

## **Chapter IV**

# **HOW PERCENTAGE LAWS WORK IN PRACTICE**

## **How Hungary's 1% Law is applied**

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**Written: July, 2003 (updated November, 2003)**  
**Status: Final version**

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The various requirements aimed at applying and executing Hungary's so-called 1% Law were greeted by NGOs partly with incomprehension and partly with a great deal of criticism.<sup>1</sup> The most common complaints were the bureaucratic process, the amount of administrative work involved, and long delay between a taxpayer's designation and the actual arrival of the sum – all of which were thought to be excessive. Critics also pointed out that APEH, the tax authority, had conflicting interests and was therefore not likely to handle cases fairly. Certain NGOs have also repeatedly voiced the wish that the organisations who receive designated amounts should get access to the names of those allocating money to them. This demand, which doubtless appears justified, is not only based on the desire to thank the “donors” in at least a brief letter but also to consolidate their network of supporters.

Looking back over the past few years it can be ascertained that criticism was strongest in the first couple of years following the introduction of the law, but subsequently became weaker and today is not noticeable at all. This is partly due to the process whereby NGOs have come to fully understand the regulations involved and have learnt how to apply them. They have also realised that in order to gain a higher number of supporters, it is in their fundamental interest to publicise their activities and make themselves known to taxpayers.

The aim of this paper is to dispel misunderstandings by describing the regulations regarding the execution of the 1% Law as well as the rationale behind them and thus demonstrate that “the devil is not as black as they paint him”. In other words, the paper argues that the administrative load for the beneficiaries involved is not as heavy or nearly as unbearable as it seemed at first sight.

During the preparation of this law, the intention was that the implementation of the various regulations should be as simple as possible, with unnecessary and overly heavy burdens not placed on the parties concerned. Certain procedural rules and seemingly unjustified administrative obligations arise from the “nature” of the designated sum, namely from the fact that it forms a part of the personal income tax which in turn forms a government revenue. In addition, this sum qualifies as state support. Taking into account these two facts, and as this paper will explain, the money involved cannot be regarded as an exception to the general legal regulations regarding taxation and state support.

The procedural order of the law prescribes various obligations and tasks of those participating in its execution: the tax-paying and designating citizen, the tax authority and the favoured NGO. These three groups fulfil unique and clearly defined functions which are described below.

### **Taxpayers**

It is the duty of all taxpayers to fill in their annual tax return form correctly (or, if an employee, delegate the task to their employer) and to pay their tax in full and without delay. On the basis of fairness, a possibility exists for citizens who are not able to pay the whole of

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<sup>1</sup> The focus of this paper is NGOs and not churches which form a separate category of beneficiaries in Hungary's 1% Law.

their tax in one sum to request and be granted the benefit of paying in instalments and thus they too are able to use their annual right to designate 1% of their personal income tax to an eligible organisation.

Once each year, the taxpayer is allowed to designate 1% of personal income tax by entering the tax number of a selected organisation on the relevant form sent by the tax office and putting this designation order form in a standard-sized, sealed postal envelope.<sup>2</sup> The taxpayer's name, address and tax number must be indicated on the envelope. The reason for this is that if the tax office makes an error in processing the designation form, it should still be possible to collate the tax return form with the designation form. The envelope containing the designation form should be enclosed with the tax return form. The completed tax return should indicate that a designation has been made, and the two documents have to be sent together to the tax office by the appointed date, which in the case of self-assessing taxpayers is either 15 February or 20 March depending on their status.

In the case of almost half of all taxpayers, tax returns are handled and payments settled with the tax authority by their employers. Such taxpayers are also able to practice their designation rights. Each year, before the specified deadline for employers submitting employees' annual returns – the end of April – these taxpayers must personally complete their designation form and sign across the seal of the envelope containing it, a measure aimed at preventing abuse. The employer is obliged, for the same reason, to give a receipt to employees making designations, stating that their envelopes have been received. The employer makes a list of envelopes containing designation forms which must also be signed by the employees concerned. The list and a package containing the sealed envelopes is sent by the employer to the tax authority together with the tax settlement account.

The regulations associated with the law may appear overly strict or rigorous but these are necessary to comply fully with legislation on taxation confidentiality as well as data protection and personal rights.

The section of the law that declares a private person's order to designate a portion of their tax to be considered a tax secret was criticised heavily. The Ombudsman in Charge of Data Protection was repeatedly consulted when the law was being prepared. The Ombudsman pronounced that individuals' designation orders should be viewed as sensitive data. He justified this stance in great detail in the autumn of 1998 at a session of the Parliamentary Committee for Human Rights and Religious and Minority Affairs. In formulating his stance, the Ombudsman took into account regulations on the protection of personal data, and Act IV. of 1990 on the freedom of conscience and religion which prohibits the state maintaining registers or collecting data in any form regarding people's religious persuasions. Designation forms regarding the second 1% (for churches) very clearly reveal people's religious persuasions and their affiliations with the various churches.

In view of the above, it is perhaps surprising to note recent statements made by the government which indicate that, in future, the designation order will be made on the tax return forms. The Ombudsman in Charge of Data Protection finds this solution acceptable despite the fact that this way the taxpayer, the sum designated and the recipient (an NGO or church) can be clearly identified. The question inevitably arises as to whether the present "envelope"

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<sup>2</sup> A translated version of this form is available at <http://www.onepercent.hu/Dokumentumok/1percentinstructions.doc>

practice can be side stepped in the case of the 2.2-2.3 million taxpayers whose taxation is settled by their employer.

### **The tax authority**

The tasks of the Hungarian tax authority are clearly defined and meticulously regulated. In the course of processing designation forms, strict rules are applied in order to enforce data protection regulations which prescribe anonymity of the taxpayer. The envelopes and the designation forms are processed separately in such a way that both documents are assigned a bar code so that they can be checked and collated at a later stage of the process. Regulations oblige the tax authority to store the envelopes and the designation forms separately. This is to ensure that even tax authority employees are not in a position to compare and thus identify private persons and the contents of their forms showing the beneficiary they wish to support.

Naturally, in cases where legal disputes arise, the tax authority is permitted to connect the documents which bear the same bar code so these can be submitted to the law courts. It goes without saying that private individuals who have made a designation can request access to their data for their own use.

Designation forms must be preserved by the tax authority for 5 years. This period of time is in harmony with the expiry rules regarding the tax-paying obligation. Beyond this, the law also prescribes that in the case of a legal dispute the obligation to preserve the relevant documents is extended until the matter is settled in a legally binding fashion. The outdated documents are destroyed according to the procedural order laid down by the president of the tax authority.

The correcting and processing of tax return forms finishes by the end of July. The tax authority is obliged to inform the designated beneficiaries (i.e. those that have been specified by the taxpayers) before 1 September each year of the total sum designated to them and to invite those concerned to provide within 30 days the certificates and declarations required by law to confirm their entitlement. A particularly important aspect of the law is that in accordance with state administration procedure regulations, non-compliance with this deadline results in the beneficiary losing its right to the sum in question. (The legality of this measure was confirmed by Decree BH 2000.475.)

The beneficiary NGO is not entitled to received the designated sums in question if it does not submit by the indicated deadline the documents and certificates, described in the next section, proving that they fulfil the conditions prescribed by the law.

Following receipt of the documentation submitted by the beneficiaries, the law obliges the tax authority to transfer the sums designated by the taxpayers within 30 days. Consequently, the tax authority has 30 days in which to ascertain whether the beneficiary is entitled to receive the designated amounts. The law provides the possibility to extend this period if more time is necessary for the beneficiary to acquire missing documentation. This is, however, only for a limited period as the tax authority is required to make the transfers no later than 30 November the same year. If a transfer fails to happen, the tax authority has to record the reason in a ruling which may be challenged in the law courts. The law stipulates that the courts make a ruling within fifteen days in the form of an out-of-court settlement, a procedure which provides legal security.

An accusation frequently voiced is that the state delays the transfer of funds as it wants to “use” NGOs’ money. It is true that the period of 8 months between the sums being designated by taxpayers and actual transfers to the beneficiaries is rather long, but the reasons for the delay are purely practical and no ulterior motives are involved. The number of private persons due to pay personal income tax is about 4.2 - 4.4 million per year. The experience over many years has shown that 34 - 38% of tax returns contain errors. Processing and checking the returns is very time consuming but this is even more so in the case of correcting errors which can usually only be done with the taxpayer’s involvement.

Contrary to common belief, the errors found while processing tax return forms arise, not from the fact that the form is complicated, but from carelessness. The best evidence of this is missing signatures, the correction of which involves the taxpayer visiting the tax office. Whereas in some cases sums and the amount of tax payable are correctly calculated, certain income data are also often missing. (This clearly comes from a lack of attention during the copying process.) Naturally, there are also errors which arise from misunderstanding or misinterpreting the instructions on the tax return form, and represent just under 10% of cases of erroneous tax returns. Miscalculations of the final sum payable also occur in several tens of thousands of cases. This, however, only means a delay in processing as the amounts can be corrected by the tax office which informs the taxpayer about any correction made.

Tax returns submitted in an electronic form certainly shorten the length of time required for processing the forms. However, it is necessary to draw attention to the fact that it is totally irrelevant in which month of the year the tax authority transfers the sum to the beneficiary, be it in July or November: the utilisation of transferred funds relates to a one-year period. Twelve months are available to the beneficiaries for the lawful utilisation of the sum, not the given calendar year. Initially the full sum received had to be spent within the 12 month period, but the law was changed to allow beneficiaries to reserve the sum or a part of it for later use. In such cases, the beneficiary reports to the tax office the amount that has been set aside.

The law also stipulates that the tax authority is obliged to inform taxpayers if their designation form is invalid, and why this is so. There is no connection between incorrect tax returns and invalid 1% designation forms: the tax office only processes correct tax returns and only after that is the validity of the taxpayer’s 1% designation form ascertained. In cases where the specified beneficiary is not found to meet the legal requirements, the tax authority must inform the taxpayers that in compliance with the law the designation order was not executed. However, stipulations regarding taxation confidentiality prohibit the tax authority from disclosing the reason why the beneficiary is not entitled to receive the designated sum.

The law specifies in detail the conditions that make the designation form invalid. The number of invalid designation forms have fluctuated over the years. Figures issued by the tax office in September 2003 show that 6.5% of designation orders (149,000 out of 2,283,759 which includes both NGOs and churches) were found to be invalid, though it should also be noted that the total number of designation orders in 2003 represented an increase of 5.2% on the previous year. The most common reasons for the invalidity of designations in 2003 were: the individual had not paid the tax due on time (26.1%), the individual ordering the designation could not be identified due to missing details on the front of the envelope etc. (18.9%); the envelope was not submitted as it should be (16.5%); the designated NGO or church was not eligible (14.8%). Other reasons included: missing tax return (5.6%); the beneficiary was unidentifiable as the envelope was empty, the form was not completed or an inaccurate tax number was given (9.4%); a beneficiary in the same category was designated twice i.e. two

NGOs or two churches rather than one of each (7.5%); the beneficiary had ceased to exist (1.2%).

Some say that the tax authority's interests run counter to fulfilling taxpayers' instructions specified in their designation forms. This accusation not only creates misunderstanding, it is simply wrong. The tax authority's interest is to collect revenues; budgetary expenditure is outside its sphere of influence.

Honouring the designation form's instructions is assumed if the tax authority does not send a notice to the taxpayer about its invalidity. This procedure is the same as used when sending a tax notice, the rules for which prescribe that the tax authority is only obliged to send the taxpayer a statement of account if their tax current account contains a reference to overdue tax or some other payment obligation (a sanction such as a charge or fine) is due.

An important element in formulating the above procedure was the intention to reduce costs. The size of the costs involved is well illustrated by the fact that to have sent a special delivery notice about valid designation forms submitted in 2003 (1,358,000 in the case of NGOs) would have cost almost 200 million forints (800,000 euros) thus increasing the tax authority's related costs considerably. The tasks fulfilled by the tax authority require formidable financial resources. Two or three years ago, with the help of experts from the tax office, we estimated the costs involved to be around 250-300 million forints (1.0-1.2 million euros). A significant proportion of these costs arises from postal delivery costs (150-180 million forints) as every tax office communication is sent by recorded or special delivery. Taking into account there are 15-20,000 beneficiaries per year, the related costs we calculated can be considered a realistic sum.

## **NGOs**

The duty of the designated NGO is to record in a declaration, made in line with the tax authority's instructions, that it has been actively involved for at least one year in one or more of the 22 activities listed in the law regulating public benefit organisations. (NGOs do not have to have the status of public benefit organisations to receive 1% funds.) In addition, the NGO has to declare that its founding document and charter are in line with the law's stipulations, namely that the NGO has a registered office in Hungary, serves the interests of the domestic population or ethnic Hungarians outside the country and is politically independent.

Providing certificates about the absence of outstanding public debts was only required in the first year of the 1% Law's application. Subsequently, the tax authority checked the validity of declarations made by designated beneficiaries. A further change added later entitles the beneficiary to the designated sum even if it has outstanding public debts, provided that the beneficiary authorises the tax authority to use the designated sum to settle the amount owed.

It should be noted that there are differences each year between the number of organisations named in the designation forms and the number of organisations which actually receive the designated sums. In the immediate period after the law took effect, this difference was extremely high. Around 6-7,000 designated organisations (approximately 50% of the total at that time) did not benefit from the funds available to them. Mostly, this was because they missed the 30 day deadline issued by the tax office for submitting the various documents required at that time. In the short time available it proved hard to obtain from several offices

(the tax office, local municipality or customs office) the 6 different certificates initially required to confirm the absence of public debts. Another problem related to the submission of organisations' founding documents which was also required at first. Some organisations waited to see whether or not they would be allocated any money before dealing with the administrative requirements. In cases where the status of being a politically independent organisation was not already included, the organisation concerned had to initiate a court procedure to make the necessary amendment to its founding document (a process which would normally exceed 30 days). In later years, the difference between designated organisations and actual beneficiaries shrunk to about 2-3,000. It can be assumed that the reduction in the number of certificates required has had some effect in lowering this figure, plus the fact that the necessary amendment of founding documents only needs to be done once. Although no precise information is available, two factors explain why the final number of beneficiaries is lower: organisations who meet the requirements may decide that the amount of designated money is too small and therefore not worth the effort involved in claiming it, and some organisations, for whatever reason, still fail to meet the legal requirements.

Twelve months after receipt of the funds, the beneficiary is obliged to provide information about how the money was used in a press announcement. Rather than regulate the minutiae of the publishing methods, the aim of this requirement is to provide information for the general public. The underlying philosophy is that the local community plays an important supervisory role. In the course of its checks, the tax authority examines the documents which verify the press announcement's publication (such as the original copy and request for publication). It is necessary to underline that in the eyes of the law the sum designated by taxpayers is viewed as state support. This is the reason why the state tax authority supervises the legally correct utilisation of the portion of central budget revenue which the state foregoes and also means that beneficiaries may be subject to spot inspections by the tax office regarding the use of the money.

### **Reflections on changes to the 1% Law**

After it was passed in 1996, Parliament accepted several amendments to the 1% Law. What is remarkable is that the procedural order has essentially remained unchanged. Bearing in mind the law was unprecedented and a new model of its kind, the need to amend it later was clearly justified. While certain amendments have resulted in improvements, others, in my judgement, can be viewed with serious reservations.

**1+1%:** The introduction from 1998 onwards of the so-called "1+1%" arrangement, allowing two separate 1% designations to be made for NGOs and churches, eradicated an artificial conflict between NGOs and churches. This measure clarified the situation and also put an end to divisions among taxpayers on this question.

**Settlement of disputes:** More circumspect rules regarding the possibilities for legal remedy increased legal security and thus it has been possible to settle quickly and fairly the small number of disputes that has arisen so far. In seven years and in over 8 million designations made by taxpayers, there have only been 60-70 disputed cases of which 80% were settled in favour of the tax authority.

**Minimum limit:** The removal of the minimum transferable sum of 100 forints (about 0.4 euro), specified at first, helped reduce designations found to be invalid for this reason.

**Eligibility of NGOs:** In a similar way, in 2001 the eligibility requirements for beneficiary NGOs were eased with the reduction in the length of time – from 3 years to 1 years – public benefit activities have to be performed prior to the year when the taxpayer’s designation form is submitted.

**Public institutions:** There have been some modifications affecting the list of so-called national public institutions included as beneficiaries (institutions such as the State Opera House, National Museum, Hungarian Academy of Sciences etc.). I have held the same negative opinion ever since the law’s preparation about the inclusion of such institutions competing for 1% funds alongside NGOs.

**Certificates:** A significant reduction in the administrative duties of beneficiaries was brought about by the amendment which allows beneficiaries to make the relevant declarations about fulfilling the law instead of having to acquire certificates from the various public offices concerned. At present, to prove they have no outstanding public debts, beneficiary organisations outside the capital are only required to submit one certificate from their local council. In the case of Budapest, two such certificates are required as a further certificate has to be obtained from the main city council.

**Reserves and provisions:** The financial management of NGOs has been rendered simpler by the addition of a later rule which enables beneficiaries to set aside part or all of the designated sums transferred to them for use beyond the prescribed twelve-month period.

**Settlement of public debts:** A later amendment permits designated sums to be used to pay off a beneficiary’s public debts and to be entitled to any remaining sums designated in its favour. I consider the modification of the law in this way a form of discrimination against taxpayers (including NGOs) who fully comply with their tax and social security payment obligations. This change does not contribute to increasing the taxation discipline and makes the central budget responsible for paying the public debts instead of the negligent in question. It also goes against the contents of the central budget law which prohibits the payment of central budget support in cases where public debts exist. As already stated, the sums transferred in accordance with the 1% Law are, in fact, regarded as state support.

**Public accountability:** Earlier regulations left it to the beneficiary to decide on the best method for informing the public each year about the amount received and the purpose for which it had been used. This approach recognised that the beneficiary is most clearly able to judge through which channel it can best access its network of supporters. A typical example is when a foundation that supports a school – the sort of organisation that represents a considerable number of beneficiaries receiving significant sums – displays a notice in the school building and informs the public at parents’ evenings about the use of the collected 1% funds. The amendment, introduced in 2000, which specifies that the sums transferred to them and the aim for which they were used have to be published in a press announcement, has reduced the options available to beneficiary organisations.

**Transparency:** A relatively new regulation, valid as of 1 January 2002, orders the tax authority to publish on its home page the list of NGO beneficiaries and the sums designated to them, the year after the designation orders were made. This measure serves transparency and provides a good overview of the whole sector and the position of individual organisations within it, and will hopefully increase confidence towards the tax authority to some extent.

**Designated but unused amounts:** An amendment, adopted in December 2002, deals with the sums designated to beneficiaries that do not comply with legal conditions as outlined in the earlier sections above, as well as the sums designated to organisations that choose not claim them. This change allows the sums in question to be used by the Prime Minister's Office in support of NGOs (in fact, the law specifies that a parliamentary committee should allocate the money concerned but it decided to delegate the task to the Prime Minister's Office). I consider that this particular amendment contradicts the spirit and original intention of the law. There are several reasons why this regulation gives ground for reservations:

- in this way, a government plan comes to stand between taxpayers and the NGOs and thus
- reinforces the redistributing role of the central government while the very essence of the 1% Law is that society, namely the taxpayers, decides freely about the support for the non-governmental sector without any influence being exerted by the state;
- and finally, the decision of the taxpayer is being altered. Instead of the NGO named in the designation form, the portion of their personal income tax is benefiting another NGO unknown to the taxpayer concerned.

### **Concluding remarks**

The 1% Law is based on the premise that it is in the vital interests of NGOs to inform society, primarily taxpayers, about their activities. The reason the government runs no campaign or information service is because such a top-down, paternalistic approach would present this means of supporting the NGO sector as a state activity. Instead, the law builds on the self-organising capacity of the NGO sector itself to develop and strengthen relationships between taxpayers and various NGOs.

In reply to those who ask for the designation procedure to be simplified, it is my considered opinion that nothing justifies changing the existing procedure for the following reason: designating 1% of personal income tax is an extremely simple operation which does not require of a person more than two minutes' concentration.

For those who wonder why the possibility for allowing corrections to be made to designation forms does not exist, my view is that the designation order form is a very simple document – the only thing that requires attention is the correct reproduction of the relevant tax identification number and the taxpayer's own (!) name and address. Given its simplicity, it is totally unjustified to provide any opportunity for mistakes to be corrected. This would only cause unnecessary complications, as the taxpayer would have to visit the tax office on the basis of a notice from that authority and in such cases it would be necessary to collate documents which are otherwise handled separately (tax return, envelope and designation form).

A different question, and one still waiting to be resolved, is whether the beneficiaries should have the opportunity to express their gratitude directly to all those who supported their activities. One idea which may provide a solution to this question would be for the private person to absolve the tax authority of the obligation for secrecy by granting it permission to provide the beneficiary with the relevant data.