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REGULATING CIVIL SOCIETY COUNTRY REPORT - HUNGARY 1995

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I. INTRODUCTION

The Not-for-profit-organizations (NFPOs) in Hungary has the *necessary* legal framework to carry on their activities. The constitutional rights and the institutionalized NFPOs' social role is recognized by the various legal and financial benefits they enjoy. The general laws of nonprofit organizations and the scope of their benefits carries many resemblances to the international standards and has Hungarian specialities, simultaneously. At the moment the Hungarian legal environment is facing a reform to attain a *sufficient* framework for NFPO's viable operation.

A. Background development

1.

The Hungarian legal and fiscal regime was exceptionally favourable at the outset, in 1989-1991. The Freedom of Association Act¹ laid the basement for association. This and the ammendment to the Civil Code provided the sufficient status rules to establish NFPOs - as institutionalised carriers of regained constitutional rights. At this time the fiscal rules contained separate rules for associations and foundations. The related business activity of the organizations was tax exempt for both. The unrelated business activity, i.e. the entrepreneurial activity of these organizations was allowed, and went untaxed unlimited as long as the association or the foundation had ploughed it back to its primary purpose activity. Both private and corporate contributors to all foundation (which are serving public interest by their legal definition) were entitled to unlimited deduction from their income tax base after their contributions. The associations and foundations could choose whether they wanted to be subject to the value added tax or not. If yes, then they payed VAT on their services and could reclaim VAT on their purchases - except for some exempt activities. For the foundations the rules contained

¹ Act III/ 1989

special advantages. Until 1992 foundations serving the *wider public* were entitled to retain and use for their primary purposes the VAT which was paid to them by the consumers. Even if the foundation had opted for VAT exempt status, it could reclaim its paid in tax on its building investments in case of serving several socially beneficial purposes.

2.

The favourable fiscal rules were not accompanied by sufficient fiscal supervision. This naturally caused that the nonprofit legal forms, especially the foundation had often become the carrier of hidden profit interests. *The response of the authorities has not aimed the improvement of enforcement standards and thus the consolidation of the NFPOs operational conditions, but the gradual reduction in the benefits of the nonprofit organizations - especially after 1992.*

3.

Nevertheless, by early 1994 more than 27.000, associations and 11.400, foundations had been registered in a country of 10 million inhabitants. It is a brilliant recovery of the civil society. The reduction of benefits, however, has had sharp impact on the majority of organizations. The resources of nonprofit organizations have been derived from operational incomes, from private and corporate donations - all of which are sensitive to changes in fiscal regulations². The state support - both normative and occasional - also has its substantial share in the income portfolio of the Hungarian nonprofit organizations. The volume of discrete government support has been higher than desirable - suggesting adverse effects of dependence and clientele. The move towards the normative financing of servicing nonprofit organizations is in progress. It is, however, tied to the reform of the State Budgetary Act.

4.

The Hungarian economy (GDP) has been shrinking 3 percent average yearly and inflation rate was 18 percent yearly in the last four years. There is considerable foreign trade and budgetary deficit, with over 1 billion USD net yearly debt service. The privatization of state owned companies is under process, private companies are in the process of initial capital accumulation. Unemployment rate has grown from practically zero to 10,7 percent. Social welfare system is overburdened, faces the need to de-nationalization³.

This state of the social economy requires the increase in voluntary, nonprofit services. Nevertheless, because of the huge excess capital demand and simultaneous resource shortage of

² Private donations in 1992 added up to 18 million USD, whilst corporate philanthropy reached 52 million USD. The direct discrete state support to foundations in 1993 was 50 million USD, to associations 23 million USD. The normative state support to social educational and human services organizations in 1993 was 34 million USD. (Source: Statistical Bulletin on Nonprofit Organizations, KSH, 1994, Budapest)

³ Statistical Yearbook(s) 1989-1993.; János Kornai: 'The most important is the enduring growth' in *Népszabadság* 23-28. August 1994.

the transitional economy, the resource endowment of the nonprofit sector is still highly casual and uncertain both from financial and human capital perspective.

II. PROVISIONS OF THE GENERAL LAWS

A.

CONSISTENCY AND CLARITY OF THE LAWS

In Hungary the structure of laws presently regulating civil society had been finalised by 1991. Since then some substantive, but no structural changes have happened. The rules for civil organizations are collected in more than one law. The Civil Code contains the status rules of the NFPOs. Altogether, five government orders⁴ regulate the registration; the economic activity and accountancy rules of associations and foundations. In November 1993 three new legal forms were introduced: the public foundation, the public chamber and the public benefit company. All these institutional forms initiated separate rules in the Civil Code and the various tax laws.

The great failure of the Hungarian laws is not their number, but that they do not use a unified set of legal categories. That is why the fragmentation in the Hungarian case implies inconsistencies and loopholes.

The need for unified set of categories for status and fiscal purposes has been recognized by the authorities. The regulatory reform is under way. The present fiscal rules can be seen as inconsistent reminiscences of former fiscal regimes which are to be changed with the hoped-for enactment of the Law on Nonprofit organizations - in January 1996.

B. CONSTITUTION

In Hungary the constitutional rights of freedom of association, conscience and expression are declared in the Constitution. Moreover, the Freedom of Association Act restates these rights⁵ and puts operational rules to them to guarantee their applicability.

C. TYPES OF ORGANIZATIONS

The institutionalised⁶ NFPOs operate as juridical entities in Hungary. The forthcoming legal forms can be established and registered:

1. Association: It is the classical continental type membership organization: voluntarily established organization having self-governance and registered membership to achieve pur-

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⁵ "The right to associate is a basic human right for every individual. The Hungarian Republic accepts this, and facilitate the undisturbed use of this right. Given the right to associate everyone has the right to form organizations or communities with others, or participate in the activities of those" in Act II/1989. 1.§

⁶ There exist *the Public interest endowment* (or otherwise the Incomplete Foundation) (Act No IV/1959 on Civil Code §§ 593 -595) which can be interpreted as a *Fund with no juridical personality*.

poses written in its Constitution ⁷. At least ten natural or/and juridical entity is needed to form an association. Association can be formed for any purpose except for carrying out business activity as a primary purpose, for criminal, military or totalitarian purposes or for purposes banned by the law.

2. Public Chamber: It is an organization with self-governance and registered membership and is *established by the force of an Act*. It fulfills public task in relation to its membership or their activity. The Hungarian Academy of Science, the business and professional chambers are specifically Public Chambers. An act can delegate certain *public tasks* to Public Chambers, and can order certain activities to be pursued only as members of them. Where not stated otherwise the rules of the Association are applied to the Public Chamber.

3. Foundation: It is an organization established in a Letter of Establishment - for *durable, public interest purposes*⁸. Sufficient assets have to be destined for the achievement of the Foundation's purposes⁹, and a management organization has to be appointed. Founders have only limited power over the operation of the Foundation.

4. Public Foundation: It is a foundation which is established by the Parliament, by the Government or by the local government to *secure the continuous provision of certain public tasks (services)*. Organs entitled to establish a Public Foundation are allowed to establish a foundation exclusively as a Public Foundation. The Founder has to point a management organization and a *supervisory organ* of the Public Foundation. Its management organization is to publish a yearly report and submit it to the Founder. The Public Foundation is supervised by the State Audit Office. The founder - in case the tasks of the Public Foundation can be achieved more efficiently in different organizational form - can initiate the abolishment of the Public Foundation at the court. If not otherwise stated, the legal rules of Foundation are applied to the Public Foundation.

5. Public Benefit Company: It is a juridical entity which regularly pursues public benefit activity - having accompanying economic activity without distributing the profit among its members. The Public Benefit Company - if not otherwise stated - is regulated by the rules applying to Limited Liability Companies. The type of the public benefit activity and the accompanying economic activity has to be declared in the Letter of Incorporation. If the Company concludes a contract with a public institution on the provision of public benefit services, that contract shall be free to the public. The main aim of this legal form is to facilitate

⁷ Specific types of associations are political party; trade union (formation of which is allowed only by natural persons); social movement (allowed to have not registered members); union of associations (formed by minimum two associations).

⁸ The content of this expression is elaborated in the 2nd Statement of the Public Administrative Department of the Supreme Court, saying that "a purpose is in the public interest if it serves the public or a wider community; or even if it serves a small group of people or one person in case this is not primarily business activity and generally accepted as being beneficial to the public."

⁹ There is no lower limit of endowment to register a Foundation. The Civil Code is silent over this matter, it is at the discretion of the Courts to decide. At an open-ended Foundation, where other contributors can join, it is enough to have endowment which allows the start of the operation (2nd statement by the Public Administrative Department of the Supreme Court).

privatisation of public services through nonprofit service providing institution.

The law does not distinguish between public, mutual and private benefit entities. The status and fiscal rules are almost exclusively differentiated by the different legal forms¹⁰.

Political parties and Trade unions are associations by legal form. The operational rules of political parties plus the status and operational rules of churches, mutual insurance companies are set out in separate laws¹¹. The specific rules considering the interest-mediating authorities and rights of the Trade Unions are set out in the Act on Labour.

E. REGISTRATION AND INCORPORATION REQUIREMENTS

The association and the foundation has to register at the district court of its headquarter. Dominantly *legal formal and minimal substantive requirements* are to be met for successful registration. Since early 1995 - due to the change in the powers of the Attorney General's Office - no attorney interference is allowed even at the registration of the foundations. This results in one of the most liberal establishment and registration rules in Europe, which fully respects and supports the relevant constitutional rights. It of course creates the danger of allowing high number of potential wrongdoers to found a foundation.

No public administrative interference is exercised at the registration. No registration fees shall be payed by NFPOs. The public has full access to the register, but has limited access to the documents on which the registration is based. In case of rejection of registration, the NFPOs is entitled to appeal to the Supreme Court - it is very rare. The organizations are obliged to signal any changes in their registered datas, however the compliance with this rule is very low.

The Public Chamber and the Public Foundation is to register in the same way. The Public Benefit Company is to register at the District Commercial Court - having the rules of Limited Liability Cooperation applied to this procedure, as to any of its legal aspects not explicitely regulated in the Civil Code.

F. GENERAL POWERS

¹⁰ To be discussed in details at the Section on Fiscal Rules.

¹¹ Act No XXXIII/1989. on the Operation and Economic Activity of Political Parties (which are formed as associations); Act No. IV/1990. on Freedom of Conscience and on Churches; and Act No. XCI/1993. on Mutual Insurance Companies

The NFPOs being juridical entities are entitled to assume rights and obligations which are not exclusively tied to natural persons. These legal acts are exercised through the representatives of the organizations.

G. MEMBERSHIP ORGANIZATIONS

Any Hungarian and foreign citizen can be member of membership organizations. There is no limitation in age or nationality, except for positions of legal representation, where full legal capacity is required. Understandably, no foreign citizen can be a founder or legal representative of a political party, neither can they exercise voting rights within the party. An association's statute cannot prescribe obligatory membership¹². It is deemed not to be undemocratic to confere extra rights on group of members, e.g. on founders¹³. It does not violate the freedom of association if a membership organization poses certain conditions towards establishing a membership relation¹⁴. Procedures of removing a member or for a member to resign are not discussed in the laws.

III. GOVERNANCE

The governance rules of Associations are those of known from the Continental legal practice. The ultimate power lies with the General Assembly of the members, or with the General Representative Assembly. The decesions to be taken exclusively by the general assembly are detailed in the Freedom of Association Act. The association is to appoint a management organ, which can assume certain power. Decesions on dissolution or unification with other association are not to be delegated. Conditions to call a General Assembly are the next: at least every five year or if the court orders it, or else if one third of members asks for it with describing the reason and purpose¹⁵.

The governance rules of the Foundations are less articulated. The founder is entitled to appoint a managing organ¹⁶ or organization. The founders cannot be in a dominant position within the managing organ. The liability for the harm caused by the foundation 'directors' towards third persons lies exclusively with the foundation. The liability of directors towards the foundation is determined by the general civil code liability rules¹⁷.

¹² Journal on Court Decesions 118/1992.(The public chamber can have obligatory membership, as recent Constitutional Court decesions reinforced this.)

¹³ Journal on Court Decesions 119/1992.

¹⁴ Journal on Court Decesions 120/1992.

¹⁵ in Act II/1989. § 11.

¹⁶ The expression of managing organ in case of foundation means a single representative or a board. No consideration is given to further articulation of foundation governance - it is left for the Deed of Establishment. This mostly means the insufficient clarification of internal structures relations.

¹⁷ In practice this has resulted in far below optimal personal liability strigency.

If the conduct of the managing organ endangers the achievement of foundation's primary aims the founder is entitled to withdraw his or her appointment and can appoint another organ or organization. If the founder did not order on this matter, or it has died or ceased to exist, the Court is entitled to take the necessary steps.

Other procedural governance rules (as e.g. voting rights, duties and responsibilities of governing bodies, detailed rules on conflict of interest) are missing from the Hungarian Laws on nonprofit organizations. Some aspects are answered in court decisions, but the lack of these written rules has resulted in gross uncertainty of the boundaries of righteous conduct. Often, the present legal wording does not provide enough orientation even for the Supreme Court's legal interpretation. Failures of complying with nonexisting legal standards are morally pitiful, but legally can not be accounted for.

IV. DISSOLUTION, WINDING UP AND LIQUIDATION OF ASSETS

The fairly detailed dissolution rules of the association and foundation are not accompanied by any bankruptcy, winding up or liquidation rules. This fact makes the responsible economic operation of these organizations almost impossible, and reduces the type and number of the business transactions they can participate in for furthurance of their purposes ¹⁸.

¹⁸ Chapters yet to be completed:
IV. A. VOLUNTARY DISSOLUTION;
B. INVOLUNTARY DISSOLUTION
V. REGULATION
A. REGULATORY AGENCIES
B. ENFORCEMENT STANDARDS
VI. FOREIGN ORGANIZATIONS

VII. FISCAL RULES IN FORCE - 1995

A. DEDUCTABLE CONTRIBUTIONS BY NATURAL PERSONS

30 per cent of all contributions to a foundation, public foundation, incomplete foundation and of contributions by non-members to a mutual insurance company which has its registered office in Hungary can be *deducted from the private income tax* of the contributor provided that these nonprofit organizations pursue qualified activities; and the bylaws and the financial practice of the organization exclude the chance that the donated sum directly or indirectly serves the financial interest of the donor. The list of qualified activities by now contains most of the socially beneficial purposes. However the deduction can not exceed 50 per cent of the annual private income tax of the contributor ¹⁹.

The novelty of the 1995 tax deductability rules is twofold. For first, the contribution is deductible not from the tax base but from the tax directly. It achieves the equal treatment of the donors no matter what is their respective income tax rate. For second, the tax deduction is not tied anymore to the organizations' preliminary permission from the Tax Authority. Terminating the need for permission whilst having the very liberal list of qualified activities means that the deductibility is not tied to any specific worthiness test, it is only dependent on the institutional form.

B. DEDUCTABLE CONTRIBUTIONS BY JURIDICAL PERSONS

Juridical persons which are subject to Corporate Income Tax are entitled to deduct up to 20 per cent of their total annual positive corporate income *tax base* for the contributions made to foundations and incomplete foundations. At the same time they can deduct the donation they make to a public foundation *without limitation in volume*, if the public foundation serves cultural, educational, health, social, religious, youth, or sport purposes. Contribution to foundations can only be made from, and to the degree of *positive income tax base*, while contribution to public foundations can be made also by a company with no before tax profit. The condition to deduct - as in the case of natural person's contribution - is that the organization shall pursue one of the qualified purposes, and it shall be assumable that the donation will not serve the financial interest of the contributor ²⁰.

The advantage of the public foundation over the foundation mirrors the government's intention to draw private capital into public financing. For this reason public

¹⁹ in Act XC/1991 on Personal Income Taxation, par. 38/A (i); par. 40 (2)

²⁰ in Act LXXXVI/1991 on Corporate Income Taxation, par. 4 (1) g-i.

foundations are assumed to serve public interest²¹, while foundations - though they are legally defined as organizations serving public interest - are treated discriminatively.

In principle donations to associations are not eligible to deductions, however if the given association receives the contribution in the technical form of incomplete foundation for one of the qualified purposes then it can lawfully enjoy the same benefits as the foundations and incomplete foundations.

C. TAX TREATMENT OF PAYMENTS FROM NONPROFIT ORGANIZATIONS

Grants to natural persons from foundations, public and incomplete foundations are exempt from personal income taxation if it is given to social, health, youth and prevention of crime purposes. Grant given as scholarship to studies and research is also tax exempt.

Grant - irrespect to her objective eligibility - which serve the founder, the contributor, the officer, the employee of the foundation or other person who is in contractual relationship with the foundation; and the grant which is payed out for purposes different to those in the Charter of the foundation are subject to personal income taxation ²².

D. RELATED BUSINESS ACTIVITIES

The association, the foundation and the public benefit company may pursue business activity as long as it supports the attainment of the organization's primary purpose and does not become itself primary purpose. The CIT defines the business income which is subject to corporate income taxation ²³; and in an appendix it defines those *activities* which can be pursued by an association, foundation or public benefit company as a primary purpose activity *without* being subject to corporate income taxation ²⁴.

The passive investments of these organizations and their occasional sale of property serving exclusively primary purposes is generally not subject to corporate tax. The associations and foundations can pursue all primary purpose activity taxexempt, because on the exempt activities list there is a "catch-all" cathegory, which says that "all other activity mentioned in the Charter of the organization as its purpose is exempt". Besides, activities which are not their primary purpose activities can be pursued by them untaxed if they are listed in the appendix. In fact, owing to this catch all cathegory almost all income of associations and foundations qualifies as related business income.

²¹ The wording on public foundation says, that it is to be established to take on 'public tasks' and it has the requirement to name the quote an/the act which declares a certain aim or activity to be a public task. This is not required from foundations.

²² in Act XC/1991 on Personal Income Taxation, par. 3 (29); par. 7 (1) 30.

²³ in Act LXXXVI/1991 on Corporate Income Taxation, par. 1 (1)

²⁴ in Act LXXXVI/1991 on Corporate Income Taxation, Appendix No. 9.
List A for Associations and Foundations, List B for Public Benefit Companies

The public benefit company has a separate, more restricted list of exempt activities. Moreover, it qualifies for the tax exemption on the grounds of related business activity *only* if it concluded a servicing contract with the local government, with the social security or with one of the ministries in one of the activities listed. This restriction is among the reasons why there is not more than a dozen public benefit companies in Hungary after more than a year of introducing this legal form.

The number of separate lists (as opposed to unified categories for all purposes) result in unnecessary and inconsistent duplications.

E. UNRELATED BUSINESS ACTIVITIES

The nonprofit organizations are obliged to keep their related and unrelated business activity separated in the books ²⁵. For the unrelated activity they are subject to income taxation. They must signal the unrelated business surplus in their annual profit and loss account. On certain condition, however, they are freed from paying in the accounted corporate income tax of their unrelated business activity.

Namely, the association, the foundation, the public foundation, the church and even the public chamber is entitled to retain its corporate income tax if their annual unrelated business income does not exceed 10 million HUF (appr. 100.000, USD) or 10 percent of their gross annual income ²⁶.

Since there is no other administrative rule to limit unrelated business activity, than it cannot become a primary purpose of nonprofits, the cap on taxfree unrelated activity serves as guarantee against unfair competitive advantage of nonprofits over business firms. The enforcement standard of taxation on excess unrelated business activity is generally low.

F. VALUE ADDED TAX

The nonprofit organizations, as a general principle, are exempt from VA taxation, since as long as they do not charge for their services to their beneficiaries they are considered as final consumers. They do not pay in and cannot claim back VAT.

In the Appendix of the Act on Value Added Tax there is a list of services which enjoy *objective immunity from taxes* ²⁷. Many of the usual nonprofit services (eg. education, social work, human health, scientific activity, sports and cultural activity) qualify as objectively immune.

²⁵ in Government Order 157/1992 on Accountancy Rules and Annual Account of Nonprofit Organizations.;
in Government order 114/1992 on Operational Rules for Associations;
in Government order 115/1992 on Operational Rules for Foundations;

²⁶ in Act LXXXVI/1991 on Corporate Income Taxation, par. 10 (1);

²⁷ in Act LXXIV/1992 on Value Added Taxation, Appendix 2.;

Nonprofit organizations pursuing nonqualifying business activity under 1 million HUF (appr. 10.000, USD) can choose for *subjective immunity from VAT*, or for being subject to VAT. Once they are subject to VAT they are liable to pay in the tax on their business activity and they can claim the VAT back on those purchases which were executed in relation with their business activity. For this reason they have to proportion the costs between business and primary purpose activities. Since the VAT is primarily viewed as normative revenue raising taxation technic, no special benefits exist for nonprofit organizations.

G. OTHER TAXES

Customs. Goods which will be part of public scientific or cultural collections can be imported customs duty free. Goods which are taken to Hungary without consideration by a foundation or incomplete foundation to serve their primary purpose in the interest of the wider public can be imported duty free, as long as they are not sold further within the country; nor they are used for business activity. The decision is done on a case-by-case base by the national Chief Commander of Customs Service²⁸.

In 1995 charitable purchases financed by monetary donations coming from abroad can be exempted from the VAT burdens by the occasional permission of the Head of the Tax Authority.

Property transfer duty, gift duties. There is an objective immunity from gift duties if the gift will serve the purposes of Hungarian science, education, art and culture, and social welfare. Besides, some legal forms are totally exempted from the duties. These legal forms are the state institutions, public authorities, the churches, *the associations and the foundations*. Churches, associations and foundations are entitled for exemption if their income from preceding year did not qualify for Corporate Income Taxation (no matter whether they had to pay it or not)²⁹.

Local taxes. For local tax purposes the nonprofit organizations are qualified to the amount of their annual unrelated business income. The local authorities are entitled to provide preferential treatment or exemption for the nonprofit organizations, so often local entrepreneurial taxes are directed to nonprofit institutions serving public interest³⁰.

²⁸ in Mutual Order by the Finance Minister and Minister for Foreign Trade 39/1976, par 80. (1).(4);

²⁹ in Act XCIII./1990 on Duties; par. 5 (1)-(3); par. 17 (1)a.;

³⁰ in Act C./1990 on Local Taxes. par. 3 (2); par. 52. (22),h.;

VIII. COMPLIANCE

Compliance with the described legal rules is problematic, since the rules are fairly formal and cover only the basic aspects of existence. The laws are silent on the most important *operative* matters, so in many cases the question of compliance can not even be raised.

The public opinion of NFPOs conduct has been dominated by the negative examples of overt political involvement and irresponsible management. Lately, due to strong campaigning of some prestigious voluntary organization, a more elaborated picture is forming.

IX. CONCLUSIONS

The underlying legal phylosophy of the Hungarian nonprofit legal regulation is liberal enough to allow the principles of freedom of speech, conscience and association fully effectuate. The development of the Hungarian nonprofit organizations has, however, reached a point, when a more articulated, complex operational framework has to be built in line of the appropriate legal phylosophical principles.

The political context of the nonprofit legal reform is contradictory. Current developments of state budgetary reconstruction and reduced public service provision by state institutions count with the increased social-economic role of the nonprofit organizations; while the current budget deficit and the resulting restrictive fiscal policy acts as a force against any development in NFPOs' operational conditions. It remains to be seen whether the sector can make the decesionmakers aware of the society's and their own long term interest. Whether changes happen or not - it will largely determine the development of the nonprofit sector and ultimately the social and economic institutional structure of Hungary for decades.