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The Hungarian Environment for Endowments and Financial Sustainability

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Executive Summary

The Hungarian NGO sector is vulnerable to governmental actions, shifting economic conditions and increased competition for attention and financial support. The sector is highly politicized and weary of the constant struggles during the past decade. There is a tendency to focus on the obstacles and to justify a complacent attitude. This report calls on the Hungarian NGO leaders to direct their attention to opportunities that will help the sector overcome its current challenges. This can be accomplished by establishing organizations that represent the sector and are dedicated to promoting its agenda, articulating its achievements, and assisting in its professional development. A key element for success will be the formation of a mutually beneficial strategic partnership with the financial service community. These two ingredients will enhance the NGO sector's ability to encourage clarity, uniformity and reasonable tax incentives into the legislative environment.

The Hungarian NGO community has been characterized by its innovation, responsiveness, and the dedication and passion of its leaders. These traits have served the sector well. However, the complexities of the current environment demand that new

organizations be developed. These organizations must be staffed with individuals that possess the skills of financial management, marketing, advocacy, facilitation and collaboration. The future for the Hungarian NGO community will be greatly influenced by its ability to develop these sectoral organizations that identify and address the broad issues that impact the environment.

Introduction

This is the third report on the critical issues and challenges facing the NGO sector in countries in Central and Eastern Europe. Past reports addressed the environment in the Czech and Slovak Republic (1998) and Poland (2001). The project is administered by the EastWest Institute and made possible with the generous support of the Charles S. Mott Foundation.

The purpose of this report is to provide information on the environment that affects the development of long term financial sustainability for NGOs in Hungary. This includes issues of legislation, regulation, financial investment alternatives, financial management skills, and a general analysis of the culture that impacts establishing and managing endowment funds and other instruments that provide for long term sustainability. The report is primarily intended to enhance the dialog among the Hungarian NGO leaders and to serve as a catalyst for future actions. It is their actions, creativity and dedication that will determine the future environment for financial sustainability. Based on their past

performance, I am confident that they will succeed in addressing the challenges and opportunities outlined in this report.

The report is also intended for parties interested in supporting the development of the Hungarian NGO sector. The scope of the analysis is limited to those issues that are critical to long term financial sustainability. It is not, therefore, a comprehensive analysis of the legal or financial environment in Hungary. For those interested in this type of information I strongly recommend *The Nonprofit Sector in Hungary* by Eva Kuti, and *Caught in the Net in Hungary and Eastern Europe* by Zsuzsa Szeman and Laszlo Harsanyi. Additional legal information is available from the International Center for Not for Profit Law (www.icnl.org). The winter 2002 issue of SEAL has an excellent overview of the laws that impact foundations and endowments (authored by Miklos Sandor). Other resources include the Nonprofit Enterprise and Self-sustainability Team known as NESst (www.nesst.org) and the NIOK – Nonprofit Information and Training Center (www.niok.hu).

The terminology in this report may be confusing. I often use the words, NGO, PBO, foundations and association. The primary emphasis of this report will apply to grantmaking organizations. From a legal point of view, both foundations and associations can be grantmakers. Foundations are the most common organizational forms in which one would expect to find an emphasis on long term financial sustainability, however, there are other non-profit organizations in Hungary that have similar interests. It is my hope that both grantmaking and non-grantmaking organizations will find value in the report.

Research for this report was undertaken from the summer of 2001 to the spring of 2002.

I made several trips to Hungary meeting with leaders from the NGO community, financial advisors, bankers and others engaged in the development of the non-profit sector. The primary instrument for research was interviews and conversations with individuals knowledgeable in their field. A questionnaire was developed and utilized to initiate discussion and gather limited information concerning the nature of planning for financial sustainability. I am indebted to those who generously shared their time, insight and experiences with me. I am particularly grateful for the administrative assistance of United Way of Hungary and the guidance and support of its executive director, Katalin Ertsey. She represents the best of the Hungarian NGO sector and those that are the foundation for hope. Like her, there are many in Hungary that are passionate and dedicated to the growth of the sector, open to new ideas, not limited by the status quo, intelligent, friendly, and possessing the leadership skills that are critical to success.

The Hungarian NGO Sector

Hungary has a long history with non-profit organizations or voluntary associations. They appeared in the late eighteenth century and played a critical role in the cultural and political life of the country. According to a recent World Bank report (*NGO Taking Stock in Hungary*, Kuti, 2000), voluntary associations created many of the social, cultural and humanitarian institutions present in Hungary in the early 1900s. The development of

kindergartens, museums, libraries, children's hospitals and employment agencies are credited to these voluntary associations.

The Communist Party derailed the influence and progress of the third sector after World War II. The State was thorough in the manner in which it eliminated voluntary associations. It developed laws and regulations that made the existence of a voluntary association all but impossible. Funding for many NGOs was assumed by the State Budget and brought under the control of the Communist Party. By the end of the 1950s there were few, if any, independent voluntary associations in Hungary.

During the 1960s and 1970s the government eased its restrictions on the third sector. By 1970 there were over 8,000 voluntary associations in Hungary. Many of these were controlled by the political elite and were used to divert public resources to enhance their lifestyles or wealth. But the government did allow some voluntary organizations to exist that met the social, cultural and often political needs of the common citizen. In many cases the real goals of these organizations were hidden or disguised. The culture of deception and mistrust between the public, the government and the NGO sector lingers today and has an impact on the environment in which non-profits operate.

There has been explosive growth in the Hungarian NGO sector since 1990. Today there are more than 50,000 non-profit organizations in Hungary. Many are small and focused on the narrow needs of their interest group or supporting organizations, such as those dedicated to sports activities and hobbies, for example. The ones of primary interest to

this project are those which have broad social, cultural and economic agendas, independent from government or corporate control, and are engaged in a process of addressing their long-term financial sustainability. It is estimated that there are fewer than 500 voluntary associations that meet these criteria.

The NGO sector has been characterized as being responsive to public needs: innovative in its approaches and solutions, developing strong personal contacts with its clients and constituents; and having strong professional identities (Kuti, 2000). These strengths are offset by the sector's financial vulnerability, management problems, lack of cooperation, and weak sectoral identity. While these challenges may appear to be daunting, the Hungarian NGO community continues to demonstrate its responsiveness, innovation and commitment by tackling the weaknesses. A key ingredient to success will be the ability to attract the financial resources necessary to sustain current activities while during this process.

The Legal Environment

The legislation and regulations affecting financial sustainability can be placed into three categories: those impacting the governance and organization of the NGO, those limiting the NGO's ability to engage in business and investment activities, and the laws and regulations affecting the source of funds. Hungarian laws in these three areas were generally supportive and liberal in the early part of the 1990's. During the past decade the government has passed a number of laws aimed at clarifying the organizational and

governing structure of non-profits. They have sought to restrict abuses of the NGO status by addressing business and economic activities. While they have passed innovative legislation that allows taxpayers to dedicate 1% of their taxes to the NGO community, they have limited the tax incentives for individual and corporate donations.

In 1997 the parliament passed the Law on Public Benefit Organizations that summarized the five legal forms for voluntary organizations. Two of these, the Public Law Foundation and the Public Law Association, can only be established by the Parliament, the Government or local governments. Voluntary associations are membership organizations that either serve their members only or a public purpose. Foundations must be operated by a governing body and must have some initial capital. In the case of a closed foundation, where no contributions are allowed in the future, the initial capital essentially serves as an endowment and must be large enough for the foundation to meet its objectives. This, however, is a rare case. Most foundations are established as open foundations, which means that others can contribute to the initial capital at a later date. In this case the initial capital must be adequate to begin the operations of the foundation. In practice the registration courts accept an initial capital as low as \$1,000.

Foundations may engage in giving grants, fund-raising and providing services.

Foundations and associations must register with the court. A Public Benefit Company (PBC) is established to provide services and products that meet public needs. They essentially operate as a limited company but are not allowed to distribute profits. For this reason PBCs must register with the tribunal.

All of the above organizations may receive public benefit status if they meet certain conditions outlined in the Law on Public Benefit Organizations. They can meet these conditions by undertaking activities that serve the social, educational, cultural, and environmental or health needs of the general public. They cannot distribute profits to their members or owners, can only pursue business activities that further their objectives and cannot directly engage in political activities.

Foundations are required to submit a charter which states its activities and statutory purpose, its assets and liabilities, and the list of members of the governing board and representatives. A major intent of the existing law is to ensure that the governing board and the founder be independent. The founder retains the right to appoint and dismiss the members of the board and therefore may limit the effectiveness of the law. The law also states that only the founder can amend the charter of a foundation. There is little case law that addresses the issue of the demise of the founder, either regarding the death of an individual or the dissolution of a corporate founder. There have been some recent changes in the law that makes it possible to name a successor to the founder.

While there is legislation addressing transparency and accountability, a standardized reporting system does not exist. PBOs (foundations, associations and public benefit corporations) must keep financial records, and those with assets over 5,000,000 HUF must create an independent supervisory board. The public prosecutor's office can take action against any foundation or association if it determines that illegal activity is taking

place. All PBOs are required to create a public benefit report, and certain ones are obligated to publish these reports to the public.

The Central Statistical Office of the Hungarian Government has collected and analyzed data from the NGO sector for a number of years. They have produced valuable reports that provide information on the NGO community. This data and analysis coupled with the work of NIOK; John Hopkins Nonprofit Studies Project and others have contributed greatly in defining the size and scope of the sector. Much of this data is based on surveys and statistical analysis. Much of the information critical for financial sustainability is not readily available.

While the parliament has moved to address some of the issues concerning the organization and governance of foundations and PBOs, there remain some serious gaps. This results in an atmosphere of confusion and uncertainty. There is a widely held belief that the NGO sector is highly politicized. These factors may have a negative influence on the NGO community's ability to attract funds for long term financial sustainability.

The first reading of Hungarian legislation addressing the ability of NGOs to engage in investment activities appears to be very supportive. According to the law, foundations and associations can engage in business activities that support their statutory purpose. The tax law provides for tax exemption for these types of activities. In the event that a foundation engages in business activities that are not in keeping with its statutory purpose, the tax law exempts the first 10,000,000 HUF (\$35,000) from tax, if that amount

is not greater than 10% of the total revenue of the entity. Earnings above this amount is taxed proportionally according to the business income share of total income.

There is, however, a great deal of confusion on this issue. Many knowledgeable individuals believe that capital gains and the profit from the sale of the assets of the foundation are subject to taxation. Most agree that interest from bank deposits and treasury instruments would be tax exempt. The confusion may come from the lack of clarity within the law. There is little guidance in helping define the difference between business and economic activity. A foundation that actively manages its assets and generated both interest income and capital gains may be declared to be engaging in non-related business activities. This would subject the foundation to taxes and possible penalties.

There is also no provision in the legislation that provides guidance to the NGOs concerning the characteristics of the investment portfolio. The lack of this guidance could result in poor investment policies (given the low level of financial management skills in the sector) and the loss of the foundation's assets. The law on Public Benefit Organizations does require that the governing board approve of the investment policies of the organization. This may encourage the board's participation in determining the investment strategy, but there is no insurance that those policies are reasonable or sound. The loss of a foundation's assets because of ill-advised investment (or fraud) could send shock waves throughout the NGO community, harming its ability to attract public funds and possibly resulting in additional government restrictions.

Hungary is known throughout Central Europe for the law passed in 1996 that allows the individual taxpayer to allocate 1% of their taxes to an eligible public benefit organization. In 1997 over 1 million taxpayers elected to dedicate 1% of their taxes to non-profit organizations. This provided 1.7 billion HUF (\$6,000,000) to these organizations. The success of this legislation is still debated, and its impact on the NGO sector is the source of much research. Approximately 30% of eligible taxpayers choose the 1% election. These funds account for less than 5% of the total revenues to NGOs. Research compiled in 2000 (*1%, Non Profit Sector Research Series*, 2000) indicates that small local NGOs are the biggest beneficiary of the 1% law. A few large NGOs have been able to attract substantial contributions from this source; however, it may prove difficult for larger, broader-focused organizations to mount effective campaigns that will allow them to base much of their financial sustainability strategy on these contributions.

Tax policy can play a major role in providing an incentive for individual and corporate donations to the NGOs. Hungary has greatly diminished this incentive in recent years. Current tax law allows an individual to receive a tax credit equivalent to 30% of his/her donations to qualifying organizations, i.e. PBOs. In other words, if an individual donates 10,000 HUF to a PBO, that person's tax liability is reduced by 3000 HUF (30% of 10,000). The deduction is limited to an amount not to exceed 50,000 HUF (\$175 USD) or 100,000 HUF (\$350) for outstanding PBOs. This may appear to be reasonable given that the official average income in Hungary is less than \$500 per month; however, it does not provide much incentive for above average earning individuals.

The corporate tax code provisions are more favorable. Corporations are allowed to deduct up to 100% of their donations to PBOs from their tax base as long as the total deduction does not exceed 20% of the pre-tax profit. There is also a provision that allows corporations to increase the percent of the deduction to 120% if the donation is recurring and does not exceed the 20% of pre-tax profit threshold. The personal income tax also has this provision, increasing the deduction to 35%. A recurring gift is allowed when the corporation agrees (in writing) to contribute the same or greater amount to a NGO for a period of four years. (PBOs that meet the “eminently public benefit” legal status have additional tax advantages).

Appendix 1 is a more detailed legal memorandum on the Hungarian laws impacting endowments. This memorandum was prepared by Ms. Nilda Bullain of the International Center for Not for Profit Law’s (ICNL) Budapest office.

Financial and Economic Factors

Two critical factors should be considered in the discussion of long term financial sustainability. The first is the availability of funds to support the NGO sector. This includes individual, corporation, and government sources in Hungary. Sources outside of Hungary including foreign individuals, corporations, governments and multilateral organizations must also be taken into account. The second factor is the financial management capabilities available to the NGO community.

The economy of Hungary continues to develop and is forecast to grow at a rate above 3% in the near future. While the overall economy has performed well, relative to the region, the average citizen is struggling to meet the needs of the family. The economy is still in the process of overcoming problems associated with the Communist period and transition to a market based economy. In the early 1990s the number of individual Hungarian donors and their total contributions to the sector were growing at an impressive rates (Kuti, 1996). These trends may not continue given the changes in the tax codes and the competition for individual's disposal income.

The economic changes in Hungary have produced many entrepreneurial opportunities and consequently created a small, but growing, class of high-income individuals and wealth. Many are professionals and business owners. The majority of these individuals are connected with a business, and often the business will be the source of financial support of an NGO. It is estimated that 20% of the revenue to the NGO community is from individuals and businesses.

The government sector has contributed 22% of the financial support to the NGO sector. This is low relative to other countries in the region and Europe. The passage of the 1% law in 1997 altered the relationship between the State and the NGO sector. It appears that the current philosophy of the government is to develop a partnership with the non-profit community that is based on efficiency and views the NGO as a deliverer of social services. This will narrow the ability of the NGO community to address issues that are

not seen as critical to the government. The new relationship will also dictate that the success of an NGO is determined by quantifying effectiveness in the delivery of services.

Over 50% of the revenue to the NGO community is derived from related and unrelated economic activity. (A recent survey by EMLA points out that much of these revenues are payment for services contracted by, and paid for, by government agencies.) Many organizations have revised their strategy to generate fees for services rendered and to develop business activities that will support their mission and create profit. Those that demonstrate that the business activity is related to their goals and objectives are able to produce income free of taxes. Where this is not possible, the income is taxed at the corporate rate (subject to its portion of total income). The growth of these activities has increased the need for NGOs to develop business skills and relationships. Often, the NGO's attention and resources are diverted to non-related business functions. As a result, the value to the original target group, or cause, may be diminished. This could have long term negative consequences for the NGO and the sector as a whole.

During the early part of the 1990s foreign assistance to the NGO sector was highly visible. Data from a survey in 1998 indicate that 6% of all non-profit revenue was from foreign donors (Kuti, 2000). The support was received by 3% of the NGOs. Less than 1% (357 organizations) of all NGOs received more than two thirds of their support from foreign sources. It must be noted that foreign support has been critical for much of the development of the NGO sector. Their support of a limited number of organizations has been beneficial for the entire NGO community. Foreign donors have elected to reduce

their support in Central Europe during the past few years. This is somewhat offset by the current and expected financial support of the European Union. As Hungary moves closer to integration with the EU, funds may become available to meet social and cultural objectives. The NGO sector may have a competitive advantage in attracting these funds. A key factor will be their ability to demonstrate sound financial management skills to the EU.

Earnings from the assets of the NGO sector accounts for 7% of the total revenue. This percentage has declined in recent months, but it may be caused by a decline in the overall interest rates. According to a government source, 66% of all NGOs have reported earnings from interest or dividends. Based on the perceived low level of financial management skills in the sector, as well as the confusion surrounding the legal ability of NGOs to actively manage their financial assets, this is an area that could be enhanced. Since it would require a substantial investment in human and financial resources to increase the level of financial skills in the sector, it is logical to explore tapping into the capacity of the financial service community.

Rapid growth, consolidation and globalization have characterized the Hungarian financial services sector in recent years. These trends have resulted in a financial community that is more professional, better supervised and aggressive for untapped opportunities. It has also created an environment in which the profitability of providing services is carefully monitored. This emphasis on profitability has altered the relationship between individual NGOs and their banker and financial brokers. During the period of consolidation the

focus of many financial service organizations was shifted from serving the client's needs to issues of reorganization. The environment may now have settled down to a point where the NGO community could develop a mutually beneficial partnership with the financial services sector. The key will be an understanding of the needs and motivation of both partners.

Recommendations

It is difficult to propose solutions to complex problems. This is especially true when one is not actively involved in the day to day details of operations. Many critical issues are often overlooked in an analysis. The following recommendations are offered with humility and respect for the dedication, commitment and passion that characterizes the Hungarian NGO community. It is my hope that these recommendations will contribute to the ongoing dialogue that is taking place in Hungary. I am confident that those individuals that have invested their time, energy and lives to furthering the development of the Hungarian NGO community will continue to overcome obstacles, create innovative solutions and address the social, cultural and environmental challenges that face their country.

Create Umbrella Organization

The critical element in the continued development of the NGO sector is the creation of an umbrella organization that will address broad needs of the community. Other researchers

interested in the development of the sector have also advocated such an organization. In 2000 Eva Kuti made the following statement (NGO – Taking Stock in Hungary);

“...non profit organizations should really organize themselves, develop their own rules of ethical behavior, establish umbrella organizations, improve cooperation and information exchange within the sector, significantly increase the efficiency and professional quality of their activities. This need for professionalization and cooperation is a very important challenge, and this is the point where the weakness and responsibility of the sector is the most obvious. Numerous and influential as they are, NGOs are still not conceptualized in terms of a separate and independent sector, similar to the public and private sectors. They can hardly claim that they would really work or identify themselves as a community, which represents civil society.

An institutional field can gain collective identity if its members tend to move in concert. The lack of these coordinated movements is one of the most difficult problems in the Hungarian voluntary sector.”

It may not be feasible to create a single organization to represent the entire NGO sector in Hungary at this time. There would be great benefit to the entire NGO community, however, if an organization were to be developed that focused on the issues of foundations and grant giving organizations. In addition to the activities outlined by Dr. Kuti, this organization would serve as an advocate for the foundation community. They would lobby for reasonable and empowering legislation from the government and parliament. They would strive to build relationships with the business community. A mutually profitable partnership could be developed with the financial services industry. The umbrella organization could engage the services of financial experts to work with bankers and financial advisors to create specialized instruments that would meet the needs of the foundation sector.

The umbrella organization would also serve as facilitator for discussions and dialogue amongst the members of the NGO community, and where appropriate, members of the public and private sectors. The organization could gather data and shape the information in a manner that articulates the benefits, needs and accomplishments of the NGO sector to constituents. The NGO community is burdened with distorted images and historical characterizations. The public is often misinformed or unaware of the contributions that foundations and other NGOs make to society. An ongoing marketing campaign undertaken by the umbrella organization would provide citizens, politicians and potential donors with valuable insight and information.

The umbrella organization could address the education and professionalization needs of the sector. This could be accomplished by adopting a set of professional and ethical standards and facilitating the development and delivery of educational courses and materials.

It will take time and resources to develop such an organization (or various organizations). Initially it may be advisable to concentrate on limited tasks or a selected group within the NGO community (i.e. grant giving foundations). With success, the organization can expand its services and reach. While this approach may be prudent, it will be beneficial to envision the impact and contributions of a much larger organization to the sector. The value of articulating the "vision" will encourage others to invest the necessary time, resources and energy.

There are currently several organizations and groups that are involved in various issues that face the NGO sector. Many are doing exceptional work and are to be commended and encouraged. Some of these groups are comprised of NGO leaders who are busy with directing their own organizations. They undertake the additional responsibility of addressing the urgent needs of the sector while maintaining their demanding work schedules. While this is admirable, it is best delegated to an organization whose primary purpose is to represent and promote the sector (or a segment). It is hoped and expected that NGO leaders would remain active as advisors and members of the Board of Directors of the umbrella organization. This organization must be properly staffed and provided with adequate resources. Support for the development of such an organization would be a valuable contribution from Western donors, whose financial resources and experience could enhance the prospects for success.

Identifying the goals and objectives of the organization is critical to success. The goals of the organization must be articulated in a manner that demonstrates its value to the NGO sector. Once the goals have been identified they must be prioritized. This includes an analysis of the need for the objective as well as the prospects for success. This may be a long and daunting process, but should not be overlooked. There are valuable models and resources in neighboring countries in Central Europe that may provide assistance and guidance.

Another key ingredient to success is to insure that the organization embraces all those in the targeted segment (for example, grantmaking organizations). As with most countries,

there is a tendency to create organizations with a bias towards the capital city. Such an approach will limit the effectiveness of the organization and deprive it of valuable experiences and knowledge. Every effort should be made to create an inclusive organization.

An alternative approach would be to designate a person to serve as a “strategic broker” for the NGO sector. A strategic broker is a person who can identify the critical players involved in an issue, and facilitate cooperation between the parties. The strategic broker could be housed in an existing organization and dedicated to addressing specific issues and challenges that face the NGO sector. Salary and expenses could be paid for by contributions from NGOs and outside donors. This could be a beginning point for the development of an umbrella organization.

It is doubtful that the other recommendations in this report will be feasible without the existence of an umbrella organization or a dedicated strategic broker.

Legal Reform

Based on a liberal reading of the law, foundations are able to invest in many types of financial instruments and maintain tax exempt status. The courts and tax authorities may not share the same view. The confusion surrounding the interpretation of the laws, the political nature of the relationship between the NGO sector and the government, and the lack of conformity within the tax, civil and corporate codes create an unstable and

uncertain environment. The dissemination of consistent legal opinions on the interpretation of the tax code may relieve some anxiety. However, the situation ultimately needs official clarity. One tactic to achieve this would be the passage of comprehensive legal reform that provides uniformity between the various legal codes. Such an approach would be lengthy and require a great deal of investment in the political process.

The current laws do not provide much guidance concerning the types of investment allowed or the balance that would be prudent for endowment type portfolios. However, the Hungarian system does have an instrument that could serve as a model. Voluntary Mutual Insurance Funds were established in 1993 (Act XCVI of 1993). Individuals are allowed to invest in various financial products that provide for financial growth while insuring prudence. The amount of funds dedicated to equities is limited to 30% of the portfolio and an approved financial manager must manage the funds. The characteristics of the Voluntary Mutual Insurance Funds are similar to endowment funds. The NGO community should use this as a model to clarify and standardize tax exempt investing of NGO financial assets.

The presence of the prosecutor system in Hungary provides another avenue to bring clarity to the legal issue. While there is no legal precedence in Hungary, there is an opportunity to utilize the opinions of the local prosecutor to provide guidance in interpreting the law. The ruling of the local prosecutor is communicated to the central office and is available for distribution to other local prosecutors. NGOs could work with

that office to explore issues such as the distinctions between economic and business activity. This is critical to the ability of NGOs to engage in investment activities that will provide the organization with reasonable and prudent returns on their financial assets. Cultivating a relationship with the prosecutor's office could also strengthen the NGOs position in proposing legislation that would clarify issues that are confusing.

The NGO community needs a legal environment that encourages individual and corporate support. The existing laws clearly do not meet this test, especially in terms of the individual. The limits on the deductibility of contributions to an NGO are unreasonable given the need to attract the middle and upper income taxpayer. Adjustment to the deductibility of donations should correspond with the income levels of wealthier individuals and the need of the NGO to gain their support.

Corporate tax incentives are adequate, but could be enhanced by allowing contributions to PBOs to be accounted for as an expense and fully deductible. The NGO community should take advantage of the recurring gift provisions of the tax code. It would be beneficial to pursue a change in the tax code that would allow corporations to take the stepped up basis for a recurring gift if the amount of the gift were based on a percentage of the profits of the corporation. Many corporations may be more inclined to sign a recurring gift agreement if the amount was based upon their level of profitability rather than a set monetary amount.

Partnership with Financial Service Sector

One of the major weaknesses of the NGO community is the lack of financial management skills. Time and a continued emphasis on education and training will lessen the severity of this problem. During that time period, however, the NGO sector could suffer the loss of many opportunities to garner financial support and generate income from services.

The European Union has indicated that it views the NGO sector as a partner for addressing social and environmental issues relative to EU enlargement. They have also expressed concern about the sector's financial management capabilities. If these concerns are not addressed in the near future, the EU may turn to professional consulting firms. This would deprive the NGO sector of income and the chance to demonstrate its contribution to society.

The financial service sector in Hungary is strong and open to opportunities to the development of profitable services. Many in the banking community are unaware of the size and scope of the NGO sector and the potential profits associated with serving their needs. A banker in Budapest stated that he had spent six months investigating the size of the NGO sector, only to give up in frustration when he could not find reliable sources of information. He suspected that the assets of the sector were sufficient to justify a serious campaign to attract customers. Without information or an identifiable organization to guide him, he was forced to abandon his idea.

There are few NGOs in Hungary large enough to warrant much attention by the financial service industry. However, by collaborating and working together, the NGO sector could present a financial service company with an attractive picture. The range of services that could be provided includes asset management, funds management, loans and personal financial services for NGO professionals. Banks and investment firms could also become interested in designing innovative instruments that would attract funds from individuals and corporations in the United States (see appendix 2 for an example of the type of product that could be developed with the financial community).

The benefits to the NGO community extend beyond financial services. The banking and investment community generally has more political capital than the NGO community. A partnership could enhance the ability of the NGO sector to pass legislation that would be supported by the finance community. Where feasible the NGO community should seek to reframe its issues in terms of economics and finance. In other words, the issue should be articulated in a way that it will be seen as beneficial to banking and the economy as a whole.

The financial community has great skills and knowledge in the area of financial management. A relationship that is properly structured could allow NGO leaders and employees to learn and enhance their financial skills. This is often less expensive than traditional training and would open the door for mutual understanding of the challenges and issues of each partner. The relationship should be reciprocal and allow the financial

service provider to gain insight and knowledge into the needs and contributions of the NGO.

Attitudes

The past few years have been difficult for the Hungarian NGO sector. The government has redefined its relationship with the sector and has implemented legislation that has diminished the advantages it held during the early 1990s. The transition to a market based economic system has burdened the NGO sector with increased operating cost, greater competition for financial support and the loss of many seasoned and experienced leaders. Globalization and the loss of many Western donors have altered the support system of the NGO community. In spite of these and other events, the Hungarian NGO sector developed a reputation for innovation, responsiveness and professionalism.

During the interview process of this project there I noticed an element of pessimism creep into many of the conversations. There seems to be a growing sense of fatalism and resignation within the sector. While much of this can be justified and understood, it is critical that this attitude be addressed and attention paid to overcoming this way of thinking. A shift in the view of the world is necessary if the sector is going to address the challenges it faces and continue to develop innovative solutions to real and imagined obstacles. This will not be easy and will require constant diligence.

The Foundation for Szeged is an example of the success of a positive attitude and a shift in viewing the environment. The Foundation for Szeged has successfully developed a funding base that includes the majority of the corporate sector in the community. They have accomplished this in spite of the growing international ownership of the industrial base. Refusing to accept that international owners are not interested in supporting the community, the Foundation has built a relationship with corporations based on addressing their need to demonstrate good corporate citizenship. The corporations view the Foundation as a valued partner in creating a positive image and have responded with financial contributions and the personal involvement of high level executives.

The Foundation for Szeged has analyzed the existing legal structure for foundations and has taken advantage of opportunities for business activities, investments and fund raising. It has created entities that provide the Foundation with income, access to funding sources and resources that lower its operating cost. The Foundation does not actively solicit donations from the 1% law based on the belief that these funds would better serve the smaller non-profit organizations in the community. This approach has enhanced the image of the Foundation and in the long run may help to expand its funding base.

The Foundation is actively engaged in supporting the social, economic and cultural elements in the community and does an outstanding job in building relationships with the public and private sectors. These relationships and their attitude of identifying and serving the needs of its constituents have guided the strategy and philosophy of the Foundation. There are other foundations and NGOs in Hungary that mirror the success

and approach of the Foundation for Szeged. It is important that this type of community philanthropy be recognized. The practices, tactics and spirit of these organizations should be replicated, shared and celebrated.

The NGO sector also needs to consider reviewing some of its long held beliefs. The work of the non-profits is often measured in terms of creating a better life, righting a wrong or addressing the needs of the overlooked or abandoned. Many of these acts cannot be measured in the terms of the private and public sector. It is important that the NGO community seek to understand the language of business and politics and where possible frame their issues and contributions in terms that can be related to the concerns of the other sectors. All three sectors will reap the reward of building relationships based on common understanding and mutual benefit. The NGO sector has much to offer the public and private sectors and can enhance their value and position by articulating its potential in terms that are understandable and well defined.

There are historical reasons for the caution and mistrust that characterizes the relationship between the NGO sector and the government. While these may be justified, the NGO community should seek avenues for cooperation and collaboration. The government does have the ability to greatly influence incentives for financial support and can limit the activities of NGOs through regulations and legislation. However, there are areas in which the NGO sector's cooperation with the government will outweigh this concern. One such area is the need for data collection. Information can be power, and it is understandable that many would prefer to limit the government's access to certain data.

On the other hand, the government can be a reliable source of information that would open opportunities of other relationships and provide some needed oversight. The NGO sector should investigate a relationship with the government that includes standardized reporting and sharing of information that both believe are beneficial.

The loss of many Western donors and the competition for disposable income in Hungary could severely dampen the ability of the NGO sector to develop. There are, however, many corporations and individuals that have wealth and are potential supporters of the work of the NGO community. Some of these already support the sector and others may provide financial resources for the operating needs of NGOs. Long term financial sustainability requires that NGOs understand the funding psychology of donors and develop strategies that address their needs. This is often accomplished by cultivating relationships over many years. The tactics are different from annual campaigns and require a long-term investment in understanding the donor and seeking to articulate the goals of the NGO in terms that address their needs. It is often believed that long-term financial sustainability means an endowment. Sometimes it may, but more often than not it is based on building a relationship between the NGO and the donor. Viewing all of the sources of funds available to the organization and designing strategies that are appropriate to each category can also enhance success. (See appendix 3).

Conclusion

It is impossible to produce a document that captures all of the elements and nuances of the environment in Hungary for financial sustainability. The objective of the EWI project on financial sustainability in Central Europe is not limited to the production of a written report, but hopes to serve as a catalyst for future action and dialog. The report is not intended to be an end product, but part of a process that assists the NGO leaders in Hungary. Hopefully, the recommendations and perceptions presented in this report will generate discussions and debate. It will be through that process that the value of our contribution will be measured.

Appendix 1



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Memorandum on the Legal Environment for Endowments in Hungary

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 Senior Legal Advisor

Although nothing prohibits the establishment of an endowment and it is even encouraged by law as one possible form of creating a foundation, in practice endowments do not exist in Hungary. (Endowment here will be understood as an entity of money or property dedicated to a specific purpose, in which the principal is kept intact indefinitely and only the income from that principal is used. In analyzing the legal environment, however, we will look at investment opportunities for NGOs in general.) Besides economic circumstances and limited organizational capabilities, this is probably due to the lack of further legal incentives, including unfavorable or unclear regulations in the areas of governance structure, risk-management, liability and taxation.

Establishment of an endowment

Interestingly, the establishment of a foundation in itself involves the possibility of an endowment. There are two ways to dedicate the property of a foundation, through the so-called "closed foundation", or through the "open foundation".

Art 74/A (1) of the Civil Code (Act IV of 1959) states that "the property needed to realize the goals of the foundation has to be designated to the foundation" (closed foundation). Art 74/B (4) states that if the founder allows others to join the foundation (open foundation), anyone can join [i.e. contribute] under the

conditions laid down in the founding statutes. In this case, only "at least the amount of property that is essential to start its operations" needs to be designated to the foundation.

In the various excerpts from opinions by the Supreme Court (which are binding on the judiciary), the following are pointed out:

"In case of a closed foundation, its property can only be increased by the yield of the initial capital [and/i.e.] possibly by the income of the entrepreneurial activity." (Since the wording here is not clear, it is also not clear whether, for example, capital gains are by definition considered entrepreneurial activity or not.)

"The founding statutes need to determine the method of use of the property, including the stipulation of whether, in order to accomplish the goals of the foundation, all of its assets may be used [expended] or only the capital of the foundation or only the gains of that capital can be used." The Supreme Court also determines that "in case of an open foundation, the founder cannot prohibit the use [expenditure] of the initial capital, because that would be contradictory to the requirement that the funds necessary to start the operation shall be available at the founding." (*Supreme Court Public Administration College, Opinion #2, Section 1[c]*)

While it is clear that the first statement (the case of a closed foundation) considers the initial capital as an investment to be harnessed, the latter ones (ways to use the property in the case of both a closed and an open foundation) contradict the notion of the initial capital as an endowment since they clearly allow the expenditure of all of the initial capital for the purposes of the foundation.

In practice, the number of closed foundations is minimal. Founders are not interested in designating large amounts of property to a foundation purpose. The law has created insufficient incentives and too many barriers to the establishment of an endowment; some of these legal obstacles are detailed below.

Governance and principles of investing

One reason why there may be reluctance in endowing foundations is that the governance principles of foundations in Hungary are not entirely clear. Although in principle the Founder retains the right to appoint and dismiss Board members throughout the life of the foundation (and is also the only person competent to modify the founding statutes), in practice the Hungarian court rulings show a tendency to restrict the founder from active involvement in decision-making about the organization. This is logical and understandable from the fact that in most cases the founder has made only a minimal financial contribution to the organization. There is also a legal argument that a foundation is a separate legal entity, so the founder should be able to exercise only indirect control over a foundation. At the same time, grant-giving endowed foundations and grantseeking, operating foundations (essentially NGOs) are not distinguished in Hungary. It is also not possible to set up self-perpetuating boards of directors. The controversies around rights and responsibilities of the founder probably impede those who want to dedicate a greater amount of their wealth to a public purpose.

Art. 4. (1)(b) of Act CLVI of 1997 on Public Benefit Organizations (PBOs), which lists the criteria for a public benefit organization, provides overall guidance on prudence in financial matters when it states that a PBO "only undertakes entrepreneurial activity in order to further its public benefit purposes and without endangering those".

A concrete example of what the PBO is not allowed to do because it would endanger the realization of its purposes is provided by Art. 16 of the PBO Act: "A public benefit organization shall not issue bills of exchange or other securities creating a credit facility" and "a PBO, except a public benefit company, shall

not draw credit with the aim of developing its business activity to an extent which jeopardizes its public benefit activity".

Art. 17 of the PBO Act require that "a public benefit organization pursuing investment activity shall prepare investment rules which are approved by its highest body". Apart from the abovementioned, however, the law provides no further guidance as to what these policies should involve.

We have to note that the Civil Code - and any other law - is silent on regulating issues such as the above in the case of foundations that do not have a public benefit status, apart from stating that a foundation cannot be founded for primarily economic purposes (CC Art. 74/B (6)).

However, as pointed out in the Report, the Hungarian system does have an instrument that could serve as a model. Act XCVI of 1993 established Voluntary Mutual Insurance Funds, in which individuals are allowed to invest in various financial vehicles that provide for financial growth while ensuring prudence. The funds are obliged to maintain an operational and a liquidity fund besides the equity, and an approved financial manager must manage the funds. At least in part, the investment management regulations of the Voluntary Mutual Insurance Funds could be applied – voluntarily by the NGOs as well as by legislation - to endowment funds of NGOs.

Taxation

In Hungary there is a differentiation between "economic activity" and "entrepreneurial activity" (or in another translation "business activity"). Act LXXXI of 1996 on Corporate Tax and Dividend Tax (CTDT Law) defines in its first paragraph (Article 1.1.) "entrepreneurial activity" as "economic activity aimed at or resulting in obtaining income and property". This type of economic activity - and only this type - is what a legal person has to pay a tax on, whether it is a for-profit or a not-for-profit entity.

Appendix 6 of the CTDT specifies that in applying Article 1.1 to foundations, public foundations, social organizations, and public societies {e.g. chambers}, from among their economic activities aimed at or resulting in obtaining income and property, the following is *not considered* entrepreneurial activity:

- public benefit activity, or in case of a non-PBO, activity according to the statutory purposes;
- revenue received from selling intangible and tangible goods and inventory serving solely the public benefit purpose or in case of a non-PBO, the statutory purposes
- **part of the interest received from the credit institution or the issuer of securities, or part of the yield of state bonds**, in proportion with the percentage of revenue from public benefit or statutory activity in the whole revenue (revenues counted without the interest and the yield).

The difficulty in the interpretation is that while "securities" in legal terminology may mean both shares (resulting in property and other rights) and credit facility (resulting in interest and other yield), the Hungarian Law on Accounting (Act C of 2000) explicitly differentiates between the two and later consistently refers to only the second group as "securities".

On the one hand, the CTDT and other laws are not as consistent in using "securities" to mean only credit facilities. On the other hand, in the paragraph above, the CTDT refers to only "interest" received from the securities and so it is not likely that it was the intent of the lawmakers to include shares under this heading. Under this interpretation, a foundation would not be able to invest in a perpetual ("open-ended") investment fund free of tax, even if the specific portfolio would include only bonds, since that is considered a form of shareholding.

All in all, if a PBO does not have commercial activity at all, its income from investments in credit type securities will not be counted as entrepreneurial income; while income from investments in shares, limited partnerships and perpetual funds will be tax exempt only as long as it is under 10% of its total revenue or less than 10,000,000 HUF. Unfortunately, most PBOs do not even take advantage of these opportunities.

Liability

As pointed out by ICNL in its memorandum on the same issue for Poland (Legal Environment for Endowments in Poland, May 2001, by Lee Irish), civil law countries do not have the concept of trust and fiduciary duty in the sense used in common law countries such as the England or the United States. In common law countries, issues of liability with respect to endowment funds have largely been derived from trust and fiduciary law. The issue of liability for bad investment decisions is not clear at the present time in Hungary, as the issue of liability of board members and management is not clear in general.

The most concrete reference to such liability is in Art. 74/C (6) of the Civil Code that determines the liability of the foundation for damages to a third party caused by a board member or official of the foundation; and states that the board member or official is liable to the foundation according to the general tort rules of the Civil Code.

Appendix 2 - Central European Charitable Gift Concept

The NGO (Non Governmental Organizations) sector in Central and Eastern Europe continues to struggle to attract financial resources. Many have suggested that American citizens would contribute to these organizations if they were aware of their need, able to receive a tax deduction, and confident that their contributions would be directed to the appropriate entity. The creation of the Trust Fund for Civil Society in Central and Eastern Europe (CEE Trust Fund) presents an opportunity for a US based bank to

develop a product that would attract individual contributions from Americans and direct these funds to support the NGO community in Central and Eastern Europe.

Founding members of the CEE Trust Fund include The Charles S. Mott Foundation, Ford Foundation, German Marshall Fund of the United States, Open Society Institute, and the Rockefeller Brothers Fund. A total of \$60,500,000 has been contributed to the Fund that will support the stabilization and development of the civil society and the NGO sector in seven Central European countries (Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, and Slovenia). The Trust fund will distribute these funds over a ten-year period. It hopes to attract additional contributions.

The opportunity exists for a US based bank to develop and market a product that would allow an American citizen to contribute to this fund. The American would make a contribution to the charitable gift fund of the bank and direct the income from this gift to the CEE Trust Fund. Since the CEE Trust Fund is registered as a public charity under the U.S. tax laws, the donor would receive a tax deduction for their contribution. The bank would manage the funds contributed and receive the appropriate management fees.

There is a large population of American citizens with ethnic roots in Central and Eastern Europe. Chicago has the second largest Polish population in the world. Pittsburgh, Cleveland and New York have sizable populations with Eastern and Central European roots. An aggressive marketing program could attract substantial contribution from these persons, as well as others interested in the development of a civil society in Central and Eastern Europe. The product is enhanced by the brand name of the founding Foundations of the CEE Trust Fund.

An addition to generating funds for management, the bank could also enhance its reputation for serving the NGO sector in CEE Europe. A bank that had a strong presence in the region could use this as an attractive marketing tool. The bank would be in a very strong position to manage the existing funds of the CEE Trust Fund.

Appendix 3 - The Board of Directors and Financial Sustainability

Before an NGO elects to embark upon a campaign to establish an endowment it must first undertake a thorough investigation of its total financial resources and uses of funds. This is a decision that the Board of Directors should make with the involvement of the staff of the organization. A model developed by Lynda S. Moerschbaeher in her book *Building An Endowment Right From The Start*, provides guidance for this task. Although written for the American audience, it holds true for the Hungarian NGO community. The sources of revenue for an NGO are:

Program Revenues	Fees Client Charges Third party reimbursements Admissions
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Investment Revenue	Income from short term investments Income from endowments
Gifts	Individuals Corporations
Grants	Foundations Corporations Governmental Units
Economic Activity	Related Unrelated

Gifts are considered as contributions from individuals and corporations where the donor has a detached and disinterested generosity. The donor does not retain a financial interest and gives up all control of the funds. Donors that provide the NGO with grant funding maintain some control of the funds and more often than not attach stipulations or conditions defining how the funds will be expended.

Another model for examining the potential revenue stream for NGOs involves sources of revenue in the areas of gifts and grants. These should be considered relevant for every NGO:

- Recurring annual gifts
- Non-recurring major gifts
 - Outright
 - Planned Gifts, outright
 - Planned Gifts, deferred
- Special Appeals
- Special Fundraising Events
- Grants
 - Corporations
 - Foundations
 - Governments

The Board should also consider the uses of the resources of the NGO. There are three primary uses of funds: 1) operational (carrying out the organization's programs), 2) capital projects (land, buildings, improvements and equipment), and 3) restricting it to an endowment. After investigating the resources and uses of funds, the Board can then make a decision concerning the proper role of an endowment in the organization. If the Board elects to pursue an endowment, it should be clear on the purpose of those funds. According to the National Association of College and University Business Officers (NACUBO), there are eight primary purposes for an endowment:

1. Perpetual financial independence
2. Changes in priorities of the organization and its environment
3. Enhance existing programs by supporting current needs
4. Expansion of new programs and growth of the organization
5. Weather unforeseen shortfalls and short term stresses

6. Acquisition, improvements, replacement & maintenance of facilities
7. Replace an income stream that is drying up
8. Support a particular program

Of these purposes, the first one of perpetual financial independence is the least likely to attract donors. Regardless of the purpose of an endowment, it must be clear to potential donors that the funds will enhance the ability of the organization to meet its mission. This must be clear, specific and compelling.

The Board should keep in mind that there are two types of endowments. Donor-funded endowments are generally restricted according to the wishes of the donor. The NGO will usually only have access to the income generated by the endowment. It would take an extraordinary event, and often court action, for the organization to have access to the principle of the endowment. This could create a situation in which the NGO has a large endowment but lacks the funds needed for operations, programs, salaries and capital expenditures.

The Board may elect to designate certain funds for the endowment of the organization. A Board-designated endowment does not carry the legal burden of a donor-designated endowment as the Board may elect at a future date to change the nature and characteristics of Board-designated endowment funds. In other words, a Board-created endowment generated by various sources of revenue may allow more flexibility for the NGO than one in which the donor has dictated that the only current revenue for the organization shall be the income from the donation.

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