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**Structural and Systemic Issues Surrounding the  
Establishment and Management of Endowments in  
the Czech and Slovak Republics**

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# **Structural and Systemic Issues Surrounding the Establishment and Management of Endowments in the Czech and Slovak Republics**

## **Introduction**

The Institute of EastWest Studies, with the generous support of the Charles S. Mott Foundation, undertook an analysis of the structural and systemic issues surrounding the establishment and management of endowments for foundations in the Czech and Slovak Republics. The motivation for this study was three-fold - the recent changes in legislation affecting endowments and foundations in both countries; the interest of many western donors in establishing endowments for non-profit organizations in the Czech and Slovak republics; and the development of a national endowment for foundations in the Czech Republic.

The purpose of the study was to analyze the current legal, financial and political environment and identify the critical issues that impact the establishment and management of endowments. A major concern was the ability of non-profits in both countries to create and manage endowments in a manner that would attract both domestic and international donations.

The project managers relied upon written documents and studies detailing the structure of the non-profit community and the analysis of existing legislation. The primary means for gathering information and insight was through interviews and meetings. Discussions were held with leaders and decision-makers from the non-profit community, legislative branches of government, public policy arena, financial institutions, legal community and organizations involved in supporting the third sector. Domestic and international donors were also interviewed.

The period in which this study occurred was marked by constant change in the political landscape of both countries. Elections were taking place in the Czech Republic, and a new government was being formed. The Slovak elections will be held before this report is finalized. Given the fluid nature of change in both countries, the researchers chose to accept the existing legislative, political and financial conditions.

The recommendations of this study are based upon the assumption that endowments established under the current conditions can be effective and possess the flexibility to adapt to future changes. The report will describe the current environment in each country with respect to legislation

foundations.

### **Legislative, Political and Legal Issues**

The Act on Foundations and Endowment Funds (see Appendix 1) requires that all existing foundations must register with the local register court. It further dictates that each foundation must establish an endowment of at least 500,000 Czech Crowns (\$15,000). The value of the endowment may not fall below this amount during the life of the foundation. These financial obligations will force many of the existing foundations to either disband or register as a public benefit corporation or foundation without an endowment.

The law provides that a foundation can operate without an endowment, but all income from the property of the foundation without an endowment (nadacni fund) is subject to tax. There are reduced tax rates for these organizations. This provision of the law has caused confusion, especially with those who are familiar with Western foundations. A nadacni fund is similar to an operating foundation. It is expected that fewer than 200 organizations will establish an endowment and register as foundations. However, as of September of this year, less than fifty (50) organizations had registered and been approved by the court. The focus of this study is upon the foundations with endowments. For the purposes of this study, the term foundation or endowment refers to foundation with an endowment fund.

There are several key issues, which are critical to those organizations, which choose to register as foundations. The first is the decision to become a grant making organization. Many foundations operate programs and provide grants to other non-profit entities and activities. While both of these activities are allowed under the law, it is expected that most foundations will convert to grant making organizations. This is encouraged indirectly by the lack of distinction within the law between administrative expenses associated with program operations and those expenses linked to grant giving.

The law requires that foundations select one of three criteria defining administrative management expense levels. These criteria are percentages based upon the total administrative expenses of the foundation divided by one of the following factors:

- a. The total revenues from the endowment (or property of the foundation);
- b. The sum of all grants provided to third parties,
- c. The total value of the endowment at the end of the current

and legal issues, the financial community, political conditions, the capacity of indigenous non-profits to manage endowments, and the philanthropic culture.

The report will identify those issues that are deemed to be critical to the development and management of effective endowments. Recommendations will be offered as possible approaches to addressing these critical issues. It is not the intent of this report to dictate solutions to the critical issues but to create a dialog in which interested parties can work together to develop a system in which the goals and objectives of a civil society can be achieved. A strong foundation community, supported by effective management of endowments, is a key factor in the development of a civil society.

## **The Czech Republic**

### **Current Environment**

The fall of communism ushered in a period of explosive growth of non-profit organizations in the Czech Republic. As of the end of 1997, there existed over 48,000 non-profit organizations. The majority of these non-profits are registered as civic associations (28,000), that are defined as an association of citizens bound together for a common purpose. A civic association is characterized by its membership. Churches and religious societies have established approximately 3,600 special purpose church associations. Churches pursue their charity, educational and cultural programs through these organizations. Public benefit corporations provide services to the public in non-profit fields of activities. Their activities and all income define these organizations and profits are used to provide services to others. Foundations are the fourth types of non-profit organization allowed under existing legislation in the Czech Republic.

Foundations represent associations of property and are intended to be sources of finance for non-profit activities within the Czech Republic. At the end of 1997 there were 5,352 foundations according to the Czech Statistical Authority. Many of these foundations were established to raise money for a specific purpose or project. Some are actually program operating organizations. A limited number of these organizations are actually foundations whose primary activity is dispersing funds for non-profit activities. There was evidence of tax avoidance and financial abuses within the foundation community. Many felt that the foundations were not accountable to anyone. For these reasons the Czech parliament enacted legislation in the fall of 1997 intended to clarify the legal framework of

year.

Whichever criterion is selected, the foundation cannot change the percentage or the criterion for a period of five years. Therefore, this election is a very serious matter. It must take into account the future plans for the foundations, as well as adjustments to funding sources, changes in the value and revenue stream of the endowment, and grant making policies. One interesting element is that the law does not specify that the percentage be less than 100%. This provides the foundation with some latitude in setting the administrative cost criteria, if the courts agree.

While it is expected that the public will use the administrative cost criteria to evaluate the effectiveness of the foundation, this will be very difficult in actual practice. The general public may not have the patience or ability to determine which criteria was used by the foundation. In addition, foundations, which continue to perform non-profit programs, will be at a disadvantage compared to those foundations that only act as grant making organizations. Finally, it will be difficult for the public to determine if the differences in the administrative percentages are based on poor management or changes in the financial characteristics of the endowment. These factors may have a negative impact on the ability of foundations to attract donors.

The strict requirements of the law could also have negative effects on the management of the foundation. For example, most foundations will choose to select a criterion that will give the foundation flexibility in the area of administrative expenses, by setting a percentage higher than is reasonable. While this is advisable given the current legislation, there is the possibility that the foundation may begin to think of this number as the benchmark. Under this scenario, management efficiencies may be lost in the desire to meet the dictates of the law. It will be difficult for some foundation managers to measure the real administrative cost structure and to judge if it is consistent with its peers.

Foundation managers may be swayed to make adjustments to grant making policies, investment strategies, and programs to insure that the legal administrative cost criteria are maintained. In the long term, this requirement may have the unintended consequence of reducing the incentives for improved managerial efficiency in foundations.

Another troubling aspect of the legislation is the potentially limiting

effect on the active management of the endowment. According to the law, any change in the endowment must be registered with the court. Those not complying with this aspect of the legislation risk losing the tax exemption on the income earned on those assets not registered.

This places an increased administrative burden on the foundation and may limit the incentive to actively manage the assets of the endowment. It may have been the assumption of the Parliament that the assets of the endowment would generate sufficient current income, through dividend and rents, so that the foundation would not need to depend on capital appreciation. However, we live in a financial environment in which large portions of income from financial assets are generated by capital appreciation.

According to a recent article in the New York Times (July 26, 1998), the average dividend yield on the Standard and Poor's 500 stock index is less than 1.25%. Without the ability to capitalize on the increase in value of the assets of the endowment, the foundation will greatly reduce its ability to generate a reasonable return and thereby, lower its grant making potential. The speed of the global capital markets requires that portfolios be actively managed.

Members of the Czech Parliament sought to insure that foundations were operated in a manner that was safe and secure. As such, they stated that the assets of the endowment must be invested in either state guaranteed instruments or placed in special accounts in a bank registered by the Czech National Bank. The Ministry of Finance has verbally agreed that the term "state" was not defined by the act and therefore could be interpreted as being the instrument of any sovereign government. The courts will ultimately decide this, but the Ministry was willing to support such an argument (this was prior to the recent change in government, which took place in September.) If the courts agree, foundations will be able to invest in the state bonds of other governments, providing them with some flexibility in investment strategy. The down side of this investment strategy is the foundations may elect to invest in high yielding bonds which could translate to increased credit risk (the risk of the original capital.)

The law states that foundations must place the assets of the endowment either in a special account of a bank or purchase state bonds. It does not place any restrictions on the type of investment or provide guidance with regard to how the banks invest the assets of the endowment. There is a strong possibility that a foundation could be encouraged (by a board member) to invest the assets of the endowment into a local bank.



The foundation management and board may not be able to adequately assess the credit worthiness of that particular bank. And if the bank was to fail, the foundation may lose a sustainable portion of the endowment (the deposit insurance in the Czech Republic is limited to 400,000 Czech crowns per account.) Such an incident could have serious consequences for the entire foundation community.

The law concerning foundations allows an endowment to hold real estate as long as that property has the ability to produce income. However, there is a restriction that the assets of the endowment may not be used as collateral or serve as a lien. This restricts the ability of the foundation to enhance the value of a real estate asset. Most financial institutions will require that the property be used as security for improvement financing. If a foundation were given a building with limited commercial value but that value and the resulting revenue stream could be enhanced by renovation, the foundation would not be able to borrow the funds to develop the property.

There is some concern about the provision in the legislation that requires that foundations create a supervisory board to oversee the financial management of the endowment. This supervisory board is comprised of members who cannot be members of the Board of Directors of the foundation. Since it is assumed that the members of the supervisory board will be required to possess some financial abilities, a problem may arise for some foundations. There is evidence that competent and committed board members are difficult to recruit, so many of the smaller foundation may have difficulties in finding members for both a supervisory board and a Board of Directors. Foundations have the option of hiring an inspector to perform the function of the supervisory board; however, this would result in increased cost for the foundation.

There is a great deal of confusion surrounding the law on foundations. Lawyers, foundation executives, and members of the government have different perspectives on the interpretation of what the law means. This confusion will result in added administrative burden on the foundation and the expenditure of unnecessary human and financial capital. The executive director of a foundation outside of Prague reported one such incidence. The judge in the local registry court questioned the composition of the board of directors, noting that several of the members were not Czech citizens. Although the law specifically addresses this situation, the judge ruled that the commercial code took priority in this case. The judge ordered the foundation to produce evidence that the foreign members of the board had residence in the Czech Republic. Several of these foreign board members took offense to this request. After several

months and much legal expense, the foundation was able to convince the court that the commercial code was not appropriate in this case and that the law on foundations covered foreign board members. The foreign board members were from the Slovak Republic.

The law on foundations requires that each foundation register with the court in their region. There are eight such courts in the Czech Republic. The judges are very independent, and there is not a principle of precedence in the judicial system. It is very likely that judges could have varying interpretations of the law and this may create additional confusion and administrative problems for foundation managers. Lawyers representing the interest of foundations are not in agreement about the meaning of the law.

### **Financial Issues**

The banking community in the Czech Republic is in the process of transition. The current government has stated that the privatization of the banks is a major priority. Many analysts are concerned about the quality of the assets of the largest state owned banks. Estimates of non-performing assets range from 25% to 40% of total assets.

During the past few years the Czech government has closed or liquidated dozens of banks and has exhausted a major bailout fund established to deal with the banking problem. The banking community has attracted several international banks. Some have entered the market through investments in existing Czech banks, while others have established branches or independent entities.

Many of the Czech banks are unfamiliar with the concept of fund management, especially in regard to the endowments of non-profit organizations. Based upon interviews, most banks were not aware of the details of the law on endowments. While many banks expressed interest in attracting the endowment funds from the foundations, they were not in a position to provide the details of investment products. However, there were a couple of exceptions, and these banks expressed a sincere interest in working with the foundation community to create products and services which would enhance the performance of the endowments.

It would be very beneficial for foundations to develop a strong relationship with a bank that would have the desire and ability to serve the

best interest of the foundations. One of the problems with achieving this objective is the size of the endowments and the cost of providing adequate service. If a foundation elects to capitalize its endowment at the minimum level of 500,000 crowns (\$15,000), the bank would find it difficult to justify special attention to the client. Even at levels of 3,000,000 crowns, the economics of banking would preclude the bank from pursuing special arrangements to meet the needs of the foundation.

The law provides that a foundation may deposit its endowment in any banks doing business in the Czech Republic would be eligible to manage the endowment funds for the foundation community. Foundation managers must weigh the expertise, which may reside in these banks, with any potential political problems associated with investing their endowment in a western bank. Given the size of most western banks operating in the Czech Republic, the foundation will still face the challenge of economies of scale and must insure that the bank is able to develop an investment strategy which matches the risk profile of the foundation.

One of the major concerns is the lack of financial management experience in the foundation community and the probability of a "New Era Fund" disaster. The New Era Fund was established in the United States and promoted as an innovative vehicle for endowment investments. The Fund promised high returns and attracted millions of endowment dollars from some of the most prestigious foundations in the United States. The New Era Fund was unable to maintain its performance and was forced to declare bankruptcy. Millions of dollars were lost, and many foundations were negatively affected. This occurred in an environment in which the securities and trust laws are well established and the financial management of the foundation community is mature.

The lack of effective oversight of the banking industry in the Czech Republic coupled with the lack of financial management experience in the foundation community creates an environment which could invite the type of abuses demonstrated by the New Era Fund. While the United States foundation community was able to absorb the impact of the failure of the New Era Fund, the foundations in the Czech Republic may not have that luxury. The consequences of fraud or mismanagement of endowments at this stage in the development of the endowment process could have devastating effects on the ability of foundations to attract donors or to fend off more restrictive government policies.

In addition to the difficulties involved in selecting a bank with the ability and capital resources adequate to handle the investment of the

endowment, foundation leaders and board members must deal with the issue of inflation and currency risk. The current inflation rate in the Czech Republic is 9% and is expected to remain at this level for the next few years. Last year, the government devalued the Crown by 20%, and some experts are concerned about further reduction in the value of the currency. These factors further complicate the endowment investment decisions and add an additional burden to those charged with directing the foundation.

The tax code and the law on foundations provide that income from the assets of the endowment may be exempt from income taxes. The legislation is very specific about the nature of the endowment, and foundations may find that certain assets are considered to be taxable because they are not registered in the endowment account. The complicated nature of the law and its lack of flexibility will result in additional administrative burden. The tax code allows that certain items, which are used for non-profit activities, are not subject to Value Added Taxes (VAT). However, it is often difficult for non-profit organizations to receive the necessary documentation, which provides this tax relief.

The foundation community should better understand the purpose of an endowment that becomes the basis for the decision to elect the status as a foundation. The project managers found the concept of an endowment is confusing to many in the foundation community. When asked about the purpose of the endowment, many expressed that it was a fund, which could be used for a "rainy day". Others expressed the opinion that the endowment was being established so that the foundation could comply with the law, and the endowment will not have an impact on the organization for a long time.

Generally, foundations, which were primarily involved in programs, expressed confusion over the purpose of an endowment. The major motivation of these foundations was to attract funds for their own projects and activities. Rarely did foundation executives express that the purpose of the endowment was to generate revenue in order to fund innovative programs and to expand the goals and objectives of the organization by giving to other non-profit entities. Such an understanding is critical in investment strategies, grant making policies, and efforts to attract donors.

### **Philanthropy**

While, there many examples of generous giving by the citizens of the Czech Republic, domestic donations to non-profit organizations are minimal by Western standards. Reasons for this low level of philanthropy

include the lack of a culture of giving, the role of the state and the church of taking care of social concerns, the state of the economy, and the lack of incentives in the governmental policy.

Currently, the tax code provides tax relief for individuals, who give to non-profit causes by allowing them to deduct contributions up to 10% of their taxable income. The limitations for corporations are 2% of taxable profits. In addition, the tax code does not differentiate between those non-profit activities, which may be promotional, and those that are social in nature. Therefore, many corporations use their philanthropic dollars to support sporting activities and other programs, which may be considered promotional in nature.

For years, the state was responsible for the social problems of society. This legacy has created a perception in the minds of citizens that it is not their role to contribute to social problems. Giving is charity, and charity is the responsibility of the church. There are positive strides being made to enhance the culture for giving, but it is still in the early stages of development. The majority of this progress has been achieved in the area of annual giving to non-profit organizations and for highly visible needs, such as the floods in Moravia in 1997.

The concept of an endowment and the role of a foundation are foreign in the minds of most citizens in the Czech Republic. The foundation's ability to attract funds for endowments will be difficult and require a massive educational campaign. More importantly, it will take time given the restrictions in the legislation, some perception issues of foundations, and the scarcity of disposable income in the economy, the lack of tax incentives, and the lack of understanding of philanthropy. It may be a generation before one can expect that the Czech foundations can solely depend on their own citizens for an endowment campaign.

Much of the funding for the certain non-profit activities in the Czech Republic has come from international donors (the Czech government has provided a great deal of funding to many non-profit organizations). Their generous support has been the fuel for the growth in many non-profit organizations. Unfortunately, many of these international donors believe that it is time to focus their financial support in other parts of the world. Some believe that the Czech Republic is ready to stand on its own and that outside assistance is no longer necessary. While the project managers disagree with this assessment, it is a factor in the development of the foundation community.

There is a commitment by several Western donors to fund a series of endowments for foundations in the region. The nature of the endowments and how and where they will be managed is the subject of debate. While it is understandable that western donors would not feel comfortable having their contributions managed by the Czech foundations and financial community, it has also been one of the stated goals of these donors to build indigenous capacity in the country. The situation presents an opportunity to help the foundation and financial community to develop the ability to effectively and safely manage endowment funds.

There appears to be a time gap between the time when the citizens of the Czech Republic will be willing and able to effectively fund non-profit activities and the present. Failure to minimize this gap may result in a stalling in the development of a civil society and the ability of the Czech citizens to address critical social issues. The benefits of continued support by international donors and their commitment to remain as partners in this process will greatly enhance the probability of success.

### **The Nadace Investment Fund**

In 1992, the Czech Parliament made the decision (see Appendix 2) to contribute 1% of shares from the privatization process to an endowment which would benefit the non-profit sector. The original intent was that the shares would become an endowment generating revenue for the foundation community. Because of the danger of depreciation in 1995 and 1996, the Minister of Privatization elected to convert the shares set aside for this purpose to cash. The conversion is still in process.

In 1998, the government decided to distribute the first phase of the Foundation Investment to a selected number of foundations. The amount of the first distribution is expected to be 500,000,000 crowns (\$15,000,000) and is scheduled to occur in the first quarter of 1999. The second distribution is scheduled to take place within one or two years of the end of the first stage. The amount of the second distribution is estimated at 1,500,000,000 crowns or \$45,000,000. The process for selection of the recipient foundations is quite simple. Foundations, who were operating as foundation since January 1, 1996; who are currently registered as a

sector. This is an area which will require strong political actions and the non-profit community could be greatly benefited by assistance from other sectors of the Czech society as well as international parties.

## **The Slovak Republic**

### **Current Environment**

The authoritarian nature of the Meciar government has been the primary catalyst for the growth in the non-profit sector in Slovakia. Not only has the sector grown in size, but also its professionalism, dedication and passion can be seen in its active engagement in every aspect of society.

As of June 1998, there were 12,599 non-profit organizations registered in Slovakia. Citizen participation in these organizations was among the highest of the countries of the former Soviet Union (according to a report by Civicus, New Civic Atlas, 1997). Many of the young urban population have turned to the non-profit community to express their concern and dissatisfaction with the political and economic situation. Strong cooperation and a desire to enhance its professionalism and managerial skills characterize the third sector. The presence of many of the intellectual and cultural leaders in the sector coupled with the active support of western donors is often credited.

Prior to the passage of the Law on Foundations (Appendix 3) there were 2,634 foundations. The law forced these organizations to register, and as a result, 422 became foundations, 161 converted to non-investment funds, and 259 registered as civic associations. The remaining foundations were either dissolved or chose another form of organizational structure. Slovakia boasts the creation of the first community foundation in East and Central Europe. The Healthy City Foundation was formed in 1992 in the city of Banska Bystrica. It was the first community foundation to develop an endowment. There is an estimated five to ten community foundations operating in Slovakia.

The strength of the non-profit sector can be best seen in the scope of its activities. The Gremium of the Third Sector, or G3S, is a group composed of democratically elected representatives of the non-governmental organizations. Its mission is to defend and pursue the interest of the NGO's, and it explains and publicize the role of the Third Sector at home and abroad. G3S has developed strong relationships with

foundation under the new law; and who have distributed at least 500,000 each year, are eligible.

The Council on Foundations (the name was changed to the Council on Non-Profit Organization in 1998) will select up to five foundations representing the following areas of non-profit activity:

- ① Social and humanitarian
- ② Health care
- ③ Cultural
- ④ Human rights protection
- ⑤ Environmental protection
- ⑥ Educational
- ⑦ Others, which are not defined above

While there is the potential that thirty-five foundations would receive a portion of the funds, most experts believe there are twelve to fifteen foundations that are eligible and able to receive approval. The decision will be made by the Council on Foundations and approved by the Parliament.

The funds will be disbursed to one or more banks, and there may be restrictions on how these funds are managed. The National Property Fund Executive Board will make the determination of the banks which will manage the funds and additional conditions attached to the management of the funds with approval by Parliament.

According to the act, which created the Nadace Investment Fund, all recipient foundations must distribute the proceeds from the endowment each year and must adhere to certain administrative reporting requirements. There is also a cap on the administrative cost associated with the management of the endowment. This is not to exceed 20% of the annual proceeds from the endowment.

The government, which was formed in the summer of 1998, has sent messages to the Council on Non-Profit Organizations that indicate that the distribution of the second phase of the program may be in jeopardy. It is felt that the first phase may take place, but that is not certain. The current government has not firmly stated its position on its support of the third



representatives of the state, local government, the business sector, unions and national and international non-governmental organizations. G3S has helped to create a better environment in which NGO's can operate. The Gremium of the Third Sector works at both the national and regional levels. The 28 members, which are elected at the annual Stupava Conference, step out of their roles as leaders of their respective organizations and assume the responsibility for the whole of the third sector. The Gremium of the Third Sector was recognized by the United States and the European Union and presented the Award for Democracy and Civil Society in 1998.

The Stupava Conference is the annual conference of the third sector and has been held annually since 1991. Participants evaluate the development of the non-for-profit sector, determine goals for the upcoming year and elect the members of the Gremium of the Third Sector. The number of participants can demonstrate the success of the conference. The initial conference attracted just 24 participants from the Czech and Slovak Republics, along with many foreign guests. The 1997 meeting, held in Kosice, recorded an attendance of 250 from Slovakia and other countries.

"Campaign OK'98" is an open, non-partisan initiative by non-profit organizations to promote fair and just elections and encourage citizen participation. The campaign was organized by eleven NGO's and cooperates closely with the Gremium of the Third Sector and the Donors Forum. OK'98 has been an effective and visible program for the NGO community and demonstrates not only the ability of the non-profits to address critical issues in the society, but also the ability and willingness of the sector to work together.

The Donors Forum is an informal group of grant making organizations that distribute financial resources to Slovak non-profit organizations. Its mission is to increase effectiveness in the distribution of grants and to create conditions for the improvement of financial support for the third sector in Slovakia. Members of the Donors Forum have been dedicated in pursuing these goals and have again demonstrated the strong desire and ability to work together for the betterment of the non-profit community.

The Donors Forum has commissioned reports, which have been critical in identifying the key issues facing the grant making foundations (much of the information contained in this report has been gleaned from the analysis undertaken by the Donors Forum). Building better relationships with the business community and the state, enhancing the culture of philanthropy, creating partnerships with international

organizations as well as developing more effective mutual cooperation within the foundation community are all within the scope of the Donors Forum. Based on the past achievement, without any formal organizational structure, and their level of commitment, there is little doubt that they will succeed.

### **Legislative, Legal and Political Issues**

Note: This research for this report was undertaken prior to the current elections in the Slovak Republic. While the election results appear positive for the third sector, the authors were not able to determine what changes will come about due to a change in the government.

It is no secret that the Meciar government is opposed to the third sector and will expend considerable energy to weaken the sector's ability to operate. The Law on Foundations, passed in 1997, was enacted to accomplish such a goal. On the surface, the legislation appears to be reasonable. Closer examination of the political environment and the details of the law point out the problems.

The primary area for concern is that foundations must register with the Ministry of Interior. It is an approval process which allows the Ministry to question the activities, policies, and budget of the foundation. This is the primary reason that the non-investment fund has become an attractive alternative for endowments.

The non-investment fund allows organizations to attract, manage and distribute funds for the benefit of the community. It is defined in the law as, "a non-profit legal person, which gathers funds for the purpose of fulfilling general public benefits or individual humanitarian help for those individuals or groups who are under threat or who have suffered disaster in their lives." A non-investment fund may own property, provided that the income from the property is used for the purposes defined by the statutes of the organization.

All financial assets must be held in a financial institution registered in the Slovak Republic. Business activities and lending are not allowed by the non-investment fund, and there is a cap on the management expenses of 15% of the total annual disbursements of the fund. All other regulations of the non-investment fund are similar to that of the foundation except for the registration process. All non-investment funds must register in the regional administrative centers. While these centers are under the supervision of the Ministry of Interior, the amount of scrutiny, reporting

requirements, and controversy are greatly reduced.

The Law on Foundations requires that the value of the assets of the foundation must be at least 10,000 Slovak Crown (SK) (\$300) at the time of registration. The value of the assets must be increased to a minimum of 100,000 SK (\$3,000) within six months of registration. The assets of the foundation may be in the form of money, bank accounts, real estate, property which can be valued in currency, and securities. There are no restrictions on the composition of these assets or limitations on the type of securities or concentration in a single stock. There is also concern on the valuation of the assets used for the endowment and its ability to generate income. In some instances, furniture and autos were designated as the assets of the endowment.

There is a section of the Law on Foundations, which obligates the foundation to manage the assets of endowment with the goal of achieving the most economical use and highest yields. Foundations may engage in lotteries and similar games, organizing sporting or cultural events, and renting the assets of the endowment all of which generate revenue.

The requirements for the Non-Investment Fund are similar except that the minimum value of the assets must be 2000 SK (\$60). Both laws require that the organization comply with administrative procedures including the adoption of statutes, election of a Board of Directors, selection of an administrator and compiling an annual report. The Act on Foundations requires that a supervisory board be established to oversee the financial management of the organization. This provision is not required in the Law on Non-Investment Funds.

There is hope that the current elections (to take place in September) will result in a more open and democratic government. The fact remains that political elite and corruption dominate Slovakia. While it will be difficult to make significant progress with the legislative environment, there is an opportunity. The majority of Slovak citizens (79%) and most political parties favor integration into Western European structures. This could provide an incentive for politicians to enact legislation which was in line with the expectation of Western European organizations. There is also the possibility that Western financial support to the non-profit community could be utilized to impact non-profit legislation.

Many policy makers have indicated that the current tax on income from foundation may be eliminated if western donors were to invest endowment funds in the Slovak banking system.

## **Financial and Economic Issues**

Economic indicators tend to present a picture that Slovakia is growing and has a stable currency. In May of 1998, GDP growth was 6.5% above the previous year. This is compared to an average of 1.14% growth for the other East and Central European countries. The inflation rate is a little over 7%, and the unemployment rate is 13.6%. The Slovak Koruna has been stable due to high interest rates and a government policy to maintain current levels. However, much of this economic performance has come at the expense of the common citizen, high levels of both foreign and internal indebtedness and a concern about the reliability of the government's data.

It is widely expected that the Koruna will be devalued after the elections in September. The amount of the devaluation ranges from ten to thirty percent. Interest rates are in the upper teens to low twenties, and the two-year state bond sold for a record 28.9% as late as May of this year. Given the inflation rate of 7%, the markets are indicating either an expectation of higher inflation or a credit risk associated with the state bonds. The major credit rating agencies downgraded the investment rating of Slovak bonds during the first part of 1998.

Tax rates on businesses remain at high levels at 40%. With these tax rates coupled with decreased tax revenues, there is a strong belief that tax avoidance is prevalent. The government continues to borrow money resulting in high and unsustainable foreign indebtedness. Evidence of cronyism and political manipulation can be seen in the dismal state of the privatization fund.

Many elderly Slovak citizens, who expect repayment of their privatization bonds, will be disappointed to learn that the National Property Funds does not have the cash to redeem these bonds. This is the result of a pattern of selling many state businesses to the political elite or their friends at prices greatly below market value. In addition, much of the banking system is controlled by the state. There is great concern over the actual viability of the banking sector and the reality of its ability to meet western capital performance standards. Overdue commercial liabilities increased 25% during the past year and now represent 18% of GDP. Classified bank credits are estimated at 30%.

Other factors impacting the economic environment are the weak capital market and the negative entrepreneurial climate. A growing tax burden, invisible legislation, high interest rates, bad payment discipline,

growth of criminality, and cronyism characterize these factors. It is not an environment in which donors or investment managers would choose to put their funds. However, there are reasons to be hopeful. It is reasonable to expect that the country will continue to grow during the next fifteen to twenty years. The pressures to integrate into the European Union will be a motivating factor for the government, and it may have to address some of the major challenges, including budget deficits, price deregulation, and internal corruption. The country has an abundance of well-educated, professional, and dedicated citizens. Its strategic location and access to Western Europe and the former republics of the Soviet Union can provide it with opportunities for economic success.

### **Philanthropy**

As reflected by the income tax returns, the total value of financial contributions to non-profit purposes by corporations in 1995 was \$13,000,000. This is an increase over the \$9,000,000 donated in 1994. These numbers do not reflect the purpose of these contributions. Most observers believe that the majority was dedicated to highly visible cultural and sports activities. In both years, 30% of profitable corporations chose to use part of their income for charitable purposes despite the fact that the tax law limits the deductibility of the gift. In addition, the majority of profitable corporations have used the maximum tax deduction allowed under the law. This has led many experts to conclude that it is likely that corporate contributions would rise if the maximum amount which can be deducted were increased.

While much of the economic activity in the Slovak Republic is concentrated in the larger firms, there are encouraging signs for philanthropy within the small and medium sized business community. Recent surveys indicate that close to 60% of small and medium sized businesses plan to make the maximum contribution (allowed under the tax law) to a charitable organization. These surveys report that small and medium sized businesses are more likely to give to causes which support children, the physically handicapped and health care. Over 50% plan to support local projects dedicated to these causes.

A disturbing aspect of corporate giving is the continued presence of corruption and fraud. Many companies have used the cover of charitable giving to disguise activities, which are intended to avoid taxation or circumvent conflict of interest laws.

The presence of the Mafia in Slovakia has created a strange form of giving, referred to as 'forced philanthropy'. There are cases when business

owners have given their assets to a charity as a way to escape the racketeering and extortion by the Mafia. In one such case, the owner of a car dealership gave his majority ownership to the Catholic Church rather than continues to be harassed by the Mafia. While these cases are rare, it does point to the dark side of philanthropy in the country.

There is no exact data on the amount of individual contributions to the non-profit sector; however, a recent survey provides some insight into this area of philanthropy. Forty-two (42%) percent of the citizens have provided either in-kind or financial contributions to an NGO within the past year. Over 30% of the contributors responded to a direct approach by the NGOs. Helping children and the physically handicapped were the primary areas in which citizen make contributions. The most prominent recipient of individual giving is the Catholic Church.

There have been several successful campaigns, which focused upon specific events or causes. The Dobra Novina door to door campaign raised \$100,000 to aid small children in Kenya. A highly visible campaign, Account of Hope, was able to raise \$100,000 by promoting the cause on television during the Christmas season. The contributions were used to support mentally and physically and abandoned children. The floods in 1997, which impacted the Czech Republic, and to a lesser degree, Slovakia, provide an example of the potential for local philanthropy. A nation-wide campaign generated over \$1,000,000 for the victims as well as the donation of materials and manpower.

The concept of payroll deduction is not common in Slovakia, but in 1995, a program launched by the Children's Fund of Slovakia demonstrated some success. While the program raised about \$12,000 in 1995 and again in 1996, it highlighted some of the obstacles, which must be overcome to broaden this type of approach. For the individual, the amount contributed is often less than the \$30 minimum required for tax deductibility. It also brings back negative images associated with forced payroll deductions under the communist regime.

Western donors have provided the majority of funds for the non-profit sector. This is due to the absence of a culture of giving in Slovakia and the lack of tax and political incentives for those possessing wealth. Many of the contributions by the financial and political elite are diverted to non-profit organizations, which promote their business or personal interest.

The tax law does not differentiate between donations to those

organizations, which have a social purpose, and to those organizations involved in sporting activities. Both the environments of political influence and the rewards available to those in a favorable position with governmental officials, creates additional obstacles for those with wealth to donate to social non-profit organizations.

There has been broad engagement in non-profit activities by the citizens of the country. Much of this has been in the form of personal assistance and in-kind support rather than financial contributions. This is caused by the lack of disposable income, high taxes, and a culture in which the individual was not viewed as a part of the solution to social problems. While the economic environment may improve in the next few years, it is anticipated that the culture for philanthropy will take at least a generation to develop.

In addition to the challenges facing foundation investment managers regarding the selection of safe investment vehicles and banks, the tax code is unfavorable. All income on investments for foundations and non-investment funds are subject to a 15% tax and are held in banks registered in Slovakia. The bank withholds this tax. Profits generated by market investments other than bank deposits are taxed at 40%. These provisions will make it more difficult for Slovak foundations to attract international endowment funds, which will be subject to this tax. The tax code does not provide much incentive for private or corporate donations. Individuals can deduct contributions to non-profit causes up to 10% of their income. The limitation for corporations is 2% of taxable profits.

## **Conclusions**

The development of the non-profit community in the Czech and Slovak Republics has been remarkable. This has been accomplished in an environment void of a culture of support of the third sector. Governments have hampered the development of the sector by passing legislation, which creates confusion and unnecessary administrative burdens, failing to address critical issues, and in some cases, outright opposition. In spite of these factors the determination and passion of those involved in the non-profit community have prevailed.

Today the sector is at a critical junction. Its lifeblood has been the generous financial support from Western donors. While this has been

critical in building the infrastructure for the non-profit community, much work is still needed. The reality is that the economies and philanthropic culture has not reached the level of maturity needed to maintain the activities of the non-profit community. Distracted by urgent financial concerns, non-profit organizations will not be able to focus on the addressing the challenges in their society. It becomes a viscous cycle – by pursuing funding in a limited market, organizations will be forced to shift their emphasis from programs, which have visible and meaningful impact on society, to creating methods to raise funds. Citizens will react to this shift by lowering the perceived value of the non-profit, making it more difficult for these organization to attract funding.

Western donors are encouraged to reassess their decision to shift their funding from the region and to seek ways to continue to provide financial support while the non-profit community continues to develop. The role of the foundation is critical to this process. While 10 years of financial support from the west is admirable; it may not be sufficient in a process, which requires changing of attitudes and the development of a culture. This will take a generation.

The non-profit communities in both countries must also respond to this challenge. To date the journey has been long and difficult; and the participants have earned the respect and admiration of those who have witnessed the progress. While a rest is deserved, the challenge remains, and it will require continued diligence and perseverance. The foundation community must assume a pro-active role and take responsibility for the development of its members. Now is the time to take the next step away from reliance on the state and to act in a manner which will best serve the needs of the foundation community. There is the distinct possibility that the government will use it powers to stall this progression, but that is a reality of politics. By asserting itself in a prudent manner, the third sector can reach its proper place as equal partners, with the state and the private sector, in the creation of a civil society.

The legal and financial situations in both countries are confusing and in a state of constant change. However, this is the environment in which the non-profit community and foundation must live. It is imperative that each member of the community be provided with the information and knowledge critical to surviving in such an environment. Both countries have demonstrated that they have the ability and desire to work together for the betterment of their fellow organizations.

The existence of a Donor's Forum in each country provides a natural



vehicle for cooperation and growth. There is an excellent opportunity for the Donor's Forum to create a platform in which members of the foundation community can explore various alternatives to the critical issues facing the third sector. Armed with the experiences for other countries and with an understanding of the environment in their country, innovative solutions can be created and promoted. Working together and with continued support from the West, there are rational expectations that these countries will achieve the civil society that they so richly deserve.

## **Recommendations**

The suggestions offered in this report are intended to inspire dialog and discussion among interested parties involved in the development of the foundation community in both countries. Recommendations are presented as being relevant to both countries, however, several will be applicable to only the Czech or Slovak Republic. The recommendations are given in this format in the hopes that each country may be able to glean insight and information from the other situation.

### **① Non-profit organizations should diligently reflect upon the decision to become a foundation.**

The legislation on foundations provides an opportunity for many non-profit organizations to elect the status of a foundation. This decision should be thoughtful, serious, and well planned. The role of a foundation is different from that of an organization that provides services through programming. Individual organizations considering this decision should take time to sincerely explore if it should accept the responsibility of becoming a foundation and if it is the best use of its organizational resources. The process must include the process of deciding the primary focus of the organization – grant making or programs.

In a civil society, the role of a foundation is critical to its development. This role can be viewed as a fountain of innovation and inspiration. An effective foundation can be of great value, especially in the environment in which these two countries find themselves. Western organizations and foundations should facilitate and encourage this process and provide information and insight into the role and responsibilities of a foundation in society.

Legislation in both countries mandates a certain level of administrative expenses. Those levels appear to be reasonable as long as the foundation is operating strictly as a grant making entity. For those organizations which desire to continue to operate programs and act as a grant maker, it is suggested that a civic association (or public benefit organization) be created.

## **② Create organizational structure and policies to meet mission of the Foundation**

Once the decision has been made to become a foundation, attention should shift to the development of its statutes, policies, goals, and organizational structure. The dictates of the legislation place a burden on the alignment of these elements to insure the organizational structure and management matches the statutes and policies of the organization. The organizational goals must be clear and understood.

In the case of the Czech legislation, this is critical to the election of the administrative cost criterion. The administrative cost criterion is a legal requirement, and while it is available to the public, it should be determined in such a way as to give the foundation the most latitude. The law does not prevent the foundation from selecting an administrative cost percentage over 100%. Therefore, the foundation should consider which criteria would give it the most flexibility during the next five years, and find acceptance by the court. The foundation must be concerned about the public perception of its management efficiency, so it must concentrate on achieving a reasonable level of administrative expenses. This goal can be articulated within the organization. Both efficiency and effectiveness can be communicated to the public via annual reports and other forms of correspondence.

## **③ Create Association of Foundations**

The development of a strong association of foundations would provide benefits to the entire grant making entities in both countries. Foundations should not rely on government regulations to determine how to manage its endowments in a safe and prudent manner. If a "New Era Fund" were to occur, it would be devastating to the entire foundation community. This will impact all foundation's ability to attract endowment funds and invite further governmental intrusion. The responsibility to assure that this does not happen lies within the individual foundation and the community as a whole.

In each country, there exists a Donor's Forum. These organizations are actively involved in the development of the foundation community. The Donors Forum could evolve and act as a facilitator for discussion on critical issues for the foundation community, provide educational and training programs for its members, and serve as a united voice in public and political arenas. Also, the Donors Forum can serve as a monitor of the

actions within the foundation community. By focusing upon increasing the professionalism of its members, these associations will strengthen all within the community.

The Donor's Forum will be in a strong position to promote philanthropy in the country with a unified campaign. The Donor's Forum could also provide its members with access to a pooled investment fund, which would reduce the administrative cost and burden for the individual foundations and may enhance the probability for better investment performance.

#### **④ Develop partnership with financial institutions**

The economics of endowments provides an opportunity for a pooled investment fund for foundations. Currently, the amounts of funds held by individual foundations are not sufficient to warrant special interest by the banking community. However, by combining these funds into one pool, banks would have a strong financial incentive to work with foundations. A partnership could be developed between the bank(s) and the foundation community. In addition to providing the foundations with investment management services, the banks could bring additional value to the table. A bank could be encouraged to join with the foundation community to promote certain critical objectives. The bank could fund and support campaigns to promote philanthropy in the country.

The bank will see this as self-serving, as an increase of giving will result in expansion of its market for investment management. Such a program will help the bank in public awareness and prestige. The bank could provide foundations with legal assistance. This would be especially valuable in the Czech Republic where different local courts will determine how the law is interpreted.

Banks have tremendous political capital and access to politicians. A bank can help change the message of the debate about legislation impacting foundations- from serving the social needs of the country to enhancing economic performance of the country. The partnership between the banking community and the foundation community could result in amendments to the legislation based on technical problems identified by the bank as unacceptable. For example, a banker could more forcefully deliver the lack of ability to actively manage an endowment portfolio, without the court approval, than a leader of a foundation. The argument would be economic rather than social, and it would have a better chance to be received by a Member of Parliament or someone in the Ministry of Finance.

In the area of investment management, banks can play an expanded role. In addition to their capacity in advising how to invest and manage the endowment funds, the bank can provide service by converting certain contributions into income producing assets.

Foundations (especially in the Czech Republic) are restricted as to what they can do with cash donations. A bank may be able to intercede prior to the official contribution and work with the donor in converting cash into an income-producing asset. The converted asset would then be donated to the foundation and registered with the court. Banks could assist in non-cash donations such as real estate. Because foundations are prevented from borrowing on the assets of the foundation, its ability to enhance the income producing aspect of real estate is limited. A bank may be able to work with the potential donor and transform the real estate into some type of investment security. This security would provide the foundation with an income stream and eliminate any need for incurring a liability.

#### **⑥ Develop effective and comprehensive training and educational programs**

Training and education are key elements in the development of foundations. There are several potential audiences for this training. Foundation executives and board members need to understand how to structure their policies and strategies in light of the existing legislation. By fully understanding the limitations and opportunities within the law, foundations can develop approaches which will help them in achieving their goals. It would be difficult to provide foundation leaders with the information needed to be competent financial managers. However, they can be given the knowledge which is critical in determining the appropriate investment managers, understanding the role of risk and appreciating the various elements involved in financial decisions.

Lawyers representing foundations need to be aware of the different interpretations of the legislation. The legal community representing foundations must have a united voice. A lack of consistency in arguments before the courts will result in confusion, and this confusion will increase the burden on foundations. The goal of this aspect of training is to come to a consensus on legal strategy and tactics. Lawyers could also help in identifying technical problems with the law, those issues which could be

presented to parliament members as technical rather than political.

An educational program aimed at judges could be beneficial in helping the judiciary understand the law from the perspective of the foundation community. Most judges value their independence and are reluctant to attend training programs, especially ones organized by a partisan party. Therefore, it would be beneficial to solicit a third party to provide this training. Another approach would be to have the subject attached to the agenda of an existing program or organization which has the respect of the judiciary.

The issue of training and education is critical to the development of the foundation community. Questions concerning the purpose of a foundation and an endowment are difficult to answer. But, the understanding of these issues will have a great impact on the ability of the foundation to serve society. Foundation leaders need to have an opportunity to discuss the pros and cons of endowments, how annual fund-raising can provide the non-profit organization with feedback from the public, and how to enhance the culture for giving.

Because endowments are new to these regions, there is an opportunity to investigate areas often off limits for Western foundations. There is an opportunity to create new vehicles for long-term financing and to develop instruments which can adjust to the changing needs and attitudes of society. But, such training and reflection will not take place in short-term workshops. A commitment to changing a culture and instilling the participants with knowledge and insight about every aspect of the role of the foundation is needed.

The Jan Hus Foundation (Czech Republic) took such an approach. Supported by a multi-year grant from the Ford Foundation, the Jan Hus Foundation began an endowment campaign by focusing on professionalism and developing strong management skills within its organization. In the second year, the project focus shifted to image building and public relationships. After building the supporting structure, the Foundation entered into the fund-raising stage, not by soliciting funds, but by learning the mechanics of fund-raising. The result has been above average success in attracting both operating funds and endowment funding. Also, the Foundation is blessed with a very committed board of directors, who are actively engaged in the investment management of the endowment.

**⑥ Encourage Western donors to consider investing endowments for Czech and Slovak foundation in those respective countries**

Many Western foundations and funding agencies are considering establishing an endowment for the benefit of the non-profit community in the Czech and Slovak Republics. At the present time, the endowment funds would be managed in by a Western financial entity. The reasons given for this decision are valid. They include the lack of safety and security in the financial community in East and Central Europe, the shortage of financial management skills within the foundation community, and the desire to maintain oversight over the expenditure of the fund. At the same time, Western donors have sought to build indigenous capacity in the Czech and Slovak Republics.

By maintaining control over the management of the endowment funds, the foundations and financial communities of the Czech and Slovak Republic will miss an opportunity to develop the necessary financial management skills critical to attracting and managing endowment funds.

Western donors should explore the possibility of creating a structure in which financial institutions in the Czech and Slovak Republics would participate in the management of these endowments. Some type of strategic alliance with a western investment manager may be a reasonable approach. The Western donors could achieve a level of confidence in the safety and security of investment decisions while the Czech and Slovak financial institutions would gain needed experience.

Another benefit for such an approach would be the influence it could have on existing or pending legislation in both countries. Western donors could use this concept as leverage to have positive changes made to the laws that impact endowments. For example, in the Slovak Republic, it is widely believed that the tax on endowment income would be waived with this type of arrangement.

Preliminary discussions with financial institution in the region as well as Western investment managers have generated interest in such a concept. The development of a strategic alliance between western

investment managers, banks, and financial institutions could become a model for other countries in the region. While the safety and security of the western donation must be a primary factor in the ultimate decision, there are other alternatives which will achieve much-desired objectives. The funds represented by the western endowment would provide the foundation community with additional leverage in developing a strong relationship with the banking community.

### **⑦ Recommendation for Western Donors to East Central European Trust Fund**

The United States government and several American based foundations are exploring the concept of establishing a trust fund for the non-profit sector in East and Central Europe. One of the stated goals of these organizations is the development of indigenous capacity relative within the countries, relative to managing endowment funds. There are valid reasons for the management of these trust funds to reside in the United States.

However there is an opportunity to enhance the investment management skills in the region by expanding the selection criteria for a funds manager to include the following non-financial elements:

1. A commitment to build the capacity of the financial community in the target countries, in the area of endowment management.
2. A commitment to assist managers of foundations in developing their competence in decision making, relative to endowment investment.
3. A commitment to assist in the promotion of a culture of philanthropy in the target countries.

These criteria would insure that the trust fund would be a catalyst for the development of the foundation community and would be accomplished at a very reasonable cost. The fee to manage the assets of the fund would be higher to reflect these non-financial commitments, but it would result in added benefits for the entire non-profit community.

The donors to the East Central European Trust Fund could also encourage countries in the region to pass legislation which would create a more favorable environment for the non-profit community by rewarding those countries which take such action. The formula for allocation among



the countries could be designed to recognize and reward countries such as the Czech Republic (for the NIF act) or Hungary (for its 1-% check-off program). This could also be used as an incentive for other countries to develop innovative public policies, which would enhance the vitality of the non-profit community.

**⑥ For the Czech Republic - Exert influence on the decisions concerning the National Investment Fund**

This is a critical time for foundations in the Czech Republic. The new government is expected to take some action on the disbursement of the first round of the National Investment Fund, and there is concern that the subsequent distributions may be in jeopardy. The foundation community should take this opportunity to devise a strategy to create support for the endowment and to develop public relations campaign that draws support from various sectors of society. By involving others in developing this strategy, the foundation community could shift the message-from helping the non-profit organizations to promoting the good of society. The flood in Moravia demonstrated that the citizens of the country would respond when there is a visible need. The citizens of the country must see the need for this endowment as beneficial.

It is an opportunity for the foundation community to build ties to the major corporations in the country. Several large companies expressed interest in seeing that the non-profit community flourished. A coalition which involves major corporations could sway many politician who may hold a less than favorable opinion of the third sector. The foundation community's message must include the role that the non-profit community plays in creating a better society. The political and marketing strength of the business community could be critical in achieving this goal.

In the event that the Parliament re-opens discussions on the form that the distribution of the National Investment Fund will take, the foundation community should be well aware of the financial consequences of various alternatives. The lack of financial knowledge may hinder foundations in pursuing alternative means of distribution, which may be more appealing to the government. While it is hoped that the Parliament will proceed with the original commitment to distribute cash, foundation leaders should be prepared to enter into discussions with the government which would result in a more timely distribution. Foundations are advised to accept a reduced financial package in exchange for total distribution in

the near future. To estimate the acceptable level of reduction, a thorough understanding of the financial ingredients of alternatives is critical.