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CIVIL VISION

Comprehensive Nonprofit Legislative Reform Concept

Questions and alternatives

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Publisher: Hungarian Environmental Partnership Foundation
Supported by: Civil-Partner Trust Program on commission by the Trust for Civil Society in Central and Eastern Europe.
Designed and produced by: Typoezis Kft.
Budapest, 2004.

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Executive Summary

This study examines strategically and comprehensively legal regulations affecting NGOs in Hungary today. It is aimed at providing a conceptual and practical overview of the legal environment of the civil nonprofit sector, and addressing and offering alternatives to its most important issues.

The analysis and the framing of the issues raised were based on the following aspects:

- to bring Hungarian legislation in line with international legal standards;
- to address regulatory issues regarding the establishment and operation of civil organizations in Hungary;
- to help ensure the independence and sustainability of civil society and the civil nonprofit sector; and
- to map the possibilities of applying international best practices and good examples.

As a starting point, we have defined the underlying principles and a vision of a vigorous civil society supported by the community and actively involved in the shaping of social-economic processes. Civil society is defined as the entirety of responsible citizens consciously organizing themselves to represent both their individual and common interests, and to help others.

The frameworks within which such organization of individuals is generally taking place in Hungary are civil nonprofit or nongovernmental organizations such as associations and foundations, as well as non-state- established public benefit companies. Collectively, they are called civil nonprofit organizations, thus distinguishing them from nonprofit organizations established by virtue of law or by state organs, such as public law associations and public foundations.

In international law special protection is given to the freedom of association and the freedom of speech that are the basis of existence of civil organizations, while, at the same time, civil organizations are crucial for the attainment of these freedoms. Furthermore, in modern democracies civil organizations have become significant players of social and economic development. Therefore, in addition to protecting these freedoms and providing operational frameworks for civil organizations, legal regulation also aims at settling the relations between civil nonprofit organizations, the public and private sectors and society. **Accordingly, in this analysis we looked at legislation in three interrelated areas:**

- the autonomy of the civil nonprofit sector (existence and operations);
- the relationship between the civil nonprofit sector and the state; and
- the relationship between the civil nonprofit and the private sectors, in other words private individuals and businesses.

Strategically, the recommended changes in the above areas point into the same direction, however, they greatly diverge in terms of legal areas and laws that need to be modified. Consequently, the findings of this paper conclude that these recommendations should be implemented gradually, in separate legal regulations and in a new law on foundations, rather than within a single code.

The autonomy of the civil nonprofit sector

1. The fulfillment of the freedom of association

In order to fully realize the freedom of association and civic activity, adequate legal forms must be available allowing self-organization and allocation of private assets for community purposes, for individuals who are ready to do something for their communities. The experience gained over the past 15 years, however, shows that the existing legal frameworks do not always satisfy the operational needs of civil organizations and that additional legal forms should possibly be introduced.

Based on prevailing standards in international practice, the analysis recommends that the minimum criterion for establishing associations be changed to a smaller number of founders (2-3 people); a civil nonprofit organizational form without legal personality be introduced (civic society); and, by joining the applicable agreement of the Council of Europe, member organizations of nonprofit (non-governmental) organizations that are already registered in a foreign country be made possible to establish.

2. Structural reform of foundations and promotion of "capitalization" of the civil sector'

As a result of limiting, in some respect to an unnecessary extent, the rights of the founder and, at the same time, making the governing body dependent on the founder, the Hungarian regulation is based on unrealistic assumptions and causes major structural problems in the development of organizations. The related recommendations of this paper call for changes in the regulation of foundations to better suit both the program implementing and grantmaking functions.

Therefore, we suggest that, along with an adequate conflict of interest policy, regulation should enable the **founder to actively participate in the work of the foundation** and to even have decisive influence in it. Also, a new concept related to the foundation, the endowment should be introduced. The establishment of an endowment should be encouraged by tax incentives, meaning that if the founder assumes in the founding document an obligation to invest funds – a minimum size of which could be determined – as capital, and to annually distribute its income in the form of grants, the foundation may be given special preferences.

3. Simplifying the operation of civil organizations

Some of the most urgent needs of civil organizations are more simple and uniform registration procedures, and that accounting and financial reporting rules should be differentiated according to budget size (and/or other relevant criteria).

The study recommends that courts should be required to specify in one written decree all missing items prescribed by law that need to be submitted for registration. Introducing a sample guide to the founding document would also make it easier to establish a civil nonprofit organization.

As indicated by figures from the Central Statistical Office, in 2002, forty-five per cent of organizations had a budget under HUF 500,000 and only five per cent of them had budgets above HUF 30 million. Consequently, accounting, reporting and bookkeeping obligations of civil nonprofit organizations could be made simpler below a HUF 1 million threshold.

THE RELATIONSHIP BETWEEN THE CIVIL NONPROFIT SECTOR AND THE STATE

4. Redefining the relationship between civil organizations and government

Legislation today does not differentiate between nonprofit institutions under public and private law. This, on the one hand, resulted in a disadvantageous position for private nonprofit organizations as most of the resources have been channeled to government founded public foundations and public benefit companies. On the other hand, financial management of organizations established under public law has slipped out of state budget control. In this analysis we recommend that a clear distinction be made between civil (non-governmental) nonprofit organizations' legal status under private law and the legal status of organizations established under public law.

In its rhetoric, government has already adopted the term "partnership" in the context of the civil sector but its mentality still reflects a very strong paternalistic and hierarchical attitude toward civil organizations. This is illustrated among others by the fact that both legislation and ministries use the word "support" to denote state funding for nonprofit organizations, uniformly, without any differentiation and regardless of the content of the funding relationship. Literature, however, recognizes two basic forms of state funding for civil organizations: subsidy and procurement. We recommend that, on the example of the public procurement scheme, the Central Budget Law should devise a system for funding ongoing public services (essentially "contracting out"), which would be distinguished from the funding of state tasks periodically prescribed by law with a concrete objective (government policy implementation). In the case of the latter, the goal should be to create a more uniform and transparent tendering system.

5. Extending the legal framework of participatory democracy

In developed countries, the idea of participatory democracy has become widespread in the second half of the twentieth century. Participatory democracy means that citizens should have the opportunity to influence decisions affecting them not only through political elections (i.e. representational democracy) but also in between two elections. Today, participatory democracy is one of the declared principles along which the European Union is operating, and will be addressed within a separate chapter in its new Constitution.

Civil society organizations represent one of the main channels of participatory democracy since through them private individuals can influence institutions that affect their lives. In order to widen the possibilities and strengthen the role of citizens, the principles furthering participatory democracy – such as information, accessibility and the right to legal remedy – should be, to the greatest extent, embodied in relevant laws, draft legislation and conceptual drafts. In particular, the study looks at the recommendations to the draft Act on Legislation and to the importance of regulatory guarantees of local level participation. Furthermore, the study finds it necessary to review non-regulatory instruments and institutions in the context of participation.

6. Making the public benefit status more functional

A recent impact analysis showed that the Law on Public Benefit Organizations has not lived up to the expectations in terms of resource mobilization: the number of donors of public benefit organizations has not grown substantially. There seems to be a consensus that the public benefit status failed to preserve its real content. The law is setting criteria that are merely formal and are required to be met only at the time of obtaining the status, while lacking the guarantees for their continuing fulfillment.

Therefore, the question as to what the purpose and content of public benefit regulation are, needs to be reconsidered. As recommended in this paper, consideration should be given to making the public benefit status a pre-requisite for not only indirect but also direct forms of state support, particularly untendered funding. It would also be important to ensure that conditions are being met continuously, for example by requiring a copy of the public benefit report deposited at the public prosecutor's office. Also, requirements of the prominently public benefit status need to be clarified and the different expressions for "public benefit" used in various laws should be harmonized.

THE RELATIONSHIP BETWEEN THE CIVIL NONPROFIT SECTOR AND THE PRIVATE SECTOR

7. Furthering civil organizations' participation in the economy

Encouraging civil organizations to be more active economically could be advantageous in two ways. On the one hand, it would make it easier also for non-state-established organizations to gain economic influence, on the other hand it

would provide the basis for the business sector to look at civil organizations not only as recipients of donations but also as potential business partners or clients. It is of primary importance that first the obstacles originating in the current application of the law be removed. For example, guidelines and policy statements should be created to ensure uniform interpretation of the definition of entrepreneurial activity by those administering the law. Another important goal should be to create conditions that enable civil nonprofit organizations to maximize their revenues from both their core and entrepreneurial activities. To this end, special regulations (such as laws relating to VAT, agricultural land and customs) should be reviewed and appropriately amended.

8. **Furthering the societal support of civil organizations**

A key indicator of the independence and public endorsement of civil organizations is the volume of private donations they receive. Donations by private individuals are not only a resource opportunity but also a fundamental form of social participation. By giving part of their income to a civil organization they not only express their support for a particular organization but also take part in solving social problems. In Hungary, this kind of conscious philanthropic culture is not yet strong enough. In order to promote its development, the tax credit system should be changed, or at least the tax-credited part of donations to public benefit organizations under the Personal Income Tax Act needs to be increased (by making donations to be deductible from the tax base). We also recommend that, along with the introduction of an endowment, the establishment of endowed foundations be encouraged, as well ensuring significant tax credit deductible from the tax base, to founders endowing a foundation.

9. **Enhancing transparency and accountability of civil organizations**

It is also important that legal rules ensuring transparency and accountability be rationalized with regards to registration, public benefit and accounting regulations. This means, for example, changing the rules of reporting the net worth of nonprofits, based on international examples; redefining transparency criteria to be met by public benefit and non-public benefit organizations; and a comprehensive regulation of termination of civil nonprofit organizations.

Introduction

Civic groups are fundamental pillars of a democratic society: only through them can an effective and constructive social dialogue be carried out. Civil organizations constitute an indispensable framework for social self-organization and real social control. They serve as a link between state institutions, society and individuals, and it is through them that individual participation and direct democracy are being implemented.

Today, their significance is gaining increasing attention as modern societies have recognized that civil society plays an irreplaceable role. However, there is a lack of uniform and generally accepted civil society standards. Even the European Union has not established the criteria that could be considered as the essential elements of legal regulation on civil society. Therefore, there were no legal harmonization requirements for accessing states in this respect, even though a set of clear guidelines would have been especially important for the continual development of these transitioning countries.

Over the past 15 years, the legal environment governing and influencing the life of civil organizations in Hungary has been, along with changes in the legal order, continuously changing and has become more and more complex. However, all this happened too spontaneously, without a well thought-out, strategic focus on creating an integrated system. Hungarian regulation has taken over specific elements from different European models it took as examples, resulting in an especially mixed nonprofit legal environment. Therefore, although created with the best intentions, the impact of regulations is often contrary to their original purpose: they might weaken and disintegrate nonprofit organizations and the civil sector rather than strengthening them.

Having recognized these problems, over the last years both the nonprofit sector and a number of government players have pointed out that legislation related to civil society needs to be reviewed. From the civil side, a number of workshops – e.g. the Nonprofit Sector Analysis – have made efforts to identify the problems and offer possible solutions. From the government side, the Ministry of Justice and the Prime Minister's Office have, on several occasions, attempted to make changes to the regulation on civil organizations.

However, these initiatives affected only certain segments of the civil legislative environment: the overall theoretic background of the sector's legal regulation has not been put to examination.

Therefore, the Civil Vision concept intentionally focused on the comprehensive and strategic analysis of the present-day nonprofit legislation in Hungary. This analysis, while undoubtedly "civil", is the first concrete result of an initiative that builds on collaboration between players of the prevailing governments and the community. Its goal is to provide a theoretical and practical overview of the civil

nonprofit sector's legal environment, addressing key theoretical and practical issues and proposing alternative answers.

The question 'why, then, was this comprehensive concept created now and by the Civil-Partner Trust Program' is a justifiable one. The answer can be approached in two ways: on the on hand, during its fifteen years of development the sector has now reached a level of conscious self-image building where it is capable of forming an opinion about itself along its independently formulated vision. On the other hand, the Hungarian Environmental Partnership Foundation – along with the Soros Foundation and The Civil Society Development Foundation Hungary – has won significant funding from the Trust for Civil Society in Central and Eastern Europe, allowing the implementation of a comprehensive three-year strategy.

The above conditions provided the basis for the development of the Civil Vision concept through which the Civic-Partner Trust Program has made an attempt to develop a common civil strategy. The project, under the direction of the Hungarian Environmental Partnership Foundation and in cooperation with the Nonprofit Sector Analysis Program and the European Center for Not-for-Profit Law, brings together civil experts and organizations playing a key role in the development of the Hungarian nonprofit sector.

The Civil Vision Concept is taking into account the special characteristics of both European and Hungarian civil society development. During its creation, consideration was given to international legal norms, internationally accepted best practices and positive examples, as well as regulatory and legal implementation issues of the establishment and operation of civil organizations. With regards to the above, our main objective has been to outline an independent and sustainable civil nonprofit model.

When developing the Civil Vision Concept we wanted to avoid in any case that its outcome only reflect the professional opinion of a small group of experts. Thus, we have, already in the initial phase, included available findings[1], and the results of a survey based on an interview series with leaders of civil organizations and those administering the law. The first more complete draft of the Concept was put to discussion by interested civil organizations and persons administering the law and in connection with civil organizations, in a conference series held in various county seats in 2004.

The Civil Vision is therefore a truly wide-ranging civil initiative, which was not meant to be written "for the desk drawer": we would certainly not like it to be another civil initiated project that will never be implemented. For this reason, we are and will be supporting the implementation of its proposals by all our means.

Budapest, January 20, 2005

[1] Such as the Nonprofit Sector Analysis project and reports by the Hungarian State Audit Office and by the Hungarian Central Statistical Office.

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" The rise of civil society is indeed one of the landmark events of our times"

KOFI ANNAN, UN Secretary-General[2]

I. Underlying Principles

The Republic of Hungary, as a modern and democratic state under the rule of law and a member of the European Union recognizes the outstanding role of civil society and its organizations in the development of democracy and in the creation of social welfare.[3] Therefore, we find it indispensable that the government and lawmakers, with regard to Hungary's accession to the European Union and in the light of their important role, review the legislation pertaining to organizations of the civil society and initiate the necessary reforms.

I.1. Definitions

In this document, we understand **civil society** as the web of individual and collective actions of citizens, pursued on a voluntary and intentional basis, aimed at improving society as a whole and the communities within, rather than pursuing political influence or profits. Thus, civil society is the entirety of responsible citizens, consciously organizing themselves to represent their common interests and to help others.

Civil society can emerge not only spontaneously and informally but also in an organized form, within a legal-institutional framework. **Civil or nongovernmental nonprofit organizations** provide the legal and organizational settings for this organized way of citizen activity.[4] Some of their key characteristics are that that they are established at the free will of individuals rather than by virtue of law (as opposed to the public sector); they cannot distribute profits (as opposed to the business sector); and they are organizationally institutionalized (as opposed to the informal household sector). In addition, they typically serve public interests and their functioning involves some elements of volunteerism.[5] In Hungary, over the past decade the term *nonprofit* has been – in an unfortunate way – also extended to not-for-profit organizations and institutions founded by government bodies (such as public foundations and public law associations or public chambers). As in this Reform Concept our intention is to differentiate between

[2] We the peoples: civil society, the United Nations and global governance. Report of Panel of Eminent Persons on United Nations-Civil Society Relations, UN (2004).
[3] See e.g. The Civil Strategy of the Government, the Prime Minister's Office, June 2003.
[4] Classic examples of these are foundations and associations.
[5] Based on definitions by the Johns Hopkins University's Comparative Nonprofit Sector Project (In: Salamon, Sokolowski and List (2003), p. 8.) and the European Commission (EU 2. (2000) p.3.).

these quasi-state organizations and civil society organizations, the term ***civil organization*** will be used hereafter.[6]

Civil organizations themselves as a whole constitute the **civil or nonprofit sector:** the third institutionalized key sector in society alongside the public and business sectors. For similar reasons as mentioned above, the term ***civil nonprofit sector*** will be used hereafter. Thus, the entirety of the organizations of civil society that is the civil nonprofit sector is a narrower and at the same time, a more tangible category than civil society.

I.2. International legal context

The question arises: why and how the state should enact legislation in support of a strong, vigorous and independent nonprofit sector in Hungary. According to the World Bank's Handbook[7] there are at least six reasons why it is in the best interest of any society to promote the existence and development of its civil nonprofit sector. These are:

- **a.)** to implement the freedom of association and speech,
- **b.)** to promote pluralism and tolerance,
- **c.)** to further social stability and rule of law
- **d.)** effectiveness,
- **e.)** to respond to the deficiencies of the public and business sectors and
- **f.)** to strengthen market economy.

Key international and multilateral organizations such as the United Nations, the World Bank, the European Council and the European Union recognize these roles of the civil nonprofit sector in a number of documents.[8] Of these special attention should be given to the UN's recently approved report on United Nations-Civil Society relations; the European Union's Declaration 23 on Co-operation with Charitable Organizations, annexed to the Treaty of Maastricht, and Declaration 38 on Voluntary Service Activities, attached to the Treaty of Amsterdam; and European Union's White Paper on European Governance.

In international law special protection is given to the freedom of association and the freedom of speech. These freedoms are the basis of the existence of civil

[6] This definition includes the so-called *general-purpose* nonprofit organizations that may be established for any legal purpose chosen by the founders. In Hungary, foundations, associations and public benefit companies fall in this category (even though the Civil Code specifies additional requirements for foundations and public benefit companies). In contrast, unions, parties, churches, co-operatives and other voluntarily organized forms are referred to as *special purpose* nonprofit organizations, the competences and obligations of which are usually regulated by separate laws as well.

[7] *World Bank's Handbook on Good Practices For Laws Relating to Non-Governmental Organizations.* This document has been prepared by ICNL on commission by the World Bank., Washington D.C.ICNL (2000), p. 10.

[8] See list of official documents at the end of this paper.

organizations; and at the same time, civil organizations are indispensable for the attainment of these freedoms.

The protection of freedom of speech and the resulting freedom of association is laid down in numerous international documents signed by Hungary as well, such as, first and foremost, the Universal Declaration of Human Rights (1948) and the International Covenant on Civil and Political Rights (1966). The latter – unlike the Universal Declaration– is a multilateral treaty of binding force ratified by 135 countries.

In addition, for Hungary, just as for every member of the European Council, the most important binding treaty is the European Convention for the Protection of Human Rights and Fundamental Freedoms (1950), proclaimed in Hungary in 1993. Section 10 of the Convention declares the freedom of speech, while Section 11 the freedom of association. In addition, the Convention calls for the establishment of the European Court of Human Rights, an international body aimed at ensuring the implementation of the freedoms laid down in the Convention.

Another fundamental document, in terms of exercising the right of participation, is the Convention on Access to Information, Public Participation in Decision-Making and Access to Justice in Environmental Matters, adopted in Aarhus, in 1998, to which Hungary is a signatory as well.

Finally, the intended Constitution of the European Union in its Article VI that deals with the democratic life of the Union, addresses, in separate sections, the basic principles of participatory democracy (Section 46) and the dialogue between social partners, among them civil organizations, and the European Union (Section 47).

I.3. Legislative areas

The non-institutionalized activities of civil society are protected by the so-called fundamental freedoms or inalienable rights. These are, for example, the constitutional rights to the freedom of speech, freedom of religion, to assembly and to property. These actions may only be restricted only in specific instances stipulated by the Constitution, or by law as prescribed by the Constitution or by international treaties. However, they are usually not subject to binding provisions.

Civil organizations, too, are defined primarily by these liberties. Decisions passed by the European Court of Justice prove that the European Convention stipulates that states are not only required to refrain from illegitimate interference as regards civil rights but are also imposed upon the positive obligation of ensuring that their legislation promotes the implementation of these rights. The creation of laws regulating the establishment, governance and operation of civil organizations is part of this obligation. Civil organizations established on these grounds and as

legal entities also pursuing economic activities, will then be subject to a number of other statutory requirements and obligations as well.

Literature often defines the activities of civil organizations as "private actions for the public good".[9] Although these organizations are primarily protected by civil liberties, public interest must also be taken into consideration in their regulation, inasmuch as they enjoy the support of the public (e.g. in the form of tax benefits or subsidies) for the achievement of their goals. In the following, we will attempt to define the principles along which regulation can best promote the fulfillment of both of these interests, thus neither hinder the private nature of actions nor harm the public interest.

Legislative action could be taken in three main areas:

a.) the existence and autonomy of the civil nonprofit sector;

b.) the relationship between the civil nonprofit sector and the state; and

c.) the relationship between the civil nonprofit sector and the private sector, including the business sector and private individuals.

I.3.1. The existence and autonomy of the civil nonprofit sector

a.) Promoting individual and collective pro-activity and self organizing

A key characteristic of civil society is that people who participate in it are doing so at their own free will and in a proactive way. Self-organizing is not only an inalienable right of people, but it is also important for the state that its citizens can take care of themselves and of each other, without always expecting help from the government. Self-organizing may take several forms - e.g. foundations, associations, clubs, movements -, the promotion and encouragement of which serves the interests of the state as well.

b.) The fulfillment of freedom of association

The most common way of self-organization is exercising the freedom of association as private individuals establish membership-based organizations with a common purpose. The European Convention for the Protection of Human Rights and Fundamental Freedoms, as indicated above, guarantees the freedom of establishing legally recognized associations. Curtailing this right, for example conditioning it to a large membership, can be justified only under strictly limited conditions. In accordance with international treaties, the state is obliged to ensure, to the greatest possible extent, the fulfillment of the right of association.

[9] E.g. Salamon, Sokolowski and List (2003), p. 1.

c.) Ensuring the autonomy of the civil nonprofit sector

Another key attribute of civil society is that it exists and operates separately and independently from the state. This, of course, does not mean that civil organizations will not colleborate with the government in terms of programs and services. Autonomy means that they are formed on a voluntary basis and make decisions related to their own affairs independently (they are self-governing). This enables the civil nonprofit sector to perform a watchdog function over the state and to effectively advocate the interests of social groups. Nevertheless, it is also in the interest of the state that institutionalized organizations of the civil society do not intertwine with state organizations, as the former are not subject to the strict financial requirements applicable to budgetary organs. Consequently, a hybrid form can give way to the misuse of public money.

„Citizens increasingly act politically by participating directly, through civil society mechanisms, in policy debates that particularly interest them. Traditional democracy aggregates citizens by communities of neighbourhood (their electoral districts) but in participatory democracy, citizens aggregate in communities of interest. And thanks to modern information and communication technologies, these communities of interest can be global as readily as local." – states a report of the UN approved in June 2004.[10]

I.3.2. The relationship between the civil nonprofit sector and the state

a.) The fulfillment of participatory democracy

In developed countries, the idea of participatory democracy and its institutions became widespread in the second half of the twentieth century. The idea of participatory democracy is that, along with representational democracy based on political elections, citizens should be given the opportunity to influence the decisions affecting them also in between two elections. Civil society organizations constitute one of the main channels of participatory democracy since, through them, citizens can influence institutions that affect their lives.

Civil organizations often undertake to represent the interests of citizens or citizen groups in political decision-making. Also, they often possess such expertise and experience in specific areas that should be taken into account in policy-making or in the drafting of legislation.

From the state's point of view, the effective inclusion of stakeholders in the decision-making will result in higher quality and more implementable policies and laws entailing lesser social resistance.

b.) Promoting the concept of partnership in terms of the involvement of the civil nonprofit sector in solving social problems

[10] UN (2004) p. 8.

Civil nonprofit organizations are often established to address some kind of social problems. Based on international studies, these organizations may be, in many areas, more effective in managing and solving problems than the state service provision system. This has several reasons. Some of the most widely recognized are that, first, nonprofit organizations are innovative (their internal motivation and their lack of resources drive them to develop more and more high-quality and cost-effective solutions); second, they can better assess and monitor the needs of particular social groups or communities to which services are being provided; and third, by utilizing volunteer manpower and private resources, they can provide the same services for less money. Nevertheless, they obviously do not and cannot replace the universal services provided by the state. However, in order to improve the standards and cost-effectiveness of its services, the state should consider partnering with qualifying nonprofit organizations in social and human services provision.

c.) A Ensuring the transparency and accountability of civil organizations as regards direct and indirect subsidies

Civil organizations are not established through the democratic political process, and therefore are not inherently eligible for public funding. In most countries, however, the government supports civil organizations both indirectly (e.g. tax preferences) and directly (e.g. through grants). This is because, through their existence and activities, they further democratic development and the attainment of social welfare. In return, civil organizations have to prove that they "deserve" such support and use the public money for appropriate, public benefit purposes. Thus, they need to comply with strict transparency and accountability criteria and requirements (e.g. public benefit regulations), which may vary according to their level of funding. It is in the interest of the civil nonprofit sector not only to acknowledge, but also to demand a set of reasonable standards for transparency and accountability. Similarly, the state also benefits from operating a transparent and accountable system.

I.3.3. The relationship between the civil nonprofit sector and the private sector, meaning society and businesses

a.) Providing access to and promoting private sector resources for civil society organizations

Civil organizations are able to mobilize private resources, i.e. corporate or individual donations, in order to help achieve their goals. All over the world and especially in Europe, governments encourage private donations through a range of policy instruments[11]. Although it can be said that tax incentives alone do not lead to philanthropic behavior, the type and level of tax allowances do influence the composition and scale of corporate and individual donations. Moreover, it is important aim to encourage the establishment and development of private grant-

[11] E.g. with complex tax benefits systems.

making foundations, as they can help ensure the long-term private sources of funding of a particular field. The state therefore has a strong interest in a legal environment that encourages philanthropy because this can result in an increased level of private sector resources and, as a result, civil organizations require less state funding.

b.) Promoting active social participation, particularly philanthropy and volunteerism, among businesses and private individuals

Eventually, the state has limited means to encourage participatory and philanthropic behavior. Nevertheless, it is possible and necessary to encourage and motivate philanthropy and volunteering through state instruments. For instance, the "One Percent Law" allowing taxpayers to offer 1 per cent of their personal income tax to civil organizations might be one way to achieve conscious citizen participation.[12] Providing a legal framework for voluntary activities and removing their administrative obstacles is also important in promoting social participation; as well as supporting specific projects aimed at promoting a philanthropic culture.

[12] To date there has been no data available on the impact of the "One Percent Law" on the willingness to give.

II. Strategic Summary

II. 1. Vision: Civil society in Hungary

„Country Report 2020: The strong and dynamic organizations of civil society actively participate in shaping social processes. The nonprofit sector, being independent from the state, plays a significant role in resolving social and economic problems: some of its organizations collaborate with the state on a contractual basis to deal with social issues, while others effectively advocate for better policies addressing these problems. Some participate in the re-distribution of private wealth, as donors. Citizens and businesses are actively engaged in civil society and in the work of civil organizations. All this has been partly the result of legislation on the nonprofit sector that provides an adequate framework for performing particular nonprofit functions; the autonomy of civil organizations is guaranteed by both funding criteria and regulations; the state subsidy system is transparent and accountable; regulations on tendering and contracting of service provision are clear, and so is the framework for participation in decision-making and lobbying; and a number of regulations and policies promoting philanthropy and voluntary activities have been in effect for more than a decade."

Currently, there is great diversity as regards the civil nonprofit sectors within the European Union. The forms, the roles and responsibilities of civil organizations as well as the extent of preferences given to organizations and their donors etc., vary according to their historical traditions, legal systems, and cultural and political aspects. There are also significant differences in their relationship to the state and in their level of state funding.[13] Nevertheless, the tendencies evolving along the above principles, even if on the long run, point towards convergence and the vision stated above. That is another reason why the Hungarian legal system should be carefully reviewed and guided to a direction that is more in line with the European models.

II.2. Summary Status Report: Issues and legal background of the Hungarian civil society in 2004

After the turn of the Millennium, there is still a great deal of confusion about the various nonprofit forms and functions in Hungary; the civil nonprofit sector is not clearly defined; and the sectors' political-economic role remains unclear, too.

The structural inconsistencies in the regulation of associations and foundations hinder their functional operations. The law does not provide organizational forms allowing for a smaller group of citizens (2-3 people) wanting to take action for the

[13] The four basic European models are corporative, liberal, social-democratic and Mediterranean nonprofit sectors. See Appendix for further details.

common good, to set up a membership organization or a non-membership based program implementation organization – except for a limited possibility to establish a public benefit company.

Quasi-nonprofit organizations intertwined with the government give way to irregularities and fraud, and force traditional civil organizations into a disadvantageous position. The state financing system is neither transparent nor consistent. It is characterized by a paternalistic "support" mentality towards civil organizations, reflecting a hierarchical relationship rather than a partnership-based "contracting" mentality.

Although the reform of the legislative process has started (shifting the emphasis to the inclusion of stakeholders in decision-making)[14], but this alone will not solve the problems that insufficient regulation of institutionalized interest representation and lobbying has set off.

While tax incentives of corporate donations show a positive example, tax credits of private donations are not particularly motivating. There is now a legal recognition for volunteer activities[15]. Even if such legislation is adopted, only in case of PBOs it will take a long time until volunteerism is recognized in practice by the various ministries, the actors of economy and private citizens.

The content of public benefit regulation also raises concerns as, in contrast to its original intentions to mobilize private resources, the public benefit status more or less yields only the prestige of state recognition. Management and reporting requirements of civil organizations are not adequately differentiated, as heavy administrative burdens imposed on small civil organizations are not proportionate to their sizes. In some areas, the requirements to ensure the transparency and accountability of civil organizations remain incomplete, particularly in terms of the termination of an organization.

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II.3. Strategic directions: Steps toward achieving the Civil Vision

THE AUTONOMY OF THE CIVIL NONPROFIT SECTOR

1. **The fulfillment of the freedom of association:** through the wider scope of possibilities for civil organizational forms and by consistently applying the principle of the freedom of association, various legal forms could be introduced – following the example of business organizational forms –

[14] See new Legislation Bill draft (June 2004).
[15] Adopted in June 2005.

corresponding to the roles and special characteristics of particular organizations.

2. **Promoting the "capitalization" of the civil sector:** structural reform of foundations; the introduction of the legal concept of the endowment and the promotion of their establishment by way of tax incentives.

3. **Simplifying the operation of civil organizations:** making registration procedures easier on the example of recommendations of the Draft of the Companies Act; differentiation of administrative operational requirements by size.

THE RELATIONSHIP BETWEEN THE CIVIL NONPROFIT SECTOR AND THE STATE

4. **Redefining the relationship between civil organizations and government:** legal differentiation between non-governmental civil and quasi-governmental, state type of nonprofit organizations; promotion of the "contracting" approach as opposed to the currently dominant support mentality.

5. **Extending the legal framework for participatory democracy:** promoting current legislative initiatives (Draft Law on Legislation); reviewing non-statutory instruments and institutions in the context of participation.

6. **Making the public benefit status more functional:** on the one hand, reducing over-regulation (e.g. easing the requirement of unrestricted publicity of public benefit operation) and on the other hand, continuous monitoring of compliance with public benefit criteria.

THE RELATIONSHIP BETWEEN THE CIVIL NONPROFIT SECTOR AND THE PRIVATE SECTOR

7. **Furthering civil organizations' participation in the economic sphere:** Uniform interpretation of entrepreneurial activities by those administering the laws; introducing special provisions in particular regulations.

8. **Furthering the societal support of civil organizations:** increasing tax allowances on individual donations; legal recognition of volunteerism.

9. **Enhancing the transparency and accountability of civil organizations:** imposing registration, public benefit and accounting regulation; e.g. changing the way of reporting the net worth of an NGO according to international examples; regulation of termination of civil nonprofit organizations.

III. Comprehensive situation analysis and identifying strategic solutions

III.1. The fulfillment of the freedom of association

In order to fully attain the freedom of association and civic activity, individuals ready to do something for their communities should have the opportunity to select the appropriate legal form for their self-organization and for allocating their assets for community purposes. In the continental law (civil law), the association and the foundation are fundamental legal forms to provide such opportunity. In Hungary, their (re-)introduction is dated to the time of political changes (1987-89). In 1993, the legal concept of the public benefit nonprofit company has been adopted as well. The experience gained over the past 15 years, however, shows that the existing legal forms do not fully satisfy the operational needs of civil society organizations; additional legal forms could possibly be introduced.

III.1.1. Setting up an association by a small number of founders

In Hungary, setting up a general purpose membership-based organizational form[16], i.e. as an association, requires a minimum of 10 members and it must be registered as a legal person. According to international practices –in Western European tradition, and recent trends in the accession countries – **civil nonprofit membership organizations may be established with a membership starting from 2-3 people.**

The 10-people criterion seems to be a legacy of the socialist legislative approach [17] assuming that a membership organization should have a broad social basis[18]. In modern democracies of the twenty-first century, there is no reason to impose a numerical restriction on citizen self-organization. Moreover, the "minimum of ten people" criteria could be a basis to declare a violation of Section 11 of the European Convention. To date no decisions have been taken regarding a minimum or maximum number of founders in the Case Law of the European Court. The Court, however, has set strict criteria for the imposition of restrictions on the right of association specified in Section 11. The restriction on the number of founders most likely does not qualify as such.

The criteria to impose restrictions on the right of association, according to the Convention: (1) an interference with the right of association is stipulated by law;

[16] In the case of specific purpose membership-based organizational forms, such as political parties, churches, trade unions etc. it may be justifiable to require greater membership in proportion to their purposes.
[17] Act II of 1989 does not include in its reasoning any explanation on the number of founders.
[18] Until recently, e.g. in Bulgaria and in Romania 20, in Bosnia-Herzegovina 30 people had been required to establish an association. Today, apart from Hungary, only Serbia (10), Slovenia (10) and Poland (15) require more than 3 people for this purpose n Central-Eastern Europe.

(2) such interference serves legitimate purposes (as specified in Section 11, see below); (3) such interference is necessary in a democratic society. In the matter in question, Items 2 and 3 should be examined. Even if any reasons – presently unknown to us – could be found to justify that prescribing a larger number of founders serves any of the legitimate purposes specified by the Convention (specifically: national security or public safety interests, prevention of disorder or crime, protection of public health or public morals and protection of the rights and freedom of others), it is unlikely that this restriction complies with the necessity requirement of the third condition allowing only the lowest extent of intervention even in the case of the above legitimate purposes (so-called proportionality test).

According to our experiences, a number of – both grass-root and national – associations struggle with the problem that although they could summon ten persons for the founding, it is difficult to convene members for the general meetings, because practically 3 to 5 persons are running the association, which actually achieves important and good results based on the tenders and donations acquired. It could especially enhance civil self-organization in smaller townships or villages, if already 3-4 active and enthusiastic citizens could found an association. In addition, it may also happen that not enough founding members can be found even in a smaller town for an association promoting a controversial social topic, such as roma integration. (Founders small in numbers, either in villages or in towns, would neither prevent the joining of further members nor the growth of the association, of course.)

III.1.2. Civil nonprofit organizations without legal personality

Beside the minimum number of founding members required, the legal personality condition also raises questions. Although, in this respect the European practice also varies from country to country, there are strong arguments for making **the establishment of civil nonprofit organizations possible without a legal personality** by the Hungarian law.[19] A possible form of this may be the so-called civic society.

The *civic society* could be regulated on the model of the *civil law incorporation* under the Civil Code. A civic society would be a non-registered partnership aimed at a community purpose to be defined by its founding document. It would neither require a legal personality nor entail the related administrative, financial, regulatory and operational burdens. Civic societies would have to elect one leader or representative acting as a representative on behalf of the civic society. The private individual undertaking the leadership and representation of the civic society, would bear the legal responsibility in all legal relations that are to be established.

[19] In Poland, this kind of solution was used to solve the dilemma of the above-mentioned 15-people limitation. An association with legal personality can be started with 15 members, while a so-called simple association without a legal personality with 3 people.

Such legal form would not require court registration; however, a minimum level of government recognition (e.g. notarial) would be necessary to allow the dispensation of law in the matters and procedures regulated by law. Although it may not pursue entrepreneurial activities, a civic society may engage in economic transactions and could be the subject, within its range of statutory activities, of financial regulations, obligations towards the state budget and accounting, similarly to other subjects without legal personality/entity, e.g. condominiums.

The institution of civic society would enable, for example, community clubs, grass-root activists, people pursuing the same hobbies, arts and creative communities, student self-government bodies and ad-hoc advocacy groups to participate in public life (e.g. in grant competitions, network building, collaboration and decision-making) by right. Furthermore, restrictions imposed on their operation by the *legal personality* criterion would be eliminated. In terms of operational possibilities, the civic society legal status would provide nearly the same conditions as the status of a registered association or foundation. In exchange, its leader (representative) would be held legally responsible in person.[20]

Operating businesses in a nonprofit form

The Codification Committee developing a new legislative concept on business associations and court registration made similar recommendations in its discussion paper when it suggested extending the nonprofit corporation form to other business associations as well, on the analogy of the public benefit company, which is the nonprofit form of the limited liability company. We believe that this initiative is taking the right direction and may be an alternative to the civic society form as proposed above.

However, the Committee's single argument in favor of this solution was the "unjustified discrimination" between the limited liability company and other forms of partnerships. Our opinion is that this issue should be considered in full depth, including the possible counter-arguments and related questions, as well.

Only to mention briefly, for example, the introduction of the general nonprofit corporation form would, to some extent, blur the borderlines between initiatives with for-profit and not-for-profit purpose. In current practice, the nonprofit organizational form may not be established to pursue primarily economic activities, with the exception of the public benefit company. A broader application of the nonprofit partnership concept would challenge this fundamental principle, since practically there would be more opportunities, within the nonprofit form, to perform economic activities than statutory ones. This alone is not necessarily a problem, however, it shifts the regulation of these legal forms towards the common law tradition, making harmonization difficult with the existing (civil law) system having the foundation and the association as the two basic forms.

If such system were adopted, tax benefit and public benefit schemes would also have to be reviewed. Furthermore, it would be useful to conduct a cost-benefit

[20] Bíró (2002) pp. 149-150.

analysis, taking the expected number of registrations and the related additional administrative costs into account.[21]

III.1.3. Hungarian registration of member organizations of civil nonprofit organizations already registered in a foreign country; Recognition of the legal personality of international NGOs

With the accession to the European Union, the lack of a specific organizational form allowing **civil nonprofit (non-governmental) organizations registered in a foreign country to set up their Hungarian member organizations** has also become a significant problem. Based on the example of subsidiary companies or foreign trade agencies, a legal form should be created permitting the Hungarian representation of civil nonprofit organizations registered in a foreign country.

At present, international nonprofit organizations wishing to operate in Hungary have two options. The first is to establish a separate foundation or association independent from their parent organization, where the control function of the international organization, however, cannot be enforced (since self-governance is a key feature in these legal forms). The second option is to set up a public benefit company, in which case they are practically forced to pursue economic activities even if their main profile is, for example, grantmaking or advocacy.

This problem would be *partially* resolved if Hungary joined the **European Convention on the Recognition of the Legal Personality of International Non-Governmental Organizations**.[22]. The Convention was elaborated by the Council of Europe nearly twenty years ago in Strasbourg. Its participating countries recognize the legal personality and capacity of a nonprofit organization, recognized as a legal personality by other signatories, given that such organization complies with the conditions of the Convention ensuring its nonprofit status and public benefit nature. A definite advantage of Hungary's joining the Convention would be – as Belgium has already joined in and the neighboring countries are also potential applicants – **that foreign activities of Hungarian civil organizations – especially those in Brussels – would become considerably easier,** enabling Hungarian organizations to extend their international activities.

III.1.4. A new legal form conforming the non-membership-based program implementation function

There is no legal form to fulfill **the non-membership-based program implementation function** in Hungary. In order to operate as an association, an

[21] In addition, to operate a *joint stock corporation* in a nonprofit form would pose an additional problem and would require ample detail regulation as its basic function and purpose is questionable.

[22] European Convention on the Recognition of the Legal Personality of International Non-Governmental Organizations (EC), prepared by the Council of Europe (European Treaty Series – No. 124).

organization must have a membership[23]; while a foundation is required to have property dedicated to a specific purpose. [24]. Based on the rationale of the current Hungarian legislation, none of these forms are adequate when one or a few founder(s) want(s) to work toward a community or social purpose, in person and without the aim of making profit. However, the majority of Hungarian nonprofit organizations are established with this purpose – currently as associations [25], foundations and, in a smaller scale, public benefit companies.

We should take a closer look at the public benefit company, in order to determine whether it can really fulfill the above role. The public benefit company is basically a nonprofit business organization. It is the only nonprofit organization that can pursue a commercial activity as its core activity to promote its public benefit purpose.[26] Profits derived from the public benefit company's activities may not be distributed among its members. Its founding members are also the main decision-makers. The size of its initial capital corresponds to that of the limited-liability company (HUF 3 million), and its (financial) management and accounting requirements are similar to those of business enterprises. Based on the above, although suitable for the private provision of public services, the public benefit company does not fit the purpose of the civil nonprofit organization, whose primary activities are non-commercial (such as grantmaking, service provision for marginalized groups, advocacy, community development, scientific, etc.)

In fact, a separate legal form[27], explicitly structured to fulfill a non-membership-based program implementation role exists only in the common law tradition. The European civil law basically operates only with the association and foundation forms. However, in most European countries, associations can be founded by 2-3 people as well, allowing for small membership-based program implementation organizational operation, while the regulation of foundations does not inhibit their program implementing nature – unlike in the Hungarian system, through curtailing the founder's scope of authority (see below). Therefore in most civil law countries, the two traditional nonprofit legal forms are able to provide for the program-implementing role.

A number of the recommendations made in this paper – such as decreasing the number of founders required for an association or, as regards foundations, redefining the competences of the founder and the boards of the foundation – are aimed at correcting the deficiencies described above.

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[23] According to Civil Code Article 61 "An association is a voluntarily established self-governmental organization, founded with a specific purpose laid down in its founding document, has a registered membership and organizes the activities of its members with the aim of achieving its purpose."

[24] See also Item III.2.1.

[25] Although they are established on a membership basis, they are in fact not aiming at extending their membership. In many cases, they even find maintaining an assembly of 10 members problematic; nevertheless they work effectively in fulfilling their mission.

[26] Here, the term "public benefit activity" is defined differently by the Civil Code than by the Public Benefit Law; therefore the definition needs to be clarified. ("Public benefit activity" in this case is defined as: serving the collective needs of society without pursuing profit or wealth.)

[27] Such as the nonprofit corporation and the public charity, a public benefit legal form complying with section 501 (c) (3) of the Internal Revenue Code in the U.S.

III. 2. Promoting the „capitalization" of the civil sector and restructuring the regulation of foundations

III.2.1. The re-assessment of the competences of founders in the case of foundations

According to Hungarian law, foundations may only be established with a long-term public purpose and with sufficient property dedicated to this purpose. (Civil Code, 74/A) The purpose is determined by the founder(s); the utilization of the property is decided upon by the governing body (Board of Trustees). Founders may not have a conclusive vote on how the property is used. Thus, in the Hungarian law the role of foundations is – theoretically – the re-distribution of wealth, as they assign private funds to public purposes.

The Hungarian regulation on foundations is based on unrealistic assumptions and causes major structural problems in the development of organizations.

In reality, in the vast majority of the cases, we have to differentiate between the "intellectual founders" and the official "property assigning" founders: the latter are asked to undertake this task by the real founders. In most cases, when starting a foundation in Hungary, the enthusiastic founder(s) coming up with the idea of the foundation, cannot be the legal founder(s) because they would lose their influence over it, although the functioning and the future of the foundation may depend on them. Therefore, the actual founders are trying to get around this: they have to find somebody, a "friend" or a "supporter", willing to undertake the legal role of the founder. Often, the initial capital is not provided by the legal founder either: the real founder raises (collects) the funds and a significant part of the foundation's assets is accrued only after it started its operations.

The real function of foundations is generally program implementation as opposed to re-distribution (grant-making) and the actual founders usually want to participate in the implementation of programs, because *they* invented and gave their "heart and soul" to the mission of the organization. Also, it is a typical and unfortunate situation that once official legal founders – who are, at first, only "outsiders" – become aware of their power to dispose over the assets of the foundation that, in the meantime have grown considerably, initiate the recall of the Board.

A similar problem is that according to the law, while founders may not participate in decision making on the operative level, they are entitled to key powers such as changing the founding document and designation or withdrawal of the members of the governing body (Board of Trustees) during their lifetime. This results in an awkward situation where, on the one hand, the foundation depends on the founder organizationally; on the other hand, the founder has no real influence on the organization's affairs and can exercise his or her competences only afterwards,

in a reactive way. Therefore the Hungarian regulation not only creates an unrealistic situation at the start up of the organization but also generates a potential source of conflict for the entire duration of its operation.

The practice of limiting the founder's power

The source of this practice is a legal principle by which the founder shall not have decisive influence on the operation of the foundation. This is also stipulated by law (Civil Code 74/C (3)) and, according to the opinion of the Supreme Court, it is necessary in order to "prevent that the founder disposes of any sum that may possibly result in tax preferences for the benefit of the founder".[28]

This reasoning may be true for "classical" foundations, i.e. those having real initial property[29]; but it has failed to suit the structural needs of civil organizations emerging after the change of the regime in Hungary.

In Hungary, there are no legal or practical distinctions between the re-distribution, support – i.e. grant-making – or program implementation functions of foundations. Here, this legal form is not conditioned to an endowment, whose principal is protected and whose income (interest or revenue) may be used for the achievement of a specific purpose. At the time of the political changes, when legislation on foundations has been developed, this was perfectly appropriate, as capital available for use as permanent principal for grant-making foundations was lacking in Hungary.

Thus, the above legislative principle as a condition may be justifiable only in those cases when the founder allocates a substantial initial capital to the foundation and, as the principal bears interest, the property, for a long time, serves the public purposes of the foundation – and the founder receives tax preferences in return. This regulation, however, becomes irrelevant for foundations where the founder provides only a fraction of the future property at the time of the start up, and even that can be used up for the purposes of the foundation within a short time. Furthermore, the tax preference itself is also questionable; it is not accidental that the word "possible" has been used in the text of law. In Hungary, the level of tax

[28]Opinion No.2 of the Public Administration College: "The governing body (organization) is the decision-making, executive and representative organ of the foundation. This means that the governing body (board of trustees) manages the property of the foundation in accordance with and in the interest of the foundation's purpose, and on its behalf, against the authorities and third parties. These tasks cannot be performed by the founder, as the basic principle would be violated, according to which the founder shall not dispose of the property – that may entitle him or her to possible tax preferences – neither exclusively nor in a way that he or she, directly or indirectly, plays a significant role in making a decision about the foundation's property."

[29] However, recent international studies consider "classical" foundations as outdated, and define the future role of foundation as more active and entrepreneurial, in contrast to the traditional "fund allocation" function. See Helmut Anheier (2001). In Holland, assets are not included any longer among the key conceptual elements of the foundation, bringing it closer to the common law system. In Eastern Europe, the Ukraine and Croatia will be the first to adopt this type of regulation. In the Hungarian context, it is worth to think about why legislation is not concerned about the influence of the founder, for example, in the case of public benefit companies established with a – relatively – significant capital, which, if privately founded, perform public tasks from private money, similarly to foundations.

preferences are rather insignificant (see Item III.8) and only donations given to existing foundations can be the subject of tax allowances; the establishment of a foundation is not compensated for by any separate tax benefits.

III.2.2. Redefining the roles and responsibilities of the founder and the governing body

In light of the above, the roles and responsibilities of founders and the governing body (board of trustees) should be redefined.

Based on the assumption that the foundation should be enabled to function as a program implementing organization – and also as a traditional foundation – **its founder should be allowed to actively participate in the work of the foundation** or even have a decisive influence over it.

In the common law system – just as in the case of the European program implementing foundations – the founder(s) may serve as board member(s), leader(s) or chair(s) as well, since here there is no conflict of interest regarding the property provided by the founder.[30] Indeed, the other type of regulation, which does not allow founders to dispose of the property because they have provided it for a public purpose and may have received (real) tax preferences through them, also exists in Europe. This, however, affects mostly grant-making foundations. Wherever the continental law distinguishes between private (e.g. family) purpose and public purpose foundations (both privately founded) that is what determines how much influence the founder may have on the use of the property.[31]

Another widely used rule is that after the foundation has been set up, the governing body (board) becomes the highest decision making organ. In this way, similarly to the general assembly of associations, a collective leadership can be achieved that is beyond any individual interests and thus can control the self-interests of founders. **Founders designate only the initial governing body, afterwards the governing body itself decides upon the selection and expulsion of its members**. Members of the governing body exercise the founder's competences in other matters, too (e.g. changing the founding document). In this way the founder's undesirable influence is restrained, the foundation will not be dependent on the founder during its entire existence.

Naturally, it can happen – and, in fact, it should be expected – that a founder, through board members he or she selected (or in case there are more than one founders, they together) exercise(s) significant influence on the organization. This alone, however, is not a problem; actually, it is a common practice in Hungary and

[30] Nonetheless, this system has its drawbacks, too. One of these is the so-called *'founders' syndrome* when founders do not want to let go of the leadership of the organization even when it is mature for it.

[31] Although in the Hungarian judicial practice the term "long-term public purpose" is interpreted in a rather broad sense, we suggest that Hungarian legislators consider the introduction of the family type non-public-interest foundation. This would allow for the fulfillment of the right of disposal over property. It should also be noted that family foundations are usually not granted full tax-exemption.

everywhere else. It becomes a source of a problem only if the founder acquires unfair advantages as a result, which can be avoided through **adequate conflict-of-interest regulations**. In addition, experience shows that founders are losing their significant influence after the first years – exactly because they don't have an exclusive lifelong right to select the members of the governing body.

III.2.3. Encouraging the establishment of endowed grantmaking foundations

The program implementing nature of foundations does not rule out the "classical" grantmaking function. **Legal distinction between grantmaking and program implementing foundations** is a common practice in the civil law tradition, too; e.g. in order to establish a grantmaking foundation, a minimum size of capital must be invested.[32] Increasing the number and role of grantmaking private foundations would be beneficial in Hungary, as well. Therefore, we believe that these organizations should be subject to separate regulations within the legal form of the foundation.

Grantmaking private foundations have an important role in a democratic society.[33] Unfortunately, there are practically no foundations that currently conform this ideal type in Hungary. Most of the few private grantmaking foundations that do function are lacking the size of principal capital endowment necessary for their sustainability. These grantmaking foundations may not use up their endowment; and they are required to use its income to support their target areas in the form of grants. An incentive scheme promoting the capitalization of foundations would help existing foundations as well as those to be started in the future to set up and develop an endowment.

[32] This solution has been chosen by the Czech Republic and Slovakia as well.
[33] For more details see framed section and surveys referred to in our Bibliography.

Why do endowed grantmaking private foundations play an important role?[34]

Private foundations, in the classic sense, have already started to appear in Hungary, although their number is not yet significant. Over the past decade a number of grantmaking foundations have been established introducing the culture of cause-related, professional and politically independent philanthropy in Hungary. Some were started partly from foreign support, while others used entirely Hungarian resources. A number of surveys have been made recently to examine their roles.[35] Findings show that even though there are not many of them, and the size of their grant facilities is considerably smaller than the amount of state subsidies, these foundations have key values that are crucial to the future of the sector.

In Hungary state support of nonprofit organizations has grown significantly, however, the level of the non-state resources stagnates, their proportion is declining.[36] State support is an adequate financing means for only certain segments the sector.

Government, both on the national and local levels, concentrates mostly on large service provision and umbrella organizations and the sector's state financing is heavily political. Innovative programs or providers of alternative services are not typically those receiving budgetary support. Although in a different arrangement but the National Civil Fund also means dependence from the state budget; while by itself it does not provide an adequate solution as to the sustainability of small local organizations. In addition, there are certain civil organizational goals and activities for which state support is simply not desirable – e.g. community collaboration, protection of rights, advocacy or lobbying.

To date, there are practically no independent and sustainable grantmaking organizations, national or local, in Hungary which,, by responding to the above needs, would ease the dependence of organizations from the central or local governments. Grantmaking endowed foundations could be the solution to fill in this gap. ***These foundations embody the redistribution principle in the private sector and allow for long-term support of issues important to the public or society.***

In this role, they have multiple advantages to the state type of redistribution, resulting from their special characteristics: they are independent – in the political, professional and financial senses; they are sustainable, through their invested endowment; they are serving the real needs of the sector on the long run; they are flexible; and they promote the integral development of civil organizations operating in the supported field. As opposed to the common belief in Hungary, these foundations are generally not "Soroses" or "Rockefellers" but local or regional foundations of private individuals, businesses or communities who want to do something good for a specific area.

[34] See Bullain et al (2003), pp 5-7.
[35] See e.g. Török, M. – Farkas, I. (2003), Thomas, N.R. (2002)
[36] According to the 2002 Report of the Central Statistical Office, state subsidy constitutes nearly 40% of the sectors revenues. Central Statistical Office KSH (2004). Furthermore, on the basis of the first release of KSH on year 2003, this has reached even 42%.

Therefore we recommend that the endowment, as an optional form, should be regulated separately within the legal form of foundation. The idea behind this is that in case the founder undertakes, in the founding document, to invest funds – a minimum size of which could be determined – as principal, and to distribute its income annually as grants, the foundation should be given special preferences. Basically, there could be two types of preferences:

a.) in the case of endowments and funds donated to the endowment, the founder, or the donor, would get greater tax benefits; and

b.) income from the principal of an endowment would be tax exempt not only if it is invested in government papers but also (partly or entirely) in money market or security investment funds. The latter is necessary so that the principal preserves its real value on the long run.[37]

Further detailed regulation on foundations should naturally be created such as regulations regarding conflict of interest, risk management and competences.

III.3. Simplifying the operation of civil organizations

III.3.1. Making registration procedures more uniform and simpler

In order to fully implement the freedom of association, it is essential that **the establishment of civil nonprofit organizations become simple and free of bureaucracy, and the registration authority do not interfere with the internal autonomy of an organization**.

At present, partly due to provisions of the law and partly as a result of prevailing judicial practice, these conditions are not entirely fulfilled. Although registration procedures have become slightly simpler since the 2001 changes in the Civil Code, the vast majority of founding documents is still being returned by the Courts for completion. When requesting completion of documentation, Courts often demand concrete bylaws (e.g. the obligation of electing the management or details of membership admission procedures) also from non-public-benefit associations, even though the law does not require this. Also, rather than expressing their concerns, they sometimes practically "dictate" their preferred version of the text at the hearing.[38] By making the regulation of court procedure stricter, Courts should be required to specify, **in a written decree, all items to be submitted for completion as prescribed by law, on a single occasion.**

[37] See Item.III.8.
[38] Bíró (2002) p. 99; interviews conducted for the purposes of this study.

Also, it would be useful to introduce a guide to the **founding document** in case of the establishment of civil nonprofit organizations, on the example of the sample contract in the new concept of the Corporate Procedures Act.

It would be effective to introduce a guide to founding charter, of statutes at the foundation of civil nonprofit organizations, similarly to the sample of contract formulated in the new concept of trade registration. The guide would serve as a kind of framework, that is, it would not contain substansive regulations, it would only determine what an organization has to regulate. (It could be a more detailed version of the already existing form of registration request.) With the help of this, the now quite diversified conditions required for registration could be more unified, as well.

Therefore we suggest:

a.) on the on hand, codifying the registration requirements of Courts that have been commonly accepted and practically considered as legal rules;

b.) on the other hand, explicitly identifying, within the framework of the Law on Association and the Civil Code, the scope of authority of the court of registration (or from the other perspective, the boundaries of organizational autonomy); and finally

c.) creating a guiding document involving a simpler registration procedure.

III.3.2. Differentiation in management rules by size of civil nonprofit organizations

One of the basic needs regarding the functioning of civil organizations is the differentiation of financial management rules according to their sizes. As indicated by Central Statistical Office data, in 2002, forty-five per cent of organizations had budgets below HUF 500,000 (about EUR 2,000 / USD 2,400) and only five per cent of them had budgets above HUF 30 million (about EUR 120,000 / USD 143,000).[39] Differentiation would be an important step in order to improve the effectiveness of their operation and could be developed alongside the NOSZA recommendations. In the case of small organizations, the removal or simplification of redundant procedural rules could also reduce over-regulation.[40]

a.) „The majority of civil nonprofit organizations will never incur taxable disbursements as they neither have employees nor employ private individuals on a commission basis. (This is also recognized by the social security registration system. Upon registration, nonprofits practically automatically get exemption from the liability to provide information on a monthly basis.) Likewise, most of them will never be the subjects of local business, communal, building or motor vehicle taxes.

[39] Central Statistical Office (2004) p.14.
[40] E.g. requiring a simplified accounting policy.

It is quite typical that, as civil nonprofit organizations are usually unaware of such obligations, they fulfill them only subsequently, when they need a certificate verifying that they have no public debts. Therefore, it would be practical to **link social security and local business tax registration obligations and the related regular administrative obligations to such activities in connection with which social security or local business tax obligations may incur.**

b.) The Accounting Law stipulates that registered nonprofit organizations shall define their *accounting policy* within 90 days upon receipt of the court decision. This includes the reporting and the accounting methods of the organization, and either common or separate regulations regarding the order of management of funds, inventory, valuation method of assets and liabilities and cost-accounting.

In the case of small organizations constituting the vast majority of civil nonprofit organizations, this is provision is considered as over-regulation, and there is no need to keep it in force. **Changes should be made to the Accounting Law in order to relieve small organizations operating under a specific level of annual income of the above obligations**

c.) As regards the **reporting, bookkeeping and auditing obligations** of civil nonprofit organizations, the law currently assumes a HUF 50 million (about EUR 200,000 / USD 238,000) annual income as a basis for differentiation. This should be complemented by a special **threshold of HUF 1 million (about EUR 4,000 / USD 4,800), applicable only to civil nonprofit organizations**. Thus, besides a differentiation encompassing just a few percent of civil nonprofit organizations setting strict requirements, the law will encompass one-half or two-third of them with a differentiation through simplified criteria. This sort of legal solution would make sense, but only if it specified such requirements that small organizations could comply with and that could promote their lawful operation."[41]

In addition to the treshold of incomes and expenses, the number of employees or their existence could also form the basis for the differentiation to be determined in the Accounting Law and other tax laws. If the organization has employees – even if they are only part-time ones– it will have more administrative commitments by definition due to social security obligations. Similarly to the regulation on for-profit partnerships, it is possible to determine several conditions, out of which two have to be fulfilled to draw on the benefit. Another possibility is to link the simplification to the all-time limit of some other benefit to be able to keep up the real value. Nevertheless, it is essential to lay down as a principle that an organization that has not received public benefit status should not apply simplified rules.

[41] Based on Bíró (2002) p. 153.

III. 4. Redefining the relationship between civil organizations and government

III.4.1. Clarifying the legal status of civil and quasi-state nonprofit organizations

In the period since the political changes, legislation on nonprofit institutions under public and private law has not been clearly distinguished. On the one hand, this has resulted in a disadvantageous position for private law organizations as most of the resources went to public foundations and public benefit companies. On the other hand, the management of organizations established under public law has slipped out of state budgetary supervision.[42]

Even though these two sectors (or in other instances, the for-profit and nonprofit sectors) are intertwined in many European countries as well, the tendency is to separate and develop partnership based collaboration between them.

We recommend that a **clear distinction be made between the legal status of civil (non-governmental) nonprofit organizations under private law and the legal status of organizations established under public law**.

Differentiation could be based on three aspects:

a) founder,

b) composition of resources,

c) composition of governing body.

The most precise way to define the legal status would be a combination of these three aspects but this would be rather complex and problematic and there would always be exceptions. Therefore, we suggest that the founder as the most basic aspect, and the easiest to evaluate, be considered as the basis of differentiation; this would also be in line with the definition of the civil nonprofit organization (an independent and self-governmental organization).

In this way, nonprofit organizations founded by budgetary organs, such as public foundations, public chambers (public law associations) and public benefit companies founded by the government would classify as budgetary organs, while privately established public benefit companies would continue to enjoy the protection of the freedoms of association and partnership under private law. Public benefit criteria and related tax benefits should be re-designed accordingly.

[42] State Audit Office (2002)

Further, we recommend that individual donors and grant-makers, such as the National Civil Fund or ministries should not exclude privately founded public benefit organizations by definition from tender possibilities for civil organizations.

III.4.2. Distinguishing between support and contractual types of funding

Government rhetoric has already adopted the term "partnership" in the context of the civil sector. But its mentality still reflects a very strong paternalistic and hierarchic attitude toward civil organizations. As an illustrative example, both legislation and ministries use the word "subsidy"/ "support" in terms of state funding for nonprofit organizations, and they do so uniformly, without any differentiation and regardless of the content of the funding relationship.

Literature identifies two basic forms of state funding for civil organizations:

a.) subsidy /support and

b.) procurement /contract.[43]

Subsidies/supports may be allocated on the basis of decisions (stipulated by law or individual) or through open grant competition. (Based on the principles of transparent and responsible utilization of tax money, the internationally preferred way of subsidizing is open grant competition.) In this case, **the state is seeking other parties to implement a government policy** that are able to execute a particular project with greater flexibility, at lower costs and at higher standards as compared with the state institutional system.

In case of such grant support, the goal is given (coincides with the government program or policy; e.g. re-training unemployed women in a specific region or reducing the number of addiction victims in a particular county). However, the state leaves to the applicants to choose the concrete means or methods of implementation. State subsidies can be allocated to several projects aimed at the same purpose. In fact, due to the complexity of problems, a single project is usually not sufficient to achieve the goal. In Hungary, ministries and funds or public foundations operating under the supervision of ministries are regularly involved in such tendering.

In contrast, the *procurement/contracting* form is used to fund **public services rather than government programs**.[44] Instead of a particular program or project goal, here a specific need in a particular area must be addressed. Thus the state knows (more or less) exactly what to do and how to do it – moreover, it sets the standards to define the parameters of the services to be provided. In this case, the

[43] See e.g. Newman (2000)

[44] Anheier et al. (1997) here distinguish a third category, the so-called third party payment, an example of which is the Hungarian normative support.

objective of state financing is that the particular service should be provided at the highest standards and the lowest costs possible. In order to achieve this objective, it uses a non-state provider, also selected through competition. This type of financing is practically identical to public procurement (i.e. purchasing services). The only difference is that, being a public service for which the state is ultimately responsible, it does not fall within the scope of the public procurement law.

In Hungary, ministries and funds or public foundations operating under the supervision of ministries conduct grant competitions aiming at the implementation of state policy while public services to be provided by the state by virtue of the law are mainly funded through normative support or, in some cases, through a public benefit contract. Nevertheless, they are also considered by the central budget as subsidy type support. Furthermore, the purposes, principles, motives, criteria and methods of the different support types are neither systematic nor regulated. One of the key tasks would be to "comb out" or to conceptually and technically reframe the state funding system. This process has now started, in the context of grant support, but on the one hand it uses the existing "system without a system" as a starting point, on the other hand it is only a partial solution.

We recommend restructuring the state financing system in a way so that the Central Budget Law **would provide a coherent system to fund public services, in line with the public procurement system (essentially "contracting out").** Furthermore, it should be distinguished from the funding of state tasks that are only periodically prescribed by law (government policy implementation) [45]. In the case of the latter, the goal is to **develop a more uniform and transparent tendering system**.[46]

Furthermore, it is worth considering that the procurement of public services based on competition should be made obligatory by the legislator.[47] For instance, in case of local social services financed out of central normative, the local governments would have to tender the service on a regular basis. This could limit the practice of the local government providing the service automatically through its own provider- system, irrespectively of its professional standards, economic results or the satisfaction of users.

[45] In fact, models that fully satisfy both the sector and the state are not easy to develop. For example, in a completely liberal system, the category „targeted support" would not exist, and that would meet with strong opposition by a number of players within the sector. On the other hand, standardizing the procurement of services would impose unwelcome burden on the state and, particularly, on local governments (as it has happened in Poland). Increasing resource automatisms, considered as desirable in the "NOSZA" publication (Bíró, 2002), would point toward a more corporative system, although both parties could be satisfied this way.

[46] An initiative for a more uniform, transparent and "civil friendly" grant competition scheme has already been made within the EU as well, by the European Social Platform. See http://www.socialplatform.org/code/en/hp.asp

[47] This principle prevails the most in the United Kingdom, and as for the Central and Eastern European states, Poland has accepted a similar regulation in 2003.

The changes in the relationship between the state and the civil nonprofit organizations are closely related to a desirable vision.[48] According to the current tendency, we are moving towards a kind of a corporative model (e.g. Germany). In this scheme, service provision organizations integrate into the welfare system and become state funded, while private foundations aimed at the re-distribution of wealth do not play a significant role. The public foundation system, if survives, is likely to follow the state-oriented French model where the scope of action of non-government established foundations is rather limited. As opposed to the above models, we recommend to shift toward a social-democratic and/or liberal model. In both of these, the independent nonprofit service provision and the re-distribution functions are given more emphasis than in the corporative and the state models. Under these systems services are funded on a competitive basis (i.e. not automatically as in the corporative system, but in line with performance) and organizations are more free of state influence.

The vision can also serve as a compass when defining the preferred level of subsidies. There are significant differences in the practices of European countries in terms of subsidy. In the Scandinavian countries (social-democratic model) the level of state funding, in relation to the sector's total revenues, is slightly above 20%, in the liberal England 40% whereas in Germany, due to subsidiarity and corporative functioning, its proportion is over 70%.

III. 5. Extending the legal framework of participatory democracy

The framework of participatory democracy shall secure for everyone the opportunity to take part in the decisions that affect them. In relation to civil organizations, such opportunity must be interpreted in a narrower sense. Civil organizations may not be the subjects of the direct forms of representational democracy (e.g. they may not participate in a referendum). Nonetheless, in nearly all forms of participation based on the reason of "being affected" rather than on civic liberties, civil organizations can play significant roles.

In international practice, there are several approaches to define participatory rights: the Aarhus Treaty [49] mentions the right of access to information, decision-making and justice as the cornerstones of participatory democracy. ICNL, in its comparative research distinguishes between legal, policy-level and institutional instruments of information, consultation and active participation[50].

Current legislation is not systematic in this area. While there are already a number of positive elements in the legal system and yet others could be introduced through the adoption of the new Act on Legislation, the participation of civil organizations in national and local decision-making processes – aside from legislation only – remains unsettled.

[48] See attached report and diagram on third sector models.
[49] UN (1998)
[50] ICNL (2003) 1.

In addition, the current practice is restrictive in terms of how the possibilities provided by regulations are interpreted. In ministries, for example, participation in branch policy making is either closed to the public or restricted on a representative basis. Institutionalized interest representation is becoming more widespread in Hungary; however it may be more effective to represent issues and social groups within a transparent and competitive representation framework (such as advocacy and professional lobbying) than in the centralized institutionalized form. It also remains unclear how it could be ensured that decision makers, at all levels and within reasonable limits, actually take into consideration the recommendations made during such participatory processes (as the related procedural rules and sanctions are missing).

To this end, the principles furthering participatory democracy – publicity, accessibility, right to legal remedy – should be embodied to the greatest extent in relevant laws, draft legislation and conceptual drafts as well. Recommendations for amendments in this direction have been made for example to the Bill of Legislation on many instances. Some of these are [51]:

a.) the ministry preparing the law should assess each opinion they receive and should not prevent any parties – for the reason of not being affected – from exercising their right to express their opinion.

b.) The law shall declare that draft laws are considered public data, thus ensuring the enforceability of publicity in case of any default.

c.) Summaries of opinions should also be publicized and made available on the Web sites of ministries.

d.) In the case of comprehensive regulation, representatives of organizations submitting an opinion should be invited to the expert committee meeting.

e.) Minutes of the Parliamentary committees should be made available on the Web site of the Parliament or that of the particular committees.

In addition, it is also necessary to clarify in the Data Protection Law the definition of public data. The Constitutional Court has recently ruled that classifying so-called "internal preparatory material" as confidential is unconstitutional, which also justifies the necessity of this classification.[52] Furthermore, the Act on Local Governments and other legislation should be reviewed and appropriate recommendations should be made to make sure that these principles are being considered in decision-making on the local level as well.

Specifically, we are proposing the introduction of the „client status"[53] that has been granted for environmental civil organizations in the law on environment into

[51] TASZ (2003)
[52] Resolution 12/2004 (IV. 7.) AB of the Constitutionality Court
[53] Act LIII of 1995 98. § (1)

the procedural regulations of other legal territories, such as of regional development, health, social service and equal opportunities.

It is also important that non-legislative means and institutions be reviewed in terms of participation and that the government encourage the implementation of such recommendations (e.g. changes in the house rules of the Parliament to allow introduction of the institution of public hearing).

III.6. Making the public benefit status more functional

III.6.1. Clarifying the purpose of public benefit regulation

In Hungary, the purpose of regulating the public benefit status has been to develop a state system of preferences based on uniform criteria. Basically, it was intended to regulate indirect state support – however, its creators also expected that the public benefit status, by ensuring greater transparency, would make nonprofit organizations more attractive for donors. This is reflected by the rule that conditions preferences on public purpose donations to the public benefit status. The most significant preferences within this scheme have been those available to corporate donors.[54]

A recent impact analysis showed that the law has not lived up to the expectations in terms of resource mobilization: the number of the donors of public benefit organizations has not increased substantially.[55] Instead, if an organization has public benefit or prominently public benefit status, today it is regarded more as a prestige by both state organs and the general public.

Therefore, the real purpose of the public benefit regulation should be reconsidered. Based on Western European examples such regulation only has to guarantee that preferences granted by the state are conditioned to criteria that can be generally accounted for.[56]. Thus, the law is not necessarily aimed at extending the range of donors – as opposed to the intention of the "one percent" regulation. Instead, it should ensure that donors are given tax preferences only if the supported organization complies with certain rules. Perhaps, besides extending tax preferences on individual donations, we "just have to wait" until the culture of giving "catches up" with the law and becomes more widespread. Then it will really matter (in statistical terms, as well) whether an organization can issue a tax

[54] Tax credits on individual donations are insignificant (see Item III.8); and several other tax incentives are also irrelevant in the context of resource mobilization.
[55] Prime Minister's Office (2003) 2.
[56] Except for, in many cases, tax-exemption of core activities.

certificate or not. Furthermore, in this case donors themselves will "force" organizations to operate in a more transparent way.

On the other hand, we suggest for consideration whether the public benefit status should be seen as preferred or even made a prerequisite for certain types of direct support. This is especially true when the allocation of funds is not subject to consideration within a grant competition, such as direct operational subsidies and normative support. In these cases, it is particularly important that tax money goes to organizations operating in a fairly transparent way.[57]

III.6.2. Re-defining the content of the public benefit regulation

There seems to be a consensus that the public benefit status has failed to preserve its real content, setting only formal criteria to be met at the time of obtaining it while the continuing fulfillment of these requirements is not guaranteed by the law.

Therefore, it should be ensured that the public benefit status is given real content. Currently, for example, the public nature of the public benefit report is not secured. An amendment – in force since 2004 – stating that public benefit organizations are required to publish their public benefit report on their Web sites by June 30, every year, is already a step forward. However, it does not specify the consequences of non-compliance. Therefore consideration should be given to the adoption of stricter regulations such as the requirement of depositing the public benefit report with the prosecutor's office (to be inspected annually). Failure to do so would initiate a process that could result in the withdrawal of the status.

A more explicit regulation, namely the assessment of the real activities of organizations, would require a further supervisory mechanism the costs of which may not be justifiable.

A more detailed formulation of the content of public benefit meaning would be necessary.[58] Civil organizations and the Treasury interpret legal regulations differently,[59] and due to this some fall from significant funds.

Examples of a higher category status similar to the prominently public benefit classification can be found in other countries as well. In Hungary, however, it is not clear why a specific organization may obtain this status. It is important to clarify, according to the recommendations of the NOSZA publication, what the "provision of public service" means in the context of the public benefit status.[60]

[57] Because in a grant competition, organizations can be evaluated in this respect as well.
[58] The most frequent formal mistake in the 2004 calls for proposals of the NCF was the inadequate content of the public benefit reports.
[59] Act CLVI of 1997. 19§ (3)
[60] Whether it needs to be prescribed by law or could also be granted upon single decisions; whether an organization should provide such services in full or can they be only "sub-contractors" etc.

In the lack of such clarification, the relevance of maintaining two levels of public benefit may be questioned.

It also needs to be clarified at the legislative level, whether the public benefit contract should be a prerequisite for the prominently public benefit status. Although courts tend to interpret it this way, in our opinion this has not been the intention of the lawmakers.

Another important aspect to be considered is that if other regulations remove non-civil nonprofit organizations – public foundations, public law associations/ public chambers or state founded public benefit companies – from the scope of legislation of nonprofit organizations, defining them within the state institutional system, would public benefit regulations apply in fact exclusively to civil organizations?

Finally, the varied terminology regarding "public benefit" used extensively in current legislation should be defined uniformly according to the recommendations by NOSZA.[61]

[61] Bíró (2002) p. 149

III.7. Furthering civil nonprofit organizations' participation in economic transactions

Revenues coming from core and business activities constitute a major source of income of an independent civil nonprofit sector. To this end, participation of civil nonprofit organizations in economic operations must be promoted; above all, obstacles due to the current practice of the implementation of the law should be removed.

III.7.1. Uniform interpretation of entrepreneurial activities by those administering the laws

The **interpretation of entrepreneurial activities** is rather problematic in terms of interpretation and implementation of the law. According to the NOSZA recommendations, uniform interpretation should be achieved by developing guidelines to facilitate the implementation of the law, rather than introducing additional substantial regulations.

"The reason why it is important to define the legal characteristics of entrepreneurial activities of civil nonprofit organizations is to avoid that the profitability, proceeds, turnover and expenditures of their core activities or their use of "sub-contractors" are taken as a basis for making wrong legal conclusions. This requires an interpretation of core and business activities of civil nonprofit organizations based on various aspects."[62]

In international practice, such aspects aimed at classifying entrepreneurial activities are e.g.:

a.) what are the organization's related and unrelated economic activities (i.e. what are the economic activities necessary for the accomplishment of the mission and what are those entirely independent from it);

b.) what activities are aimed at fundraising and resource mobilization (e.g. charity gala event);

c.) what is the relation between core activities and entrepreneurial activities in terms of economic volume (the latter is marginal/complementary or significant/dominant within the organization's revenues);

d.) does the entrepreneurial activity have a concealed purpose (e.g. private interest use of public purpose assets or concealed business enterprise) and how that can be proved;

[62] Bíró (2002) p. 154.

e.) what are the civil nonprofit organization's reasonable economic interests (e.g. financial investment of temporarily liquid assets).

"Once again, we would like to emphasize that in order to make the regulation of entrepreneurial activities of civil nonprofit organizations more effective and more appropriate, in principle, we need qualification, monitoring, comparative and registration procedures, techniques and methods that can be applied to individual cases, rather than concrete substantive regulations (such as provisions specifying extent, amounts or ratios and prohibitions)"[63]

III.7.2. Special regulations aimed at recognizing and strengthening the economic power of civil nonprofit organizations

The role of the civil nonprofit sector in the economy has become more and more significant. According to Central Statistical Office data, the total revenues of the nonprofit sector, its contribution to the GDP and the number of full-time employees working in the sector have been continuously increasing over the past decade.[64] The European tendencies are similar as well. Furthermore, in the EU countries, parallel to the expansion of the sector's political influence, its economic importance is also expected to grow. Accordingly, an important goal should be to **create conditions that enable civil nonprofit organizations to optimize their revenues from both their related and unrelated economic activities.** On the hand, this would allow also for privately funded organizations to gain economic influence. On the other hand, it would create the basis for the business sector to look at civil organizations not only as recipients of donations but also as business partners or clients.

In order to achieve this objective, a great deal of regulations should be reviewed and possibly changed. One of these is the VAT Law where the range of VAT-exempt services and the possibility of VAT refund should be examined, with respect to the related Directive 6 of the EU[65]. The anomalies in the existing VAT regulation system should be singled out (e.g. by a more accurate specification of VAT-exempt services and activities classified in line with Section 13 of the Directive). Also, consideration should be given to the possibility of registering nonprofit organizations as so-called „target organizations" for supported employment, and to treat civil organizations equally with businesses in the Employment Concept, the preparation of which is currently under way.[66] Furthermore, it should be examined whether the acquisition of agricultural land by civil organizations should be made possible on the example of canonical legal persons; and what the effects of changes in customs regulations are (especially after joining the Schengen Agreement).

[63] Based on Bíró (2002) p. 154.
[64] Central Statistical Office (2002) pp. 30-32, 41 and (2004) pp. 15-16 and 37. Combined figures relating to civil and state founded nonprofit organizations.
[65] EU (1977). See e.g. such initiatives of Red Cross and other humanitarian organizations.
[66] See concept by Ministry of Employment and Labor.

Finally, special provisions should be made as regards organization providing credit facilities (and possibly other banking services as well) to nonprofit organizations. The introduction of endowments and the regulation of termination and liability of nonprofit organizations (see Section III.9) would also help preparing the way to make loans available to civil organizations, mainly to help overcome any (temporary) liquidity problems.

Tax preferences relating to entrepreneurial activities

In addition to the above recommendations[67], the possibility to raise tax preference levels of organizations pursuing entrepreneurial activities should be considered. This could even mean ***full tax exemption to income arising from entrepreneurial activities.*** *In our opinion, it would be preferable to develop a system of tax preferences within the boundaries of economic reality, which is in fact motivating and always corresponds to the current status of the central budget, while extreme demands should be objectively rejected.*

Here the key question is whether the alternatives of making business income tax-exempt and increasing tax preferences on private donations (see Item III.8.) rule out each other. If yes – e.g. because only one of them is reasonable from the perspective of the state budget – then we think that the latter, that is increasing tax benefits on private donations, would serve better the long-term interests of civil organizations. One reason for this is that the promotion of business income often diverts organizations from pursuing their non-profit-making core activities, whereas fundraising provides resources exactly for these core activities without restrictions on their use, as they are not linked to a specific project. However, a more important reason is that, according to international experience, full tax exemption on business activities can give way to significant abuse, for example, in the form of entrepreneurial nonprofit organizations established to avoid paying taxes. Furthermore, this is against the fundamental EU principle of fair competition meaning that the state shall not subsidize businesses. The fact that they are established by foundations need not be a reason for making an exception to this principle.

Therefore, while existing tax regulations are rather favorable (with upper limits on exemptions at 10 and 15%) and could be set as exemplary even in international comparison, making them even more moderate or perhaps granting full exemption would raise concerns since that would give businesses of nonprofit organizations a questionable advantage in market competition.

III.8. Furthering the societal support of civil organizations

The key indicator of the independence and social endorsement of civil organizations is their volume of donations from private citizens. Donations of private individuals are not only a resource opportunity but also a highly important

[67] Tax-exemption as a possible solution was considered e.g. by the Prime Minister's Office.

form of social participation. By giving part of their income to a civil organization, people express that the purpose this organization is working toward is in fact important to them, and that they are ready to devote their own resources to help achieve it. In this way, they participate in solving societal problems and declare their support for a particular organization. In Hungary, this kind of conscious philanthropic culture is not yet strong enough. In order to promote its development, the **level of tax-credit for individual donations should be increased or the system of tax preferences should be changed** (by making donations to be deductible from the tax base).

III.8.1. Tax allowances for donations by private individual

In Hungary, tax allowances on individual donations are strikingly low and there is a strong need for their reform. Hungary has opted for the less common (because less effective) tax preference type: the *tax credit* system, where the tax payable on the consolidated tax base is being reduced.[68] In Central and Eastern Europe, this system is used only in Hungary and Lithuania.

In most countries with progressive tax systems, the *tax-deduction* type of tax benefit is used as opposed to the *tax credit* type. This reduces the tax base itself. Research shows that the reason for this is that the *lower income population does not take tax implication into account when donating to nonprofit organizations;* and due to other regulations they are often unable to utilize this tax preference, anyway.[69]

However, various empirical data verifies that *higher income taxpayers are especially sensitive to the size of preferences decreasing the tax base;* and deduction from the tax base may result in more and larger donations than the tax credit type incentive.[70]

In most Western European countries, e.g. in Belgium, Germany or Spain, private individuals can typically deduct donations from their tax base up to 10% of their net income.

In terms of the Hungarian tax preference reform, there may be two alternatives:

a.) By keeping the existing form, the extent of preferences should be increased – i.e. more than only 30 per cent of the donation should be made deductible from the tax of the consolidated tax base, to an extent of considerably more than just HUF 50,000 to 100,000 (HUF 1 million has already been suggested, as well).

b.) The type of the tax preference should be changed. Instead of deducting it from the calculated tax, it should be made deductible from the tax base. In this way a tax preference system that corresponds to the most widely used form in Europe could be introduced in Hungary.

[68] ICNL (2003) 2.
[69] The most typical reason – in Hungary as well – for employees not using the tax benefits they are entitled to for their donations is that their tax returns are prepared by their employers.
[70] See Bullain (2003) p. 2.

Because of its greater impact on higher income population to donate, we suggest to adopt the latter.[71] Although tax allowances alone do not encourage philanthropy, they have a **significant influence in terms of how much people give and in what structure.**[72] In a society where the culture of giving has just begun to take shape, besides the size of tax preferences, it is also important to make the proper choice between their various types. Indeed, this change could be of particular significance if endowments were made possible to establish, as major capital donations are most likely to come from people with higher income.

Therefore, we recommend that, parallel to the introduction of endowments, the **establishing of such foundations be encouraged** as well. This would mean significant tax allowances, deductible from the tax base, to founders endowing a foundation. In Germany, for example, private individuals making an endowment can write off EUR 307,000 from their tax base, in installments and over up to 7 years.

Much depends on how the government is planning the forthcoming tax reform. Based on the Slovak and Polish experience, it must be kept in mind that a radical simplification of the tax system could lead to the abolishment of the majority of tax allowances. Even today, small enterprises choosing the simplified enterprise tax (EVA) are not entitled to tax preferences for donations and if the simplified personal income tax (ESZA) were introduced, the same would be true for private individuals as well.

III.8.2. One percent

Strategically there is a lot to be reconsidered in this area as well. The experience gained over the past 7-8 years shows that the "One Percent" Law has greatly contributed to the development of civil society in many respects (mainly, to the improvement of civil organizations' communication techniques) but its positive effect on philanthropy is still questionable. It certainly became clear, however, that Hungarian taxpayers are not particularly enthusiastic about giving away their money to *de facto* state institutions.[73] This is already a sufficient reason why state institutions should be removed from the range of beneficiaries. On the other hand, it should be noted that the future of this tax incentive scheme is closely linked to the debate on church funding. [74]

It also deserves consideration that in every country that adopted any form of the "one percent" concept based on the Hungarian model, tax preferences on donations have been either cancelled or attempts have been made to cancel them.

[71] Unfortunately, regulations limiting the recourse of tax benefits for those having higher incomes, have opposite effects.
[72] Id. Bullain (2003) p. 5.
[73] Whereas, for example, in Lithuania, preliminary surveys showed that the composition of beneficiaries will look very differently.
[74] According to a recent recommendation by the Alliance of Free Democrats, for example churches and civil organizations should compete for 2% of the taxpayer's taxes.

Thus, these countries regarded the "1 (or 2) %" as an alternative mechanism to donations. Although this threat does not seem to exist in Hungary, the tendency certainly calls for alertness as, in the long run, the sector benefits, financially and morally, more from the spread of the "traditional" way of donating – i.e. real philanthropy.

With great caution, and in spite of the fact that a new funding mechanism (National Civil Fund) has just been built on its bases, we would also indicate the "temporary" nature of the "One Percent" Law and suggest that this financing mechanism may soon become outdated.…[75]

However, a concrete problem will arise if pre-generated tax returns are in fact to be introduced. This will result in additional administration for the allocation of the "one percent" that, most probably, less people will undertake. We believe that making it the taxpayers' responsibility to transfer the amount of their donation themselves to the selected organization is not a liable alternative. [76]

III.8.3. Legal and policy-level recognition of voluntary activities

We believe it is essential that the Bill on Voluntary Activities be passed as soon as possible.* It is also important that, at the same time, relevant tax regulations be changed (e.g. relating to the reimbursement of costs of voluntary activities). This Bill is also significant as it will provide a legal basis for the various ministries to introduce regulations that recognize and encourage voluntary activities. These are, among others: voluntary activities that can be taken into account in the evaluation of students in secondary or higher education; recognition of voluntary activities of public employees and servants as work experience, in the assessment of their aptitude; professional recognition of voluntary services performed in social institutions etc.

[75] A number of international financial and nonprofit experts referred to the "one percent" system as "transitional form of philanthropy". See details in Bullain (2004) and at www.onepercent.hu.

[76] This method is used in the Polish version of the one percent law, where only a few percent of taxpayers used this possibility.

* By the time of the translation being published, this Law has been adopted. See English text at www.onkentes.hu or http://www.ecnl.org.hu/index.php?part=14news&nwid=34

III.9. Enhancing the transparency and accountability of civil organizations

As regards management, more transparency is needed in the accounting of larger organizations, especially on how they report their capital. Based on international examples, the restricted and unrestricted portions of the net worth should be accounted for separately. Today, the balance statement of a foundation does not indicate whether, e.g. out of its HUF 10 million net worth, 9 million comes from a grant for the implementation of a specific project and must be spent in the following year or whether the whole of their capital serves long-term grantmaking purposes.

Additional changes are necessary to ensure smoother operation, increased transparency and accountability of civil nonprofit organizations[77]. Recommendation for such modifications could be included in the same package.

Another question is the regulation, or to be more precise, non-regulation of the termination of organizations.[78] For instance, it is not specifically regulated what happens to the assets of the public benefit association in case of its termination. According to current regulations, members in theory could demand "shares" from the assets up to the amount of the paid-in membership fees. It is also doubtful whether a donor can step up as a creditor in case an association or foundation is terminated; and if so, out of two donors which one and to what degree may be paid from the remained assets. Provisions on the instances of termination, the determination of insolvency, the satisfaction of creditors and other related norms should be codified within either the Civil Code or in a separate act.

The method of legislative reform – do we need a "Nonprofit Code"?

In response to recent surveys focusing on the nonprofit sector and its legal environment, especially research conducted by NOSZA, the question whether nonprofit related regulation should be codified into a single comprehensive law emerged.[79]

The main purpose of a separate act integrating civil nonprofit organizations into a single system could be to promote the uniform implementation of legislation.[80] The systematic overview and the harmonization of the rules and regulations of particular nonprofit forms would help those administering the law, nonprofit organizations and legislators alike, for example, in the development of a system of benefits.

[77] E.g. the law currently requires the general assembly of an association to meet once in 5 years; we believe this should be changed to one meeting per year. The law also currently provides unlimited publicity to the internal operation of a PBO, which should be revised to allow reasonable limitations.
[78] Bíró (2002) p. 109.
[79] Bíró (2002) p. 144.
[80] As regards its content, it could regulate the definition and types of the civil nonprofit organization; the organization without legal personality; the common regulations of legal entity organizations; the separate regulations of the association, foundation and public benefit company; and the conditions of the public benefit status.

The regulation of these rules in the form of a code – similarly to those relating to business organizations – would probably also improve the sector's image and increase its prestige.

A number of potential disadvantages and counterarguments have also been expressed alongside the expected benefits of the legal theoretical systematization and a possible increase in prestige. Some of these are that the Code would isolate this legal area by "closing it in" and defining it in an introverted way, although it is the interest of organizations that regulations "permeate" other legal branches. Its opponents also say that the nonprofit legal area is still in development and changing, and it is not yet mature enough for consolidation. In addition, regardless of a separate code, there will always be key provisions that need to be defined within other laws, typically in tax laws, in the Central Budget Law and in the Act on Accounting; thus regulation pertaining to civil organizations could never be found in on place.

A single Nonprofit Code is not typical in Europe. Legislation on foundations and associations and the associated branches of law[81] have developed in separate ways. Only in the past decade have Europeans started to look at them as a single domain, as civil society. But even then, mainly in the context of political and, most recently, economic participation. At the same time, nonprofit organizations, regardless of their organizational forms, had been subject to certain tax preferences long before, and their special characteristics are generally taken into account in the various laws.[82]

In Eastern European countries, legislative concepts regarding the nonprofit area have been much more systematic. Here, there are many examples of legislation within a common system or even within a single act.[83]

As far as Hungary is concerned, an important aspect in the "code or no code" dilemma is to what extent do we want to consolidate the existing legislation and to what extent do we want to introduce new elements. The latter is probably easier to accomplish on a "piecemeal" basis, taking small steps at a time. Therefore, instead of creating a Code, we recommend: on the one hand, adopting a separate act on foundations; on the other hand, making the appropriate changes in existing laws (Civil Code, Law on Association, Public Benefit Law and Tax laws)

The present concept of the new Civil Code seems to be wanting to integrate the entire regulation of business organizations into the Code and this is in contradiction with the attempts to remove the regulation of nonprofit forms from its scope. Indeed, the harmonization of legislation could also be effected within the Civil Code, although theoretically we agree with the Codification Committee for the new Company Act suggesting that only the framework legislation should be built into the Civil Code. Another argument for separate acts is that unavoidable legislative changes would be easier to make in individual laws.[84]

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[81] E.g. canon law and cooperative law.

[82] The employment legislation is a good example for this, which, for example in Germany, includes provisions on volunteers without having a separate law on voluntary services.

[83] E.g. Bulgaria and the Baltic states. Currently, preparations are under way in Slovakia and in Slovenia to create their respective nonprofit codes. However, these are aimed at the reform of the entire regulation of the sector, rather than integrating the existing legislation and the prevailing practices of its implementation into a single system.

[84] Furthermore, it remains unclear whether it is possible or necessary to draw a line between the quasi-nonprofit and civil nonprofit forms in terms of organizational types. If harmonization is to be done within the Civil Code, it less likely that separate legislation could be adopted according to organizational types because public foundations, public law associations (public chambers) and public

BASED ON THE FINDINGS OF THIS PAPER, THE ABOVE RECOMMENDATIONS SHOULD BE IMPLEMENTED GRADUALLY, IN SEPARATE ACTS AND IN A NEW LAW ON FOUNDATIONS, RATHER THAN IN A SINGLE CODE.

I V. CIVIL SOCIETY OPINIONS ABOUT THE CIVIL VISION

The Civic-Partner Trust Program, while it has paid particular attention to the breadth of views already in the preparatory phase of the Civil Vision concept, put to debate the first relatively complete working paper in a national conference series. Discussions were held among the expert group, interested civil organizations and those administering regulations relating to civil organizations – such as cooperating staff of the county chief public prosecutor's offices, county courts, county offices of the Hungarian State Treasury and county directorates of the Tax and Financial Control Administration.

At the discussions, held in eighteen locations throughout the country between the end of September and the middle of November 2004, nearly 500 civil organizations got to know in detail the draft concept, and contributed to the final phrasing of its theoretical directions and concrete ideas by giving several hundreds of useful comments. The following – without striving for completeness – is a summary of the experiences of these conferences and the most common reflections of civil organizations.

A particular problem was reflected in the fact that, in the majority of cases, no prior contacts have been established between local officials and civil organizations, their relationship was restricted solely to official communication channels. However, the need for a broader relationship could be recognized even in such narrow point of contact. Another experience was that, in some of the conferences, officials administering the law have refused to attend the events.

- For the vast majority of civil organizations it has not been easy to shift their attention away from daily operational difficulties to conceptual issues of the sector's development. Consequently, most of the civil organizations requested help to manage financial and funding problems.

- Participating organizations considered it vitally important that while state funding continues to grow, dependence on the state should be reduced. In this context, participants most often referred to the National Civil Fund and the ambivalent opinions about it.

- A great part of the remarks and comments was concerned with the issue of the regulation of foundations. Present regulation is considered as difficult to comply with; therefore the idea of a legislative reform of foundations was unanimously welcomed.

- Participating civil organizations mentioned a number of concrete examples of selecting inadequate organizational types. Basically, it was a collective opinion

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benefit companies will continue to be part of the legislation (provided that they will not be abolished). Perhaps "civil" nonprofit organizations would be therefore easier to regulate in a separate law.

that existing organizational frameworks are not functional enough, supporting the idea that new organizational forms might need to be developed.

- A general expectation was that civil organizations should be differentiated by size in terms of administrative duties and obligations. However, due to the complexity of this issue, only a few specific suggestions were made.

- Participants particularly supported the proposed regulations aimed at simplifying the operation of civil organizations. Most often they mentioned financial and accounting burdens that can put at risk the achievement of their goals.

- The shortcomings of the current system of public benefit organizations have been brought to attention at practically every conference site. It was generally agreed that the public benefit status lost its meaning and generally failed to achieve its original and desired purpose. The main reason why organizations apply for the public benefit qualification is to be eligible to participate in tenders or receive subsidies.

- Civil organizations attending the conferences mentioned, at various levels, that opportunities to participate in local decision-making are scarce and there is a lack of partnership-based relations. Many of them, in fact, want to be given the opportunity to be actively involved in public services. However, they pointed out that the current rules and practices of overtaking public tasks do not at all support the effectiveness or the possible "contracting-out" of such services.

Key related legislation

Act IV of 1959 on the Civil Code of the Republic of Hungary

Act XI of 1987 on Legislation

Act II of 1989 on the Right of Association

Act LXXIV of 1992 on Value Added Tax.

Act XXXVIII of 1992 on the Central Budget

Act CXVII of 1995 on Personal Income Tax

Act LXXXI of 1996 on Corporate Tax and Dividend Tax

Act CXXVI of 1996 on the Use of a Specified Amount of the Personal Income Tax in Accordance with the Taxpayer's Instruction

Act CLVI of 1997 on Public Benefit Organizations

Government Decree No. 114/1992. (VII.23.) (On the Economic Activities of Membership Organizations)

Government Decree No. 115/1992. (VII.23.) (On the Order of Financial Management of Foundations)

Government Decree No. 217/1998. (XII.30.) (On the Order of Operation of the Central Budget)

Government Decree No. 224/2000. (XII.19.) (On Special Features of Reporting and Book-keeping Obligation of Particular Other Organizations as Defined in the Act on Accounting)

Decree No. 6/1989. (VI.8.) IM of the Ministry of Justice (On the Procedural Rules of Registration of Membership Organizations)

Decree No. 12/1990. (VI.13.) IM of the Ministry of Justice (On the Procedural Rules of Registration of Foundations)

Draft Laws:

a.) On Legislation

b.) On Public Interest Volunteering

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3. (1966) *International Covenant on Civil and Political Rights*

http://www.unhchr.ch/html/menu3/b/a_ccpr.htm (in English)

4. (1948) *The Universal Declaration of Human Rights*

http://www.unhchr.ch/udhr/lang/hng.htm (in Hungarian)

Council of Europe

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European Union

7. (1977) *Directive 77/388/EEC on the common system of value added tax.*

http://europa.eu.int/eur-lex/en/consleg/pdf/1977/en_1977L0388_do_001.pdf
(in English)

8. (1997) Communication from the Commission: *Promoting the Role of Voluntary Organizations and Foundations in Europe*

http://europa.eu.int/comm/enterprise/library/lib-social_economy/orgfd_en.pdf (in English)

9. (2000) Commission Discussion Paper: *The Commission and Non-Governmental Organizations: Building a Stronger Partnership*

http://europa.eu.int/comm/secretariat_general/sgc/ong/intro_en.htm (in English)

10. (2002) Communication from the Commission: *Towards a reinforced culture of consultation and dialogue – General principles and minimum standards for consultation of interested parties by the Commission*

http://europa.eu.int/eur-lex/en/com/cnc/2002/com2002_0277en01.pdf (in English)

http://www.civil.info.hu/downloads/seged/NK/EU/20040203_konzparb.doc (in Hungarian)

11. (2001) Commission of the European Communities: *European Governance: a white paper*

http://europa.eu.int/eur-lex/en/com/cnc/2001/com2001_0428en01.pdf (in English)

12. *Declaration on Co-operation with Charitable Associations*, annexed to the Treaty of Maastricht

http://europa.eu.int/eur-lex/en/treaties/dat/EU_treaty.html (in English)

http://www2.datanet.hu/im/Primleg/11992M-HU.htm (in Hungarian)

13. *Declaration 38. on Voluntary Service Activities*, attached to the Treaty of Amsterdam

http://www.eurotreaties.com/amsterdamfinalact.pdf (in English)

14. (2003) Draft Constitution, Title VI, *The Democratic Life of the Union* , Sections 46, 47, 51

http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/c_169/c_16920030718en00010105.pdf (in English)

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