behind private giving, they play a key role in the donor’s decision as to how much and in what form to give and they do influence the culture of giving.\(^\text{36}\)

Tax incentives are also a form of indirect support and as such are sometimes dependent on the type of activities and purposes of the SEOs. Thus, most countries of the region have decided to allow tax deductions or credits only for donations given to public benefit SEOs (Hungary, Estonia) or to those SEOs who are engaged in services which are considered of public benefit (Croatia).

(2) In addition to the monetary donations, the **contributions by volunteers** are also considered a significant part of philanthropy - “*It isn’t just the money; philanthropy is time and mental work, and it’s all tied in together*”.\(^\text{37}\) Thus, if the value of volunteer contributions is added to the philanthropy, its share in the “civil society revenue pie” increases from 12 to 30% and thus places philanthropy in second place (in comparison to the 43% from economic activities and 27% from government funding).

This shows that the volunteer contribution, if calculated based on average salary for fields where volunteers are engaged, is twice as large as donations. Volunteers are an important human resource for SEOs and indispensable part of the civil initiatives. To illustrate this in numbers, according to the John Hopkins Survey volunteers represent approximately 43% of civil society workers in the

\(^{35}\) Tax deductions allow the donor to reduce all or part of the money that has been contributed to an SEO from the taxable income, thus diminishing the tax base upon which tax will be calculated. Through tax credits the donor deducts part of the donated amount from the total amount of tax liability.


\(^{37}\) “Why the Wealthy Give -The culture of elite philanthropy”, Francie Ostrower, Princeton University Press

\(^{38}\) Supra fn.8
surveyed countries. To bolster volunteering and remove legal impediments to volunteering, countries throughout EU, such as Spain, Portugal, Poland, Czech Republic, Lithuania and Hungary have adopted laws governing volunteering, while Croatia, Macedonia and Serbia have launched legal reforms. Additionally, the mobilization of volunteers is a consideration in granting government or municipal funding to SEOs (e.g., for example this is one of the criteria for receiving municipal funding for social service provision in some cities in Croatia).

However, the economic situation is also a factor to be considered when assessing the potential of philanthropic giving, similarly to the case of economic activities. In addition, the local tradition of giving and the image and degree of development of SEO skills, which are necessary to reach out to the local community and mobilize their support, are equally important.

39 For country specific analysis of specific legal systems and legal reform initiatives see www.icnl.org and www.ecnl.org
IV. CONCLUSION

Governments and SEOs around the region have recognized that they can support SEO sustainability through creating a sound legal environment that creates opportunities for diversified funding resources. The successes and challenges of various legislative initiatives have shown that it is not sufficient merely to address the general sustainability issues. Countries need to identify the key problems and to prioritize legislative tasks if they aim to create a solid ground for long-term sustainability.

Primarily, the legal framework needs to be enabling for all revenue sources. We have seen that not all SEOs benefit from one source only. As the examples showed, social service organizations rely more on government support, while advocacy organizations benefit from philanthropy and self-generated income. Consequently, none of the three main sources (government funding, income-generating activities and philanthropy) are going to provide for an effective solution for the sector if considered independently.

Furthermore, the different levels of economic development of the countries, the diverse needs of SEOs and the stage of development of the sector are important factors that need to be taken into account. Thus, in creating public policies and deciding on state strategies for support of the sector, governments should undertake a holistic approach and look at all factors. If they decide to apply models from other countries, governments need to conduct careful analysis of the local circumstances and consider the possible implications of introducing them. Finally, governments should partner with SEOs and seek their input in the process of creating public policies and deciding on priorities for legal reform. Only through concerted and joint efforts, and inclusion of all stakeholders can the reforms achieve the desired results.