Laws and Other Mechanisms for Promoting NGO Financial Stability

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INTRODUCTION

Among the most pressing questions facing the non-governmental, not-for-profit (NGO) sectors in countries in the CEE/Eurasia region is financial sustainability. From Albania to Uzbekistan, NGOs are still predominantly dependent on foreign donor funding. In many countries of the region, foreign donors are withdrawing or reducing their levels of support, thereby increasing the urgency of the challenge of long-term sectoral sustainability.

This paper seeks to present an overview of legal mechanisms that have emerged in the region of Central and Eastern Europe (CEE) and the Newly Independent States (NIS) relating to financial sustainability, and particularly, for promoting indigenous sources of NGO funding. Section I sets the context by examining potential NGO income sources. Section II provides a brief overview of good regulatory practices that support a sustainable sector and have developed as trends in the region. Section III then turns to highlight innovative funding mechanisms that contribute to financial sustainability of the NGO sector.

This paper does not seek to focus on the financial sustainability of any individual NGO, but rather on legal and infrastructure aspects of financial sustainability of the NGO sector as a whole. Any of the good practices and innovative mechanisms highlighted here may be appropriate for some NGOs but not appropriate for others. In considering the sector as a whole, however, it is important to adopt a holistic approach, as we find below.

CONTEXT: SOURCES OF NGO INCOME

To appreciate the challenge of financial sustainability it is necessary to understand the potential sources of revenue for the NGO sector. This is particularly true in countries where the NGO sector is largely dependent on a single category of NGO income. While there is, of course, tremendous variation in the sources of NGO revenue among countries and NGOs within any sector, there are at the same time identifiable trends of NGO financing.

Nearly all NGO revenue falls within three broad categories. They include (1) government funding, and (2) private giving, or philanthropy, and (3) self-generated income. Government funding includes a broad range of direct and indirect support.

Direct funding comes in the form of state subsidies, government grants, and contracting. Exemptions from taxation can be considered a government subsidy. Private giving usually comes in the form of cash and in-kind donations from individuals, businesses, and foundations or other grant-making legal entities. The efforts of volunteers may also be considered donations and can be embraced by the concept of philanthropy. Self-generated income includes membership dues, fees and charges for services (that is, economic activity), as well as income from investments.

In 2003, the John Hopkins University Comparative Nonprofit Sector Project published a comparative analysis on global civil society, which based its findings on research in 35 countries, including five countries of Central and Eastern Europe.[1] Among other issues, the overview examines the sources of NGO income. The results are revealing:

- Self-generated income is the dominant source of revenue in nearly every country surveyed (53%);
- Government or public sector support also ranks as a significant source of NGO income (35%);
- Private giving – that is, individual, corporate and foundation-based philanthropy – accounts for a smaller portion of NGO income (12%).

It is critical to underscore that there is no ‘magic bullet’ for the financial sustainability of the NGO sector. Solutions to the challenge of sectoral sustainability must lie in a holistic approach, recognizing the relative importance of all categories of NGO income.

LAWS AND MECHANISMS TO PROMOTE FINANCIAL SUSTAINABILITY

Good regulatory practices have emerged in many countries throughout the region to support the financial sustainability of NGOs. Each major category of NGO income, from self-generated income to government funding to private philanthropy, can be encouraged through appropriate regulatory mechanisms. While not all countries have adopted such progressive regulatory approaches, they are common enough to be identified as trends and referred to as ‘international good practice.’

Government support

Government support comes in the form of tax exemptions – in effect, indirect government subsidies – and in the form of direct financing, via budget subsidies, grants for specific purposes, and contracts to perform certain work. Tax exemptions recognize that NGOs are using income to pursue a not-for-profit mission, often for the public benefit. For example, income from grants and donations is typically exempt from income taxation. Direct government financing is growing in importance as an income source for NGOs. As recipients of government grants and bidders for government contracts, NGOs

[1] The study included 16 advanced industrialized countries, 14 developing countries from Africa, Asia and Latin America, and five 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.

are becoming increasingly engaged in service delivery. Legal frameworks generally allow NGOs to receive government funding and, to a somewhat lesser extent, to participate in public procurement procedures. Furthermore, governments in several countries have developed innovative approaches to government funding, from the creation of public funds to taxpayer allocation mechanisms.

Private philanthropy

The most common mechanism for encouraging individuals and corporations to make cash and in-kind donations to NGOs is through tax incentives for donors. Corporate tax incentives for giving to NGOs are commonly available throughout the region, and generally in the form of tax deductions.[2] Individual tax incentives are also available in a substantial number of countries. While important, tax incentives are not sufficient to promote corporate philanthropy; donors give based on a variety of motivations, of which tax preferences are only one. The establishment of community foundations in several countries has sought to appeal to a wider spectrum of donor interests in giving. At least equally, if not more important to NGO sustainability are the donated efforts of volunteers.[3] Yet few countries in the region have developed a framework to support and encourage volunteering.

Self-generated income

One of the most significant issues affecting the ability of NGOs to generate their own income are the laws and regulations governing income from economic activities. In nearly all countries, NGOs are able to engage directly in economic activities, within certain defined limitations. Furthermore, in many countries, income from economic activities is exempt from taxation, albeit to a limited extent. Critical to many associations and membership organizations is income from membership dues; such income is exempt from taxation in nearly all countries in the region.

Grant-making foundations may rely significantly on investments and the income generated from those investments, in the form of interest, dividends, and capital gains. While a substantial number of countries in the region do provide full or partial exemptions from taxation of investment income, few countries have created an environment that supports the maintenance and growth of endowments.

[2] The only countries that do not provide donor incentives for corporate giving to NGOs are Azerbaijan, Belarus, Macedonia and Russia. Reform initiatives are underway in Macedonia to provide such incentives.
[3] According the John Hopkins study referenced above, the picture of civil society organization revenue changes when the contributions of time represented by volunteers are added to the contributions of money and treated as part of philanthropy. The resulting proportion of sector revenue breaks down as follows: self-generated income (43%), government support (27%) and philanthropy (30%).

MECHANISMS TO PROMOTE FINANCIAL SUSTAINABILITY

Government Funding

Funding trends indicate that government funding is the second largest source of NGO revenue internationally (second to self-generated income). Indeed, for NGOs engaged in health and social service activities, government funding represents the predominant source of income in most countries. And in many EU countries, including Ireland, Belgium, Germany, the Netherlands, France, Austria and the U.K., government funding represents the largest source of revenue for NGOs. This Western European funding pattern is indicative of the significance of the welfare partnership approach, in which the state provides financing for public services, but relies on NGOs for their delivery.[4]

It is inevitable that CEE/Eurasia governments with shrinking resources will increasingly look to partnership with private actors to deliver public services. Yet the potential impact of government funding is far broader and can potentially affect the entire NGO sector, including advocacy and human rights organizations. Government funding takes many forms, from tax exemptions to subsidies and grants, to more innovative mechanisms, which we will examine here.

Percentage Philanthropy

A tremendous amount of attention has been devoted to the rise of percentage philanthropy in recent years – and for good reason. Percentage philanthropy – that is, legal mechanisms allowing taxpayers to allocate a certain percentage of their tax payment to beneficiaries, including NGOs – is one of the most truly innovative funding mechanisms to have emerged from Central and Eastern Europe. Nevertheless, it is not without controversy. Nor is it not a panacea for NGO sector sustainability.

The first controversial issue relates to how to classify taxpayer allocation mechanisms. The very name "percentage philanthropy" directly labels this mechanism as philanthropic giving. After all, the taxpayer is choosing to give a percentage of his tax payment to a private beneficiary rather than to the State. At the same time, the money received by the beneficiary is government money (that is, money owed by the taxpayer to the State) and not a donation of the taxpayer's own money. In this way, the taxpayer allocation seems to fall more properly within the category of government funding. At best, the percentage mechanism can be seen as a hybrid and called transitional philanthropy.

Hungary introduced the mechanism to Central Europe in 1996, where it bas become known as the "1% Law." Interestingly, the initiative came from the Ministry of Finance, and the goal was to increase resources for NGOs, while also promoting development of a philanthropic culture. Individual taxpayers can designate 1% of their taxes to an NGO (and 1% to a church). There is no cost to the taxpayer; the allocation simply requires filling out a form and submitting that form with the filing of tax returns. To be entitled to

[4] See "Global Civil Society: An Overview", Lester M. Salamon, the John Hopkins Comparative Nonprofit Sector Project, 2003.

receive 1% contributions, a foundation or association must carry out public benefit activities.

Following Hungary's lead, several other countries have adopted similar mechanisms: Slovakia, Lithuania, Poland, and most recently, Romania. In Slovakia and Lithuania, taxpayers can designate 2% of paid tax to NGO beneficiaries. Corporations can also take advantage of the 2% allocation in Slovakia. Poland uses a somewhat different procedural approach by requiring the taxpayer, rather than the tax authority, to transfer an amount equivalent to up to 1% of his or her income tax.

The second and more controversial issue relates to the true impact of the percentage mechanism on NGO sustainability and on the development of a more philanthropic culture. There are clear positive benefits to NGOs. First, the sector benefits from receiving a pool of unrestricted funds. In 2001 alone, for example, the equivalent of more than 15 million USD was allocated for NGOs in Hungary. In 2004, the equivalent of more than 22 million euro was allocated to NGOs in Slovakia. Second, NGOs have increased incentives to reach out and develop stronger links to the community, thereby improving their marketing skills and public image. Third, taxpayers develop a greater awareness of civil society and the contributions that NGOs make to society. This may be especially important in countries with low levels of trust and understanding of civil society and may signify an important shift to a more philanthropic culture.

The challenges and limitations of the percentage mechanism are also clear. Despite the impressive amounts allocated to NGOs in Hungary and Slovakia, these resources represent only a small fraction of overall sector revenue; in Hungary, for example, taxpayer allocations are less than 1% of overall sector revenue. Moreover, there is little room for growth of this category of income, as taxpayers are limited to giving only 1%, and in Hungary, the number of taxpayers who designate seems to have reached a plateau of about 35%. In addition, the most likely beneficiaries are those NGOs pursuing causes that resonate with the public (children, animals, disease prevention).

Perhaps most troubling, however, is the impact of percentage laws on "true" philanthropy. A taxpayer may be less likely to make actual donations, because of a sense that he or she has already 'given' to NGOs through the taxpayer allocation. In both Slovakia and Lithuania, following the introduction of the percentage mechanism, the government abolished traditional donor incentives for individuals (and corporations in Slovakia). The net impact on both NGOs and philanthropy could turn out to be negative; in other words, the NGO sector may receive less funding over the long term and fewer individuals and corporations may engage in philanthropic giving. It is too early to assess the full impact of the percentage mechanism, but it does appear to bring mixed blessings.

Privatization Proceeds

The privatization of state-run enterprises has been a pressing and problematic issue in countries across the region during the past 15 years. The Czech Government developed a truly innovative approach in its privatization process, which provided a significant boost to NGO sustainability, by creating the Foundation Investment Fund (FIF) and by distributing 1% of all privatization proceeds to the Fund, for re-distribution to foundations as endowments. The FIF is governed by a board, which includes representatives elected both by the government and by the NGO sector.

In 2002 alone, 27 million euro was distributed to 64 foundations by the FIF. One-third of all Czech foundations received significant contributions from the FIF. This distribution process created the need for more enabling legislation and led to the enactment of amendments to the Czech Foundation Law (see above). In 2002/2003, there were more than 330 registered foundations in the Czech Republic with endowments valued at more than 80 million euros.

Lottery Proceeds

Lotteries and games of chance offer an alternative source of revenue for NGOs. By directing a designated percentage of lottery proceeds to public benefit purposes, the Government can provide significant support to the NGO sector. In Croatia, for example, the Government directs 50% of proceeds from the national lottery to support certain public benefit purposes, including amateur sports and civil society. Of these proceeds, 14% is currently sent to the National Foundation for the Development of Civil Society (see below), which in turn provides funding to NGOs and community initiatives. Similarly, in Montenegro, the Government has established a lottery mechanism and directs approximately 60% of lottery proceeds to finance plans and programs of organizations active in social services, humanitarian activities, and other public benefit areas, though the criteria for distribution of the funds have yet to be defined. In addition, in Macedonia, the law provides that 50% of proceeds from games of chance shall be used to finance the programs of associations of disabled persons, sports and for the Red Cross of the Republic of Macedonia. The distribution procedures remain opaque, however.

National Funds and Foundations

Strong NGO/government cooperation is fundamental to a healthy funding relationship. NGO/government cooperation can take many forms, from compacts to government strategy documents, to NGO/government liaison offices. In recent years, both Hungary and Croatia have established public funds or foundations specifically dedicated to support civil society and to provide funding to NGOs. Neither, however, has remained free from controversy.

Hungary's National Civil Fund was created by law in June 2003 as an instrument designed to help provide institutional support to Hungarian NGOs. The Fund is financed by the Hungarian government, which provides matching funds based on the amount of actual taxpayer designations under the 1% tax designation law each year, and in no case contributes less than the 0.5% of personal income taxes collected. Thus, the more money designated by taxpayers, the more money contributed by the Government. At least 60% of the Fund's resources each year will be dedicated to providing institutional support to NGOs in Hungary. Besides covering the costs of the Fund's administration, the remaining funds may be directed towards the support of various programs related to the development of the NGO sector, including sector-wide events, festivals, international representation, research, education or publications. The highest governing body of the Fund will be a Council, consisting of 17 members, the majority of which (12) are delegated by nonprofit organizations.

The Croatian National Foundation for the Development of Civil Society was established through legislation enacted in October 2003. As a public law, not-for-profit entity, the Foundation's mission is to serve and strengthen civil society in Croatia. The establishment of the Foundation marks a shift from a highly centralized public financing system, in which the Government Office for Cooperation with NGOs played the critical role, into a more de-centralized system. The new model of public financing for NGOs -- in which the National Foundation plays an integral part – envisages an increased role for multiple stakeholders, including the respective ministries, thus ensuring a more equitable distribution of responsibility among government stakeholders. Accordingly, while the ministries will be responsible for the funding of and cooperation with NGOs within their own jurisdictions, the Foundation will focus on supporting grass-roots initiatives and programs that do not necessarily fall within the competence area of any particular ministry.

The clear benefit of the Hungarian National Civil Fund is that NGOs will have a new opportunity to apply for much needed institutional support. At the same time, NGOs will have an additional incentive to increase their efforts at reaching out to citizens for the 1% designations. There are claims, however, that the Fund is being administered so badly that it may have negative effects on the NGO sector over the long term. (See the Hungary report for more details.) Somewhat similarly, the Croatian National Foundation has been at the center of controversy since the 2004 call for proposals was issued, with claims from some Croatian NGOs that grant decisions were not properly carried out under the law. The future shape and impact of the new National Foundation thus remains uncertain.

Private Philanthropy

Throughout the region, there are significant challenges in developing local sources of income. The development of local philanthropy presents perhaps the greatest challenge. NGOs routinely report low levels of citizen understanding and interest in civil society, leading to low levels of donations in the form of either monetary support or volunteerism. Despite the fact that nearly every country has enacted corporate donor incentives, the complaint that few corporations give still rings loudly. Individuals are even less likely to donate money, given difficult economic circumstances and distrust of the NGO sector.

In promoting the development of a more philanthropic culture, the focus is properly on greater community involvement, stronger ties to constituencies, and civic activism. Undeniably, however, there is a strong beneficial impact on the sustainability of organizations that receive support from philanthropic donations of time and money. It is through this lens that we will now examine two innovative trends in the area of philanthropy.

Community Foundations

As of September 2004, community funds have been established in several cities in Bulgaria. Four of these community funds have raised a total of $144,506 in cash and $69,140 as in-kind contributions from local sources. Foundation resources were then used for a variety of community-based projects, including modernizing streetlights, renovating a public swimming pool, and creating a children's playground.

A "community foundation" is a local not-for-profit organization that works to gather, manage and redistribute local resources for the good of the community. Governed by a cross-sectoral board with representatives of business, government and NGOs, the community foundation has a diversified funding base, fed by contributions from business, local government and NGOs, as well as individuals. Usually organized on the local level, the foundation makes targeted grants to a specific geographic region. In some cases, the foundation will develop an endowment to support its goals.

Bulgaria is not the only country to boast of the growth of community foundations. Indeed, the community foundation concept has gained momentum in several countries in Central and Eastern Europe, and in Russia. In Slovakia, for example, there are at least a dozen community foundations, perhaps the most famous being the Health City Community Foundation. In only a few years after establishment, this Foundation was able to create an endowment of $300,000. In Russia, at least 15 community foundations have been established and have actively supported scholarships, study visits and exchanges, among other activities.

The impact of community foundations is clear. They raise public awareness of local needs, increase local participation in meeting local needs, stimulate cross-sectoral dialogue and partnerships, and promote individual giving. Finally, the establishment of community foundations can, if managed properly, create a long-term local source of funding for civic initiatives and local NGOs. While community foundations are more about building communities than endowments, the community foundation concept is an important model for promoting philanthropy and the sustainability of the NGO sector.

Volunteerism

While usually viewed through the prism of civic activism, volunteerism is also a critical aspect of NGO sustainability. Indeed, the picture of civil society revenue portrayed above changes when the contributions of time represented by volunteers are added to the contributions of money and treated as a source of philanthropy. According the John

Hopkins overview, "the inclusion of volunteers in the revenue stream of civil society organizations boosts the average philanthropic share of total revenue from 12% to 30%. This reflects the fact that contributions of time, even when valued conservatively at the average wage in the fields in which volunteering occurs, are twice as large as contributions of money or material."

Since the UN International Year of Volunteers in 2001, there has been increased attention on promoting volunteerism in many countries. With greater attention being paid to the benefits of volunteerism, the importance of the regulatory framework for volunteerism has been brought into sharper focus. An enabling legal framework is one of many factors affecting volunteerism; others include public awareness of the importance of volunteerism, promoting private sector support, and research on the impact of volunteering.

Regulatory barriers to volunteering vary from country to country. Often there is simply no clearly recognized legal status for volunteers. Without a recognized legal status for volunteers, host organizations – including NGOs – may risk violating labor code provisions if volunteers do not receive paid compensation. Contract laws may not recognize a volunteering contract. In addition, unemployed individuals serving as volunteers run the risk of having their unemployment benefits rescinded by the State. Tax laws also may not provide proper treatment for volunteers; for example, tax exemptions may be extended to employees for reimbursement compensation, but not to volunteers.

To overcome these barriers, several countries in the region have launched initiatives to improve the legal framework for volunteerism. Some countries in the region, such as Poland and the Czech Republic, have enacted specific legislation on volunteerism. Other countries, including Lithuania, have adopted amendments to existing regulations in the labor law. In several other countries, including Bosnia, Croatia, Hungary and Russia, specific laws have been drafted and are currently under consideration by the respective governments. A supportive legal framework is even more critical in countries that lack a tradition of volunteering – or have a tradition of 'coercive' volunteering, as is the case in some NIS countries. Indeed, in Belarus and Uzbekistan, coercive volunteerism (i.e., government requirements that citizens provide their services free of charge to various public projects) is still practiced.

Self-Generated Income

Key to the long-term sustainability of the NGO sector in any country is self-generated income. The NGO sectors in the Czech Republic, Hungary, Poland and Slovakia already receive the bulk of their revenues through self-generated income.[5] In the countries of Southeastern Europe and the NIS region, the percentage of income through self-generated income is certainly much lower, but will need to rise significantly to sustain the sector.

[5] Czech Republic (47%), Hungary (55%), Slovakia (55%), Poland (60%).

Social Enterprises

Enabling NGOs to engage effectively in economic activities is of paramount significance. Once the legal framework is in place, the greater challenge lies with developing the capacity of NGOs. Specifically, more NGOs need to develop available services, financial plans, and business skills to be able to conduct economic activity effectively. 'Social enterprise' projects are one approach to addressing NGO capacity. A 'social enterprise' is a business venture operated by an NGO with a social purpose. Social enterprise projects seek to empower NGOs to operate income-generating ventures and to make a social impact.

Among the most innovative approaches to social enterprise development is that promoted by the Nonprofit Enterprise and Self-Sustainability Team (NESsT) through the Venture Fund. The NESsT Venture Fund is a philanthropic investment fund providing financial and capacity-building support to a select portfolio of social enterprises owned and operated by NGOs in Central Europe. All of the social enterprises are intended to generate revenues to help diversify their financing bases and further the mission of the nonprofit organization.

For example, "Vydra" is a national association of young people dedicated to promoting sustainable rural development in Slovakia. To support this mission and to sustain its operations, Vydra has launched a "Tourist Camp" designed to encourage tourism and to create local employment opportunities. The camp will include a buffet near the new Museum of the History of Forestry, offering refreshments and meals to tourists, cultural events on an outdoor wooden stage, environmental education programs for schools, and recreation areas for tourists. As another example, a Hungarian NGO – the BTA "Megálló" Group – offers rehabilitation services, self-help, work groups and education for alcohol and drug addicts. Megálló plans to launch an alcohol- and smoke-free social meeting point to generate income and further its mission.

Investment Income

The use of "endowments" as a means for creating wealth to finance grant-making foundations and other organizations is not widespread in the region.[6] There are, however, innovative approaches that have been adopted in some of the new EU Member States. The approach taken in the Czech Republic is particularly instructive.

The Czech Law on Foundations requires foundations to have an endowment with a value of at least 500,000 CZK (approximately 16,000 Euros).[7] Due to amendments adopted in

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[6] The term "endowment" is used here to refer to that part of organizational assets consisting of money and/or property dedicated to a specific purpose, which cannot be diminished during the life of the organization; periodic income generated by the endowment may be expended to support organizational purposes.

[7] It is worth noting that many countries do not require minimum levels of capitalization for foundations. This is a policy decision that depends on the desired concept of a foundation. Grant-making foundations need to have some minimum level of capital; operating foundations do not. In countries requiring

2002, foundations may now take advantage of a wider range of investment opportunities, offering potentially higher yields than the more restricted investments permitted under the prior law. In addition, tax-free investments now include capital gains and exchange rate gains, which should allow further growth of endowments. At the same time, the law contains rules for safe investment, limiting investment in designated high-risk instruments. Foundations are also subject to stricter governance rules and independent audit requirements. Perhaps most important, foundations may now contract with professional financial institutions to handle their investments and provide consulting. Taken together, these improvements in law and practice have created far more stable conditions for endowed foundations – and therefore for the entire NGO sector in the Czech Republic.

CONCLUSION

Financial sustainability is an ongoing challenge for NGO sectors in countries around the world. As the Index reports make clear, the problem is particularly acute, for the NGO sectors in the transitional countries of Southeastern Europe and the former Soviet Union. Those countries that have been most successful in meeting this challenge have employed a range of legal mechanisms that allow NGOs broad opportunity to diversify their funding bases as appropriate to their organizational needs. As these examples demonstrate, to address the transition of NGO sectors to greater financial sustainability, governments in partnership with NGOs will need to consider the multiple potential sources of NGO income. Issues will include promotion of greater opportunities for philanthropy, but also improved mechanisms for government funding and consideration of frequently overlooked areas, such as support for volunteerism.

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foundations to have significant capital (as in the Czech Republic and Slovakia), there should be an alternative non-membership form available that does not require minimum capitalization.