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## ***Letter from the Editor***

In this issue, the *International Journal of Not-for-Profit Law* looks at regulations and their impacts on civil society in varied settings. **Eric Gorovitz**, an attorney specializing in nonprofit and tax-exempt legal issues, outlines proposed regulations that seek to clarify the permissible political activities undertaken by “social welfare organizations” in the United States. Next, **Mária Svidroňová** and **Helena Kuvíková** of Matej Bel University (Slovakia) analyze the Slovak Republic’s tax regime, specifically the tax assignment mechanism, and its effect on civil society organizations. **Renzo Rossi**, an attorney and postdoctoral research fellow at Università Cattolica del Sacro Cuore (Piacenza, Italy), considers the European Commission’s proposed European Foundation Statute and its influence over Italian legislation.

We feature two additional articles as well. **Lucas R. Arrivillaga** and **Georg von Schnurbein** of the Centre for Philanthropy Studies at the University of Basel (Switzerland) evaluate Switzerland’s legal framework governing foundations, with particular attention to its principles concerning transparency. **Jussi Laine** assesses the contemporary understanding of civil society and recommends placing greater emphasis on organizations’ functions rather than their forms.

We are grateful, as always, to our authors for sharing their expertise. And we invite readers and their colleagues to share their own expertise: We welcome manuscripts addressing legal aspects of civil society, philanthropy, and not-for-profit organizations around the world.

Stephen Bates

Editor

*International Journal of Not-for-Profit Law*

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*Civil Society Regulations and Effects*

## **New IRC Section 501(c)(4) Regulations Proposed, On Hold**

**Eric Gorovitz<sup>1</sup>**

On November 29, 2013, the Internal Revenue Service (the “IRS”) issued a Notice of Proposed Rulemaking (“NPRM”)<sup>2</sup> setting forth new regulations purporting to clarify the boundaries of political activities that may be conducted by “social welfare organizations,” which are exempt from U.S. federal income tax under Section 501(c)(4) of the Internal Revenue Code (the “Code”).<sup>3</sup>

The NPRM concluded a year that set the high-water mark for public discussion surrounding the relatively little-known tax law concept of “social welfare” in general, and more specifically the questions whether, and if so to what extent, social welfare organizations should be permitted to conduct partisan political activity. Practitioners have been asking these questions for years, because IRS regulations have long provided that (a) a social welfare organization remains qualified for exemption so long as it “primarily” conducts social welfare activities,<sup>4</sup> and (b) “social welfare” does not include direct or indirect participation or intervention in a political campaign on behalf of or in opposition to any candidate for public office.<sup>5</sup>

These questions gained urgency, however, in 2010 when the United States Supreme Court, in *Citizens United v. FEC*,<sup>6</sup> struck down a rule under federal election law prohibiting corporations and labor unions from making certain “independent expenditures” (that is, expenditures that are not coordinated with political parties or candidate campaigns) at certain times in connection with federal elections.<sup>7</sup>

Suddenly, social welfare organizations (most of which are corporations) acquired the ability (for federal election law purposes) to make unlimited independent expenditures to

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<sup>2</sup> 78 Fed. Reg. 71535 (Nov. 29, 2013).

<sup>3</sup> Unless otherwise stated, all references herein are to the Code.

<sup>4</sup> Treas. Reg. Sec. 1.501(c)(4)-1(a)(2)(i). The IRS’s assertion in the regulations of the “primarily” standard is itself controversial because Section 501(c)(4) of the Code requires a social welfare organization to engage “exclusively” in social welfare activities. In other contexts, the IRS has interpreted “exclusively” to mean not “more than an insubstantial part”. See, e.g., Treas. Reg. Sec. 1.501(c)(3)-1(c)(1).

<sup>5</sup> Treas. Reg. Sec. 1.501(c)(4)-1(a)(2)(ii).

<sup>6</sup> 558 U.S. 310 (2010).

<sup>7</sup> 2 U.S.C. 441(b). At issue in the case was the application of the prohibition to communications that referred to a federal candidate within 30 days of the 2008 primary election. The specific communications in question were a documentary film critical of Hillary Clinton, who at the time was a candidate for President, and advertisements promoting the film, which Citizens United, the corporate producer of the film, wanted to distribute via on-demand cable services.

influence federal elections, so long as the organizations remained, for federal tax purposes, “primarily” engaged in social welfare activities.

Perhaps most important, because social welfare organizations are not required by the tax law to publicly disclose their donors, the financiers of these independent expenditures in support of or opposition to federal candidates would remain hidden from public view. For funders concerned about anonymity, this made social welfare organizations more appealing than political organizations exempt from federal tax under Section 527, which solely conduct partisan political activity but must publicly disclose their donors.<sup>8</sup>

*Citizens United* thus set the stage for the hubbub leading to the NPRM, which arose in May 2013 after a top Exempt Organizations official at the IRS, Lois Lerner, disclosed, during a public question-and-answer session at an American Bar Association meeting, that IRS agents charged with evaluating exemption applications from social welfare groups had flagged for further review applicants whose names contained certain words, such as “Tea Party” and “patriot.”<sup>9</sup> Swift and intense public outrage ensued, particularly from the political Right, which perceived the focus on such terms, generally associated with conservative interests, as evidence that the Obama Administration was specifically targeting conservative groups. In materials and statements released after the initial firestorm, the IRS revealed that the use of watch-words was actually broader, including left-leaning terms like “progressive” as well.

A crescendo of far-reaching Congressional and independent investigations ensued, some of which continue today. None of these analyses have so far revealed persuasive evidence of political meddling from outside the IRS (including, in particular, the White House), but the scandal and its fallout put the rules governing the political activities of social welfare organizations squarely on the public agenda.

The conversation has continued, with vigor. In response to the NPRM, the IRS received over 160,000 comments, more than ten times the previous record, fueling speculation that the summer might bring exciting (!) IRS hearings on the proposed regulations.<sup>10</sup>

However, under the weight of the public commentary, much of which leveled criticisms, complaints, and concerns about the NPRM, the IRS announced on May 22, 2014, that it will not hold hearings until after it issues a revised draft of the regulations.<sup>11</sup> In an interview on June 17, 2014, IRS Commissioner John Koskinen indicated that the revised, proposed regulations will be issued early in 2015, and will be broader in scope than the NPRM.<sup>12</sup> Commentators such as the

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<sup>8</sup> 26 U.S.C. 527(j)(3)(B).

<sup>9</sup> Ms. Lerner has since retired from the IRS and declined to testify before a Congressional hearing (invoking the Fifth Amendment). On May 7, 2014, the House of Representatives voted, along mostly partisan lines, to hold her in contempt of Congress. Prosecution, which would fall to the U. S. Department of Justice, seems unlikely.

<sup>10</sup> For a look at 25 unscientifically-selected but well-crafted comments submitted by organizations ranging from the ACLU to the NRA, visit Adler & Colvin’s blog, [www.nonprofitlawmatters.com](http://www.nonprofitlawmatters.com), and search for “Top 25.”

<sup>11</sup> *IRS Update on the Proposed New Regulation on 501(c)(4) Organizations*. Retrieved from <http://www.irs.gov/uac/Newsroom/IRS-Update-on-the-Proposed-New-Regulation-on-501%28c%29%284%29-Organizations> on June 24, 2014.

<sup>12</sup> Patel, J., (June 18, 2014). *IRS chief promises stricter rules for ‘dark money’ nonprofit groups*. Retrieved from <http://www.publicintegrity.org/2014/06/18/14960/irs-chief-promises-stricter-rules-dark-money-nonprofit-groups> on June 24, 2014. Commissioner Koskinen was quoted as saying that the new regulations would address

American Bar Association Section on Taxation, among others, encourage the IRS to consider expanding the reach of the new regulations to encompass political activities by organizations exempt under other subsections of Section 501(c)(3), as well, such as labor unions (exempt under Section 501(c)(5)) and trade associations, chambers of commerce, and business leagues (exempt under Section 501(c)(6)).<sup>13</sup>

Meanwhile, political operatives on both sides of the aisle continue to take advantage of the opportunity created by *Citizens United*, using social welfare organizations to gather anonymous contributions and spending them lavishly to influence elections. We must wait to see whether the IRS will take meaningful steps to restore transparency.

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three aspects of political activity by social welfare organizations: “what should be the definition, to whom should it apply, and how much . . . can you do before you jeopardize your exemption?” *Id.*

<sup>13</sup> Available online, as of September 18, 2014, at <http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/050714comments.pdf>

*Civil Society Regulations and Effects*

# **Sustainability and Operation of NGOs Influenced by Tax System: The Case of Slovakia**

**Mária Svidroňová<sup>1</sup>**

**Helena Kuvíková<sup>2</sup>**

*In this article we summarize and analyze the tax system affecting nongovernmental organizations in the Slovak Republic. We chose the field of tax law based on results from questionnaire research with Slovak nongovernmental organizations, results from an expert evaluation employing the Delphi method used in the dissertation “Self-Financing Strategy and Sustainability of Non-Profit Organizations,” and rankings of the American agency USAID. The most important elements of the tax system which affect the sustainability and operation of NGOs are, first, exemption of their core work from income/profit tax, and, second, tax assignation – the mechanism of distributing a percentage of the income tax to a qualifying NGO. The second element is enacted in only few countries.*

*Slovakia is one of the four countries in the CEE region to adopt tax assignation. The article analyzes the reasons for the introduction of the mechanism in 2001, as well as the reasons for the amendments adopted since then. We focus on the option for corporations to assign a share of their income tax. The corporate income tax accounts for an important part of tax revenues, and this option has undergone major changes since its first adoption. Our aim is to analyze the tax laws affecting the sustainability and operation of NGOs in Slovakia, as well as the changes in tax assignation and their impact on both public finance and NGOs.*

## **1. Introduction**

One of the principles of the financing of nongovernmental organizations (NGOs) is tax exemption. This principle is applied in two directions: it can refer to the legal form of the organization, or it can refer to the activities of an organization irrespective of its legal form.

In this article we will focus on public funding of nongovernmental organizations, especially the form of indirect support where the state waives certain income and thus enables NGOs to “save.” This category includes the following:

- exemption from taxes (e.g., value added tax, customs fees)

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- tax reductions for NGOs
- tax reductions for donors (who can deduct donations from their tax base) and others (Stejskal et al, 2012)

Indirect public support of NGOs confers advantages on these organizations in the field of taxation as well as on those individuals and corporations that support the NGOs through donations. NGOs must heed the non-distribution constraint principle: i.e., they can make a profit, but it must be fully reinvested in their operations to support the mission and purpose for which they were founded; it cannot be used to enrich the owners, members, or employees. Weisbrod (1988) considers tax relief as a form of compensation for this restriction on profit distribution. Other authors indicate different reasons for tax exemption, such as the fact that exemption based on the character of NGOs' activities enables them to fund charitable or generally beneficial services in education, health, social care, or other areas (Anik et al., 2009; Billis & Glennerster, 1998; Hansmann, 1996; Sokolowski, 2012; Markowska-Bzducha, 2012).

This article analyzes the changes in the exemption of NGOs from different types of taxes and the changes in the mechanism of assignment of the income tax, as well as the outcome of primary research conducted for the dissertation "Self-Financing Strategy and Sustainability of Non-Profit Organizations." The outcome of the dissertation confirms the importance of the tax laws that affect NGOs.

According to the U.S. Agency for International Development (USAID, 2013), which has been assessing the sustainability of nongovernmental organizations in Central and Eastern Europe since 1997, the legal environment should support the needs of the nonprofit sector, allow the entry of new organizations, prevent political interference with NGOs, and provide conditions under which NGOs can conduct entrepreneurial activities to ensure income and to enhance their stability. Among the monitored factors are the difficulty of registering new organizations and the laws governing their operations, their taxation, and their access to information.

The importance of the legal environment in general and the tax laws in particular is confirmed not only by USAID but also by the results of the primary Delphi research, as presented later in this article.

We examine the tax laws that affect the operation of NGOs, with emphasis on the law on income tax. The article further provides an overview of changes in tax laws, particularly those providing for tax assignment. Here we focus on the impact of this change on public finance and the state budget. In the end we develop models to predict the amounts that NGOs in Slovakia will receive from income tax assignment, and on the basis of these models we propose recommendations for NGOs to ensure their financial stability.

## **2. Methodology**

The aim of this article is to analyze the tax system affecting the operation and sustainability of NGOs in Slovakia, the changes in tax assignment, and the impact on both public finance and NGOs.

The material consists of primary and secondary information on NGOs and the Slovak tax laws. As secondary data we use the NGO Sustainability Index<sup>3</sup> compiled annually by USAID, which rates NGOs in Central and Eastern Europe and Eurasia on seven dimensions: legal environment, organizational capacity, financial viability, advocacy, service provision, infrastructure, and public image of NGOs. The scale runs from 1 to 7, where 1 means a very high level of sustainability of a nongovernmental sector and 7 is a very poor level. According to their scores on NGO sustainability, countries fall in three basic stages of development: Sustainability Enhanced, Sustainability Evolving, and Sustainability Impeded (USAID, 2013).

Primary data was obtained through a structured questionnaire sent to 670 NGOs; 182 respondents completed the questionnaire with applicable information. Appropriate structure and scope of the sample were confirmed by statistical significance of the results of a Chi-square test.

We also collected primary data by the Delphi method. We addressed a group of experts on the nonprofit sector and NGOs with a questionnaire. Based on the analysis of the NGO sustainability index and our research results, we confirmed the importance of the legal environment on the operation of NGOs, particularly tax laws. The result led us to compose two regression models for the development of the percentage of income tax assignment as stated in the amendment of Act No. 595/2003 on Income Tax. The first model presumes that corporations will provide an additional percentage from their own sources (direct donation); the second model presumes that corporations will not give any direct donation.

The expert group in the Delphi research was made up of specialists from scientific, public, and nongovernmental spheres. From the nongovernmental sector, we chose representatives of the so-called umbrella organizations as well as significant figures in this field who examine the issue from a practical point of view. We asked experts from all three spheres to assess the significance of various factors that affect the sustainability of NGOs and to assess the state of the six selected dimensions in Slovakia. The expert group was assembled based on citation analysis (the most frequently cited names in scientific publications) and purposeful selection (our own decision after consultation with another expert).

Electronically we contacted 40 experts. Of them, 22 responded to the questionnaire, four did not want to be involved in the research, and three indicated by marking “other” that they did not consider themselves experts in the field. After the first round we addressed 33 experts, of whom 15 answered (for more detailed description of the selection process see Svidroňová, 2014). The participation of experts in both rounds of research and their expertise are shown in Table I and Table II:

**Table I: Number of participating experts in both rounds**

	TOTAL	Public sphere		Nongovernmental sphere		Scientific sphere		other	
Round 1	22	6	27%	8	36%	5	23%	3	14%
Round 2	15	4	27%	5	33%	5	33%	1	7%

Source: own research, 2012.

<sup>3</sup> In 2011 it was renamed the CSO Sustainability Index (Civil Society Organizations), but the subject of analysis, methodology, and content remain the same. We use the term NGO to correspond with the abbreviation in this article.

The experts evaluated the significance of the selected determinants as well as the current state of Slovak NGOs in terms of sustainability in accordance with the USAID methodology.

To examine the rating of the sustainability by the expert group we compiled a questionnaire, which asked the experts first to identify the significance of the selected determinants according to their impact on the sustainability of nongovernmental

**Table II: Expertise of participating experts**

Criteria of expertise	TOTAL		Public sphere		Nongovernmental sphere		Scientific sphere	
	Round 1	Round 2	Round 1	Round 2	Round 1	Round 2	Round 1	Round 2
Years of experience	4.5	4.6	5.5	5.5	5.2	5.5	4.4	3.9
Number of expert publications	6	7.2	4	6.6	7	8.6	9	7.7

Source: own research, 2012.

organizations, and, second, to assess the level of the determinants in Slovakia on a scale from 1 to 5, where 1 means the most important determinant and 5 the least important. The determinants were grouped into six dimensions corresponding to those in the Index (legal environment, organizational capacity, financial viability, service provision, infrastructure, public image). The experts also had an option to propose their own determinant.

Based on the responses in the first round we evaluated the importance of the determinants as ordinal variables using median and variance. We added other determinants stated by experts in the first round. After one month we again sent the questionnaire to the experts with the results from the first round. Experts could modify their opinions or could argue their original opinion. After the second round we conducted an overall evaluation, and the changes of opinions resulted in the changes of values of median and variance (Table III).

### **3. Legal environment affecting operation of NGOs in Slovakia**

The U.S. Agency for International Development (USAID) annually publishes the NGO Sustainability Index. It is a key analytical tool that measures the development of the civil sector in Central and Eastern Europe and Eurasia. The Index analyzes and assigns scores to seven interrelated dimensions: legal environment, organizational capacity, financial viability, advocacy, service provision, infrastructure, and public image of NGOs.

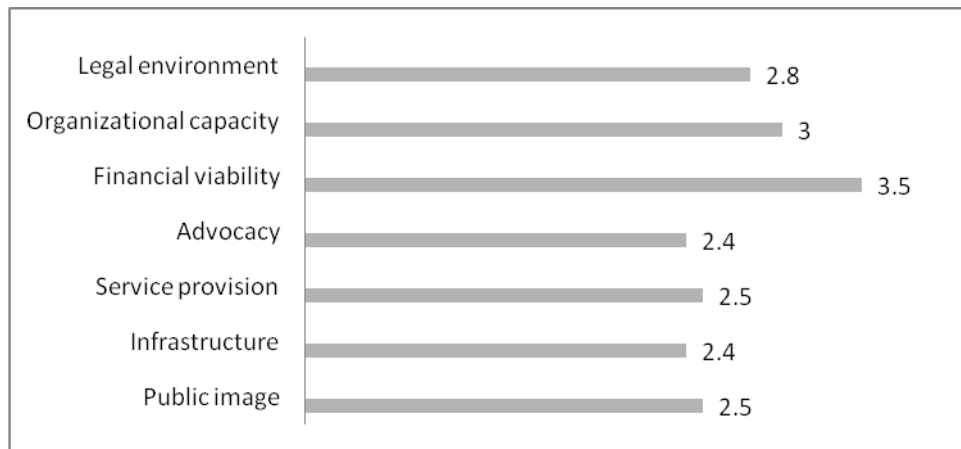
The Index is always published retrospectively for the previous year; the currently available document, from July 2013, evaluates the year 2012. In that year, the sustainability index (overall score) for Slovakia was 2.7, which ranked Slovakia in the top five of the 29 countries from Central and Eastern Europe and Eurasia. In Slovakia, USAID has implemented sustainability research since 1997 in cooperation with the Pontis Foundation. Individual dimensions and their scores are in Chart 1.

In this article we focus only on the dimension of the legal environment. As mentioned above, the legal environment should allow the entry of new organizations, prevent political interference in NGOs, establish conditions under which NGOs are able to conduct entrepreneurial activities to ensure income, and enhance their stability. Among the monitored

factors are the difficulty of registering new organizations and the laws governing the organizations' operation, taxation, and access to information. The index score for the Slovak legal environment in 2012 reached 2.8, unchanged since 2009.

This score is affected by the acceptance of the proposal of the Ministry of Finance to change the rules for the assignation of 2 percent of the income tax; the organizations expected a reduction in income from this source. The need for legislation on volunteering has been filled by Act no. 406/2011 Statutes on Volunteering. One positive factor in the score is the simple procedure of establishing NGOs without unnecessary bureaucratic steps, although the report suggests that the global trend is to place the documents for establishing NGOs online, which Slovakia has not yet done. One negative influence is the changes in the Labour Code at the end of 2012, which modified the conditions for various part-time workers other than contractual employees. According to the amendments, the wages of these workers will be levied by contributions to social insurance and health insurance as if they were employees on regular contracts, which has increased the costs for NGOs. On the other hand, a positively perceived factor is the activities of the first Slovak nonprofit center, which provides legal advice as well as information on its website concerning legislative changes and proposals affecting NGOs.

**Chart 1: NGO sustainability index for Slovakia, 2012**



Source: USAID, 2013.

The respondents in the structured questionnaire evaluated (among other areas of sustainability) legislation, especially the tax system in Slovakia. On a scale from 1 to 5, nearly 48 percent of NGOs said they consider Slovak tax laws complicated and unclear. On the other hand, 56 percent of respondents consider these laws favorable in terms of NGOs' operations and sustainability, or at least as neutral in this respect. Only 16 percent of respondents see the tax laws as totally unfavorable, and 28 percent see them as more restrictive than favorable. From the responses we calculated a rating for Slovak legislation environment, in the opinion of NGOs, as 2.78.

The evaluation of the experts in terms of significance and development (current state) of determinants of the legal environment in Slovakia is summarized in Table III.

We can compare the three scores for the Slovakian legal environment. The experts scored it at 3.4, placing it in the transit phase (Sustainability Evolving). USAID's NGO Sustainability Index scored it at 2.8, placing it in the consolidated phase (Sustainability Enhanced). The Slovak NGOs assigned a score very close to USAID's, 2.78. In other words, USAID and Slovak NGOs

place Slovakia in the consolidated phase, whereas the expert group puts it in the transit phase. This disparity underscores the need to examine the legal environment and its influence on the operation on NGOs closely. Because the topic is very broad, we focused on those determinants that scored the worst median (in our case a value of 4). As shown in Table III, those determinants

**Table III: Significance of the determinants influencing NGO sustainability**

Determinants	Significance					
	Round 1		Round 2		Total significance of the determinant	
	median	variance	median	variance	Round 1	Round 2
<b>Legal environment</b>	<b>2,3</b>	x	<b>2,4</b>	x	<b>62%</b>	<b>60%</b>
Suitability of laws governing the operation of NGOs	1,5	0,45	2	0,42	70%	60%
Clarity of laws governing the operation of NGOs	2	0,62	2	0,49	60%	60%
Tax laws (allowances for NGOs)	2	0,53	2	0,53	60%	60%
Availability of legal advice for NGOs	3	0,6	3	0,46	40%	40%
Opportunities to apply for government / public contracts	3	0,55	3	0,43	40%	40%
Determinants	State in the SR					
	Round 1			Round 2		
	median	variance	median	variance	median	variance
<b>Legal environment</b>	<b>3,4</b>	x	<b>3,4</b>	x		
Suitability of laws governing the operation of NGOs	3	0,41	3	0,37		
Clarity of laws governing the operation of NGOs	3	0,37	3	0,51		
Tax laws (allowances for NGOs)	4	0,44	4	0,29		
Availability of legal advice for NGOs	3	0,48	3	0,45		
Opportunities to apply for government / public contracts	4	0,49	4	0,44		

Source: own research, 2012.

are “Tax laws” and “Opportunities to apply for government / public contracts.” We focus here on the first determinant, reflecting its significance. In addition to the expert evaluation regarding the current state of sustainability of NGOs, the research by the Delphi method provided an assessment of the significance of individual determinants and dimensions. The significance of the legal environment for the operation of NGOs reached the value of 60% after the second round. Among the other surveyed dimensions, a higher ranking was achieved only by public image, at 67%, and by organizational capacity and financial viability, both at 63% (on the outcome of research, see Svidroňová, 2013; on enhancing financial viability with modern managerial tools, see Vaceková, 2013).

We focused on determinants where the significance on NGO activities was identified as important and deemed to be underdeveloped currently in Slovakia. From Table III it is clear that the category of tax laws represents such a determinant. For this determinant, the difference between significance and current state was 2 points. (Besides the legal environment, other dimensions were financial viability, service provision, and public image, but these are not the focus of this article.) Based on this result, we selected the tax laws affecting NGO activities and sustainability for closer analysis.

**Table IV: Taxation of NGOs in Slovakia**

<b>Revenue from the perspective of income tax</b>	<b>Definition of the income</b>
Income subject to tax (§ 12)	income from activities that generate a profit for NGOs
	income from activities that may lead to generating a profit
Income not subject to tax (§ 12)	income gained from the tax assignment
	income gained from donation or inheritance
Income exempted from tax (§ 13)	income from activities for which the NGOs (taxpayers) were founded or activities that are their core work, except income from business activities and income on which withholding tax is levied
	income from church collections, religious acts, and allowances for registered churches and religious societies
	income from membership fees stated in statute or constituent documents received by civic associations, including professional associations, trade unions, political parties, and political movements
	income from grants provided by international treaties by which the Slovak Republic is bound
Income subject to withholding tax (§ 43)	interest, win, or other income accrued on deposit saving books or cash balances on current accounts
	income from assets in a mutual fund, income from shares obtained from redemption (repayment), income from deposit certificates, income from bonds and treasury bills

Source: Own processing based on DUBIELOVÁ, V. 2011. Entrepreneurial activity and the taxation of non-profit entities.

#### **4. Tax laws affecting the operation of NGOs in Slovakia**

Due to their nature as organizations or the nature of their activities, NGOs are either totally or partially or conditionally exempted from most taxes in the Slovak Republic. Tax exemptions are mainly regulated in Act no. 595/2003 Statutes on Income Tax, as amended. Table IV categorizes the types of NGO income and their tax status.

In the past, NGOs enjoyed additional tax benefits, including relief on property taxes, VAT, income tax, and road tax. Income from entrepreneurial activities was also exempted up to 300,000 SKK, with income over this amount taxed (abolished in 2006). Amendments to the Act on Income Tax in the years 2001 to 2006 eliminated these tax benefits and provided for the possibility of tax assignment to NGOs, which will be discussed further below.

The current tax system of the Slovak Republic influencing NGO activities consists of the major tax types listed in Table V.

Exemptions from the Income Tax are described in Table IV. Except for the motor vehicle tax, the Acts allow tax exemption or tax relief for legal entities not founded or constituted for business purposes, i.e., NGOs. The tax exemption or relief is regulated in some Acts; in other cases, it can be established by a local tax collector applying a regulation to local conditions (local taxes are determined by the municipality or higher territorial unit).

**Table V:  
Overview of selected taxes affecting the function of NGOs in the tax system in Slovakia**

<b>Type of tax</b>	<b>Act</b>
Income tax from individuals and legal entities	Act no. 595/2003 Statutes on Income Tax as amended.
Tax on transfer of property	Act no. 554/2003 Statutes on Tax on Transfer of property
Property tax	Act no. 582/2004 Statutes on Local Taxes and Fees for municipal waste and construction waste
Motor vehicle tax (road tax)	
Gift tax	Abolished from 1 January 2004
Inheritance tax	Abolished from 1 January 2004
Value added tax	Act no. 222/2004 Statutes on Value Added Tax

Source: Own processing based on relevant Slovak legislation valid to 31 August 2013

Act no. 563/2009 Statutes on Tax Administration (Tax Code) is also important. It governs tax management, tax collection, tax control, filing of tax returns, remedies, and sanctions that the tax authorities may impose.

#### **5. Tax assignment**

Tax assignment is a mechanism that allows individuals and corporations to assign a percentage of the paid income tax to benefit a selected NGO. Tax assignment can be regarded as a mixed source: it has the characteristics of public funding (the state foregoes part of the income tax) and private funding (the allocations are based on the private choices of individuals and corporations). In the event that they do not decide on a particular NGO, the entire amount of the

paid income tax remains in the state budget. Tax assignment thus can be seen as a unique form of support, at the crossroads between public funds and private funds.

The tax assignment in Slovakia has been developed thanks to an initiative of the NGOs themselves. The first impulse was at a conference in Stupava (1997) which brought together representatives of the nonprofit sector. After the 1998 elections and the onset of a coalition led by Mikulas Dzurinda, the representative of the Committee of the Third Sector succeeded with the proposed amendments to the Income Tax and tax assignment. The main argument was a gradual withdrawal of foreign foundations that had previously supported the Slovak NGOs but now shifted their support to NGOs in the less developed countries of Eastern Europe. Philanthropy was still underdeveloped in Slovakia, and NGOs sought further sources of funding. Inspiration was found in implementing the tax assignment mechanism in Hungary.

In 1996, Hungary enacted a unique “tax designation” law that permits taxpayers to designate 1% of taxes paid to be turned over to civil sector organizations, and an additional 1% to be turned over to churches, provided that each of the two designated amounts is at least 100 HUF. In 2001, this law resulted in \$25 million USD worth of 1% designations by 1.4 million taxpayers. In the next three years, Slovakia, Lithuania, and Poland followed Hungary’s lead and enacted 1% type laws, though Lithuania’s law allowed for a 2% designation (International Center for Not-for-Profit Law, 2003).

This funding mechanism appeared to be successful, and the conditions were similar in these countries. The goal was not only to bring additional resources to the nonprofit sector but also to help build relationships between NGOs and citizens – the assignment of a percentage of income tax would give corporations and individuals to participate a more significant way to participate in financing NGOs.

The mechanism of tax assignment has undergone several important changes since its introduction in 2001, which we briefly summarize.

Act no. 561/2001 Statutes on Income Tax amended the Act no. 366/1999, and one of the changes allowed individual taxpayers to assign 1% of their personal income tax to the public benefit services provided by defined nonprofit organizations which operate in the fields of education, health care, social services, physical education and sport, environment, culture, and restoration of cultural monuments. This amendment abolished the option of tax relief on the value of the donations for public purposes, which had been up to 10% of the tax base for individuals and up to 2% of the tax base for corporations.

In 2003, Act no. 595/2003 Statutes on Income Tax changed the amount to 2% of the paid income tax and gave corporations as well as individuals the option of assigning this percentage of income tax (hereinafter also referred as “2% law”). By allowing tax assignment to corporations, Slovakia became unique in the world. Other amendments in this Act established criteria for determining which organizations and which activities would be eligible for the tax assignment. A tax assignment recipient must be registered by a notary. The received funds must be used by the end of the next year for advancing the organization’s core work. If the recipient fails to fulfill these obligations, it must return the funds within 90 days to the state budget, and it is subject to a breach of budgetary discipline under a special regulation. An organization that receives more than €3,319.39 from tax assignment in one year is required to specify precisely the use of the received funds in the Business Journal (*Obchodný Vestník*) within 16 months from the date that the Tax Directorate publishes the list of recipients. The organization must specify in



the amount of received funds and the purpose for which they were used, as well as provide an auditor's statement that conforms to special regulation.

Based on this amendment, the Ministry of Finance estimated that funds from the tax assignment for nonprofit organizations should have been around 300 million SKK (approximately 10 million Euros). The estimation of the 1st Slovak Non-profit Service Centre doubled the sum, i.e. 600 million SKK (approximately 20 million Euros). There was shock when the total amount of tax assigned was 845,222,347 SKK (over 28 million Euros) (Marček, 2007).

Act no. 504/2009 Statutes on Income Tax, which came into effect in 2010, amended the responsibilities of recipients. Under it, a recipient of more than €33,000 in one calendar year must within 30 days open a special account used only for the funds from tax assignment. The recipient can use the funds for advertising but only for the purposes defined in Act no. 504/2009 and for the purpose for which the NGO was established. The recipient can also use the funds to purchase movable and immovable property, if these are to be used for the core work of the NGO. The core work is certified by a notary at registration for tax assignment.

A major change in the Act was the reduction of the percentage from 2% to 0.5% starting in 2010. The main reasons for these changes were outlined in 2006 by Jan Počiatek, the Finance Minister at that time, who argued that 2% of corporate income tax was too high; it threatened the core goal of the tax assignment, which was to build relationships between NGOs and taxpayers. Although research indicates that tax incentives help involve businesses with the nonprofit sector (Guthrie, 2008), the tax assignment was not seen as the optimal tool for enhancing this involvement. Another argument was that large companies established and assigned their 2% of tax to their own foundations. An example is the SPP foundation, whose income from the corporate tax assignment was on average about €3,375,590 ([www.rozhodni.sk](http://www.rozhodni.sk)). Jan Počiatek originally proposed the abolition of assignment of the corporate income tax. NGO representatives campaigned to preserve the 2% assignment. Thereafter, a compromise was implemented, under which the limit for corporate income tax assignment will gradually reduce from 2% to 0.5% during the years 2011 to 2019.

This amendment also seeks to ensure that large corporations support the NGOs established for public purposes from their own resources, and not solely via tax assignment. The main aim of this amendment is thus to encourage corporate philanthropy. The state will assign an

**Table VI: Possible development of Corporate Income tax assignment**

Year	If corporations do not donate directly, they can assign:	NGOs get:	If corporations donate directly	State assigns additionally:	NGOs can get:
2012	1,5%	1,5%	0,5%	0,5%	2,5%
2013	1,5%	1,5%	0,5%	0,5%	2,5%
2014	1,0%	1,0%	1,0%	0,5%	2,5%
2015	1,0%	1,0%	1,0%	0,5%	2,5%
2016	0,5%	0,5%	1,5%	0,5%	2,5%
2017	0,5%	0,5%	1,5%	0,5%	2,5%
2018	0,5%	0,5%	1,5%	0,5%	2,5%
2019	0,5%	0,5%	1,5%	0,5%	2,5%

Source: Own processing based on Act no. 504/2009 amending Act no. 595/2003 Statutes on Income Tax.

additional percentage of corporate income tax if a company provides a direct donation in that tax year as a corresponding percentage of the tax paid. An overview is provided in Table VI.

Act no. 504/2009 also changed the percentage for individuals for 2012. An individual who volunteered for at least 40 hours in 2012 could assign 3% of their income tax instead of 2%.

The overview of funds raised through the tax assignment for the period since the introduction of the mechanism is shown in Table VII. From Table VII it is clear that the mechanism of tax assignment is very popular among NGOs. The number of NGOs registered has been growing since 2005 which corresponds to the development and increasing number of NGOs in Slovakia (see more in Kuvíková & Svidroňová, 2013). The use of tax assignment is also confirmed by the results of the primary research in 2011 focused on NGO funding, which found that 92% of respondents received funds through tax assignment (Svidroňová & Vaceková, 2012).

Another obvious reason for the abolition or reduction in the percentage of tax assignment mechanism, so far unmentioned, was the government's effort to keep the full amount of the tax in the state budget instead of assigning any percentage to registered NGOs. This trend was associated with the economic crisis and efforts to sustain economic growth, which was reflected in several countries (Izák, 2011). According to an estimate by the state, the decrease in the percentage of corporate income tax assignment should have brought to the state budget about €6.7 million in 2011 and about €7.3 million in 2012 (Faiglová, et al., 2010). Table VII shows that in 2011 the amount assigned by corporations dropped by €3.15 million, which was less than half of the estimated amount that should have remained in the state budget. This fact is due to both a decrease in economic growth, which reduced the state revenue from corporate income tax, and a decrease of 745 corporations that participated in tax assignment in 2010 (i.e. their income tax automatically became part of the state budget; the state did not consider any percentage that should be assigned to NGOs and Table VII does not show this amount).

**Table VII: Income tax assignment from individuals and corporations, 2002-2012**

<b>Year</b>	<b>Number of recipients</b>	<b>Number of participating individuals</b>	<b>Number of participating legal entities</b>	<b>Personal Income tax assignment (thousands €)</b>	<b>Corporate Income tax assignment (thousands €)</b>	<b>Total amount of Income tax assignment (thousands €)</b>
2002	4 042	341 776	-	3 382	- €	<b>3 382</b>
2003	3 398	286 164	-	3 222	- €	<b>3 222</b>
2004	3 829	402 057	8 364	9 159	19 792	<b>28 951</b>
2005	5 746	418 241	14 063	10 371	20 525	<b>30 896</b>
2006	7 100	446 973	17 740	11 713	25 629	<b>37 342</b>
2007	7 662	408 277	21 632	12 819	29 306	<b>42 125</b>
2008	7 759	449 909	26 691	15 036	34 144	<b>49 180</b>
2009	9 098	503 253	30 078	17 684	37 496	<b>55 180</b>
2010	9 585	467 983	26 172	15 553	28 592	<b>44 145</b>
2011	10 049	475 843	25 427	16 526	25 444	<b>41 970</b>
2012	10 565	n/a	n/a	18 548	26 146	<b>44 694</b>

Source: Own processing based on data the Tax Directorate of the Slovak Republic - Annual reports on the activities of tax authorities for years 2004 - 2011([www.drsr.sk](http://www.drsr.sk))

We cannot determine the number of corporations involved in the mechanism of tax assignment for 2012, but from the overall tax collection on corporate income tax, the state transferred €26.1 million for public purposes, i.e. the annual increase was € 0.7 million (2.8%). Compared to 2010 (before the amendment) the total amount of corporate income tax assigned declined by just €2.5 million, which is only about a third of the planned volume that had been supposed to stay in the state budget.

From the above, it can be deduced, first, that the amendment has not had the expected effect; and, second, that revenues from corporate income tax that actually stayed in the budget and did not have to be transferred to the NGOs were not particularly high. The argument that corporations support mainly their own foundations (founded by the corporations themselves) contradicted by data from the Centre for Philanthropy, which finds that more than two-thirds of the 2% of the corporate income tax is assigned to NGOs that are not directly linked to, established by, or controlled by these corporations. That the tax assignment is not an enrichment of corporations via their foundations can be proved by another fact: among the 200 largest recipients of the assignment in 2011 were 16 corporate foundations which together received the amount of €7.6 million. In the same year, however, the top 20 corporate foundations reallocated grants to a total amount of more than €9 million ([www.cpf.sk](http://www.cpf.sk)).

## **6. Models of development of raising funds from the tax assignment**

Based on the experience with the corporate income tax assignment from 2004 to 2011, we created two models to estimate the income for NGOs from the tax assignment up to 2015. From a statistical point of view, an attempt to estimate beyond 2015 would decrease the reliability of the model, given the relatively short period for which data is available.

The first model estimates the income if all corporations make direct donations to the amount as shown in Table VIII, such that the total amount that NGOs can receive would increase from 2% to 2.5%. To calculate the model we used a linear regression; because the share is fixed (2.5%), it would not make sense to calculate a regression model based on the change in the percentage. We therefore modeled the state budget revenues from corporate tax, which we estimated up to 2015, and from that amount we calculated 2.5%, on the assumption that all corporations would engage in tax assignment. We recalculated this amount using the coefficient of 64.76%, which was the actual usage of the maximum allowable amount in 2011.

**Table VIII: Estimated Development of Corporate Income Tax Assignment  
Combined with Direct Donations from Corporations**

<b>Year</b>	<b>State budget revenues (in €)</b>	<b>percentage of corporate income tax paid</b>	<b>theoretical assignment of corporate income tax paid: maximum possible amount</b>	<b>total amount if participation remains unchanged from previous year</b>	<b>percentage of maximum possible amount</b>
2011	1 946 920 981,62 €	2%	38 938 419,63 €	25 216 755,00 €	64,76%
2012	2 048 692 491,43 €	2,5%	51 217 312,29 €	<b>33 168 639,81 €</b>	
2013	2 150 464 001,24 €	2,5%	53 761 600,03 €	<b>34 816 335,88 €</b>	
2014	2 252 235 511,05 €	2,5%	56 305 887,78 €	<b>36 464 031,94 €</b>	
2015	2 354 007 020,86 €	2,5%	58 850 175,52 €	<b>38 111 728,00 €</b>	

Source: Own processing based on data by the Tax Directorate of the Slovak Republic and own calculation.

Table VIII shows that the total amount that NGOs could receive would be gradually increased to €38 million in 2015. The significance of the model as a whole was confirmed at level  $\alpha = 0.05$ . The reliability of the model is 67%, and we can interpret it as follows: annually, the volume of revenues to the state budget from corporate income tax increases by €101.77 million due to the time component. It will influence the increase of the corporate income tax assigned by €1.65 million per year. The problem is that the model assumes 100% involvement of corporations in the direct donation from their own sources (financial or non-financial), so the total percentage for tax assignment would be 2.5%.

The second linear regression model estimates the income from the tax assignment for NGOs if corporations do not allocate additional funds from their budgets, i.e. the total amount that NGOs could receive would be gradually reduced from the original amount of 2% of the tax paid to 0.5%. The significance of the model as a whole was confirmed at the level  $\alpha = 0.05$ , the reliability of the model is 90.6% and it can be interpreted as follows: 82% of the changes in the total amount of assigned corporate income tax can be explained by the change in the percentage of tax assignment (other changes can be explained, e.g., by a smaller volume of corporate income tax due to a decrease in their income or by reducing the number of corporations, but we do not know how to illustrate these influences in the model). The estimated amount of the income that NGOs can acquire is shown in Table IX.

Table IX illustrates the real development of the percentage of corporate income tax paid in years 2004 to 2011. As we can see, it rose until 2009 and then dropped in 2010 and 2011. In the event that corporations would not support NGOs by additional direct donations, this drop would continue. In 2015, the model estimates that the amount for NGOs would be less than a third of what NGOs received in 2011. The model assumes that no corporation would support NGOs with direct donations, which is probably exaggerated; corporate philanthropy is at least partially developed in the Slovak Republic.

**Table IX: Estimated Development of Corporate Income Tax Assignment Without Direct Donations from Corporations**

<b>Year</b>	<b>percentage of corporate income tax paid</b>	<b>corporate income tax assignment – total amount</b>
<b>2004</b>	<b>2%</b>	<b>19 686 174,00 €</b>
<b>2005</b>	<b>2%</b>	<b>20 525 144,00 €</b>
<b>2006</b>	<b>2%</b>	<b>25 629 046,00 €</b>
<b>2007</b>	<b>2%</b>	<b>29 306 225,00 €</b>
<b>2008</b>	<b>2%</b>	<b>34 144 247,00 €</b>
<b>2009</b>	<b>2%</b>	<b>37 495 973,00 €</b>
<b>2010</b>	<b>2%</b>	<b>28 591 712,00 €</b>
<b>2011</b>	<b>2%</b>	<b>25 216 755,00 €</b>
2012	1,5%	20 680 807,25 €
2013	1,0%	13 787 204,83 €
2014	1,0%	13 787 204,83 €
2015	0,5%	6 893 602,42 €

Source: Own processing based on data by the Tax Directorate of the Slovak Republic and own calculation.

Comparing the calculated and real data available for 2012 from the Finance Directorate of the SR, we can conclude the following: the first model, which assumes that all corporations would engage in the tax assignment and also donate 0.5% from their own sources, indicated that the amount which NGOs could have received in 2012 should have been €33.168 million. However, the actual amount in that year was €26.148 million, which is 7 million less than the estimation of model 1. The second model, which skeptically calculates that no corporation involved in the tax assignment would donate the percentage from their own sources, forecasts for 2012 that NGOs should have received €20.68 million. The reality in 2012 shows that this amount is lower by almost €5.5 million, i.e., model 2 underestimates the amount obtainable from the tax assignment. The second model is closer to reality; however, a comparison based on one year cannot draw decisive conclusions. It is interesting that averaging the amounts of model 1 and model 2 comes to €26.924 million, which differs from the real amount in 2012 by only approximately €778,000.

We believe the second model is more likely to apply to the development of raising funds from the tax assignment, i.e., corporations will not be motivated to make up the percentage from their own sources as direct donations to NGOs. The mere amendment in the legislation as an incentive for corporations to undertake more philanthropic activities is not enough. NGOs must have the reputation of credible and transparent organizations in order to attract more corporate philanthropy. We therefore recommend that NGOs regularly inform their donors about their activities and involve donors in the activities in order to raise awareness. We also recommend that NGOs build long-term strategic partnerships with corporations identified with the values and missions of NGOs. The long-term partnerships can be created either through networking or through cooperation in the field of corporate social responsibility (CSR). These and other steps based on the initiative of NGOs may lead to corporations willing to fund NGO activities from their own resources.

## **7. Conclusion**

NGOs are favored in many areas of the tax system of the Slovak Republic. One of the benefits is the tax exemption, the terms of which we stated in the article. Another benefit is the possibility of obtaining funds from tax assignment. After 12 years of the existence of this mechanism, the NGOs have grown used to, it and the number of registered organizations as recipients has been increasing since 2005. Therefore, NGOs will observe and comment on any changes to the mechanism. Lobbying may seem to be the optimal solution regarding the tax laws. This could improve the NGO Sustainability Index evaluation of the legal environment as a whole from the current score of 2.8. On the other hand, the legal environment includes other factors in addition to the tax laws, e.g. Labour Code, which the USAID evaluates for their impact on the sustainability of NGOs.

NGOs may be able to stabilize their income from tax assignment by changes to the tax laws. But doing so requires long-term effort, and the results are volatile; a new government may disregard the previous government's promises to the NGOs. Then there are the other possibilities of cooperation between NGOs and corporations (networking, CSR, shared marketing) which help to build long-term partnerships. In our opinion, these partnerships are more effective than tax assignment. However, NGOs also have to make an effort if they want to be involved in the mechanism of tax assignment; they must comply with the administrative regulations (register for the tax assignment at a notary), and they have to persuade corporations and individuals to assign the 2% of their taxes, e.g., by proving their reputation, transparency and credibility. Registering

as a recipient for the tax assignment might be sort of “lesson” for NGOs to learn how to act in a transparent and credible way, which is another positive aspect of this mechanism. We recommend that NGOs continue in their efforts to obtain funds from tax assignment, as these activities contribute to building their sustainability.

There is only a short time series of data available for further expert analysis using the relevant mathematical and statistical methods. We want to continue to monitor these issues in the coming years and conduct more detailed analyses to establish the effects of the legislation.

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*Civil Society Regulations and Effects*

# **The Proposal for a European Foundation Statute and Its Influence on Italian Legislation**

**Renzo Rossi<sup>1</sup>**

## **1. Introduction**

The proposal for a European Foundation Statute presented by the European Commission in February 2012 is an important innovation in the framework of the law of charitable organizations.

The idea of a uniform tool in non-profit organizations is not new, but it is relatively recent.<sup>2</sup> In the last decade of the past century, the European Commission worked on a proposal for a Statute of a European Association (which never has been transposed into a Regulation), though the attention devoted to foundations has always been low, probably in consideration of the wide diversity of national traditions across Europe.<sup>3</sup> More precisely, the initial idea of the community legislator was to discipline both associations and foundations in a unique Regulation on a European Association. The preamble to the proposal for a Council Regulation on the Statute for a European Association published in 1993 was explicit in referring to both forms.<sup>4</sup>

In the meantime, the number of foundations and founders willing to develop transnational activities has grown significantly. Moreover, the foundations that operate across borders face legal obstacles that raise operating costs and thereby reduce the funds available to pursue their public benefit purposes. Therefore, the idea that foundations deserve special attention has become widely shared. The failure of the proposal on the European Association has contributed, too.

Several solutions have been examined by the EC.<sup>5</sup> The first of them is the so-called “baseline scenario,” which includes ongoing initiatives in order to support cross-border activities

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<sup>2</sup> Since the idea of a European Foundation was first presented in 2001 by Klaus J. Hopt, it has received growing attention from legal scholars and, since 2003, from the European Commission, which first launched a feasibility study on such a Statute. Cf. K. J. HOPT, *The European Foundation: A New Legal Approach*, Cambridge University Press, 2006, p. 21.

<sup>3</sup> As an example of diversity, we can consider that while in some countries foundations are legal bodies, under common law foundations typically take the form of a trust which is not an organization but a relationship between property and trustees. Even the United States, where the phenomenon of foundations is highly developed (H.K. ANHEIER – S. TOEPLER (ed.), *Private Funds, Public Purpose: Philanthropic Foundations in International Perspective*, New York, 1999, p. 8: “the modern foundation is often perceived as a genuinely American invention”), in 1969 introduced a definition of this legal form through tax law, not civil law. See section 501 (c) (3) of the Internal Revenue Code, which defines negatively foundations as tax-exempt organizations.

<sup>4</sup> OJ n. C 236/1, 31.8.1993: “the introduction of a European form of organization should enable all associations and foundations to operate outside their own national borders.”

<sup>5</sup> The policy options considered by the Commission are fully explained in the *Executive Summary of the Impact Assessment* accompanying the Proposal, 2012, pp. 3ff.



and giving. In the Commission's opinion, this would have a limited impact, because a Member State might still impose tax discrimination between domestic and foreign foundations or between donors. Further uncertainty might arise from the varying definitions of public utility across States.

The second option examined by the EC is an information campaign aimed at educating foundations about their prerogatives outside their national borders. In addition, a "European quality charter" could be introduced, the compliance with which would ensure the trustworthiness of the foundation. However, as a soft law instrument, this label would have a limited impact.

A greater impact would result from the simple harmonization of laws on foundations, with or without consideration of the fiscal aspects. This would mean harmonizing those requirements that foundations need to meet to register and operate abroad, such as public benefit purposes, minimum assets, registration requirements, and some aspects of internal governance. In the opinion of the Commission, this option would encounter some difficulties due to the need for changes in national laws and the difficulty of achieving compromise among Member States on harmonized definitions.

Finally, the European Commission came to the conclusion that a Statute for a European Foundation (*Fundatio Europaea*), with automatically applied non-discriminatory tax treatment, would be the most appropriate option, removing cross-border obstacles for foundations and donors and facilitating the efficient channeling of funds for public benefit purposes.

## *2. A possible effect: improving continental solidarity*

Since its publication in 2012, the proposal has been welcomed by many scholars and institutions. The European Foundation Centre (EFC) calls the EC proposal "a major step towards having a new legal tool that will make it easier for foundations to support public-benefit causes across the EU."<sup>6</sup>

Such a change should be considered alongside the European legislation already developed in commercial law pursuant to article 352 TFEU, which aims at giving operators of philanthropic organizations a tool to help expand their activities outside their individual Member States.

In the field of philanthropy no less than in the market, the opening of single systems across the European dimension seems fully justified. As has been noted, since the Second World War all European Constitutions have returned the legal system to an ultimate moral order, which recognizes the fundamental human rights and the related duties of solidarity. In other words, given that the foundation of the Constitutions is the person, laws ought to encourage further continental solidarity.<sup>7</sup>

The European Foundation Regulation, once adopted, would as its first effect set a common core of purposes that can be considered of public benefit across Europe. The list of

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<sup>6</sup> EUROPEAN FOUNDATION CENTRE (EFC), *Revised legal analysis of the European Commission proposal for a Council Regulation on the Statute for a European Foundation (FE)*, 2012.

<sup>7</sup> A. NICOLUSSI, *Europa e cosiddetta competizione tra gli ordinamenti giuridici*, in *Europa dir. priv.*, 2006, p. 90. This author refers to the European Constitutions entered into force after World War II having a moral foundation as to "Post-Auschwitz Constitutions" (*Costituzioni del dopo Auschwitz*).

purposes, which is to be considered exhaustive, is broad enough to include most of the aims that existing organizations pursue, but it is surprisingly too narrow in one respect: it does not include religion. The exclusion of religion has been rightly criticized, whereas this purpose is acknowledged in almost all Member States, whereas purposes that are not regarded as public benefits in all Member States, such as amateur sports, are included.<sup>8</sup> Indeed, the omission of religion appears to go against the substantive law of all Member States and the common history of our continent.

### *3. The leverage on national legislation*

Although the European Foundation Statute would neither replace nor harmonize existing foundation laws, it undeniably would affect national legislation, once adopted as a Regulation.

It has been noted that “in addition to providing solutions to the barriers that foundations encounter in their cross-border work, a Foundation Statute would also provide further benefits to the foundations sector. The Statute would help to clarify terms and the concept of foundations as organizations with their own resources and independent governance. It would also help to develop a common definition of public benefit purpose foundation, as currently the term *foundation* is much too loosely used.”<sup>9</sup>

#### *3.1. The recent praxis of private foundations in Italy*

One of the countries in which the term *foundation* is used too broadly is Italy. For some time there have been attempts to hybridize associations and foundations, which have been criticized in the literature. I am not referring to the forms of foundation specifically defined and regulated by law, such as banking foundations, or those resulting from the conversion of public institutions, but rather to the so-called foundations created by individuals exercising their private autonomy.

In recent years in Italy, new institutional forms between association and foundation have emerged, in the absence of a legislative framework that upholds their validity and outlines their features. As a consequence, there seems to be question as to whether non-profit organizations can continue to be categorized as associations and foundations.

The first feature of the new institutional forms is participation. This element distinguishes them from the “historical foundations” (still solely taken into account by the civil code), in which the founder establishes the purposes to be achieved, the assets, and the rules for the governance and for the assignment of annuities, and then remains aloof from the new entity. Instead, in the new foundations the founder actively participates in managing the legal body and in developing operational strategies, following a model similar to a corporate company.

The second feature is the frequent plurality of founders, which allows for interaction between public and private entities or even between individuals in order to carry out a project or pursue a goal. But the peculiar—more problematic—characteristic is that the institution is

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<sup>8</sup> Cf. S.J.C. HEMELS, *The European Foundation Proposal: An Effective, Efficient and Feasible Solution for Tax Issues Related to Cross Border Charitable Giving and Fundraising?*, Paper for the 2012 EATLP conference Taxation of Charities, p. 13.

<sup>9</sup> G. SALOLE, *Why Is the European Foundation Statute Needed?*, *International Journal of Not-for-Profit Law*, vol. 11, no. 1, 2008.

conceived as open in its genetic code. It permits entry by subsequent founders with additional assets, all of whom become members of an assembly that makes decisions for the foundation.

Accordingly, this new foundation model that emerged in Italy looks structurally more like an association than a foundation. Such a hybrid, in the absence of a legislative reformation, threatens to undermine postulates underlying the Civil Code. In particular, it calls into question the criteria for differentiating between types of charities (associations and foundations) and for distinguishing charities from commercial companies.

The new form seems to render outdated the old distinction between the foundation and the association, according to which the first is a “*universitas bonorum*” and the second a “*universitas personarum*,” because the foundation is presented not as current assets intended for one purpose, but rather as a collective organization formed by directors that uses the assets to achieve the purpose. Some statutes recognize that the assets can be not only current but also subject to an expectation of addition.

In addition, the dichotomy between public purpose bodies and for-profit entities appears much less marked than the tradition and the Civil Code suggest.

To be sure, the provisions of the Italian Civil Code, which refer only to the grant-making foundation, need to be reformed. But the goal ought to be, not to abolish the traditional figure of the foundation (grant-making), which remains relevant, but to make the legislation more closely match the needs of non-profit organizations.

### *3.2. The possible influence of the European Foundation Statute in Italy*

In fact, in countries such as Italy, where legislation on foundations is considered obsolete or otherwise in need of reform, it probably would have been more effective to harmonize disciplines rather than to introduce a new legal form, which may remain poorly applied. The experience of the European Company Statute (SE) has fed skepticism about the ability of a European Foundation Statute to resolve problems of organizations that want to work abroad.<sup>10</sup> Although harmonization would have met resistance from many States, it would have forced the legislature to comply with the European directive, effectively changing the existing law and making it better suited to needs of the times and at the same time open to the European dimension.

In any case, a Regulation on European Foundations may also prod the legislature into modernizing the foundation. Such modernization is more necessary than ever in Italy, given the inadequacies of the law on foundations established by individuals.

In addition, the adoption of a Regulation, one that introduces the European Foundation legal figure without having to replace or modify the national organizational forms, would create a harmonizing effect within the jurisdiction of the Member States. In the process of European integration, European private law—understood in its effectiveness as a system of regulating private relationships—reflects formally different disciplines that are objectively oriented to harmonization. This means that national rules should be interpreted not only in accordance with

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<sup>10</sup> O. B. BREEN, *EU Regulation of Charitable Organizations: The Politics of Legally Enabling Civil Society*, *International Journal of Not-for-Profit Law*, vol. 10, no. 3, June 2008, notes, “It remains difficult ... to see how the introduction of a European Statute—even one tailored to the specific characteristics of nonprofit associations or foundations—could hope to resolve the central structural problems encountered by such entities.”

the European Community law, but also in a harmonizing manner. Harmonization of legal systems is one of the undeniable and unavoidable goals of the European Union.<sup>11</sup>

It is clear, therefore, that a Regulation on European Foundations would lead to a rapprochement between the legal systems of the Member States in the field of the third sector. By identifying a common core of general principles, it could foster the process of European integration in the field of philanthropy. Given this inherent ability of European law, the European Foundation Statute could be a harbinger of conceptual cleanliness, specifically in Italy.

First, regarding the current flexible use of the term *foundation*, the European Foundation could reemphasize that the association and the foundation are distinct concepts. Non-profit organizations (like commercial entities) require standard legal forms through which individuals can form distinct, autonomous legal bodies. The traditional types of organizations provide certainty in legal relations. They establish a legal entity distinct from natural persons by referring to an organizational model (the formation of contractual consent, representation, and publicity) and to a discipline (responsibility for obligations). Moreover, clear definitions of an institution's type and structure are essential for the protection of third parties who provide funding.

Second, the introduction of the European Foundation would redefine the difference between association and foundation from the point of view of their method of formation. The association is necessarily an entity formed by a plurality of subjects, whereas the creation of a foundation—through deed, testamentary disposition, or written declaration—is to be considered a unilateral act. The act remains unilateral, according to the legal doctrine, even if several subjects act simultaneously to create a foundation.<sup>12</sup> The wording of article 12 of the Proposal (*Methods of formation*) appears to allow this interpretation in referring to the deed and the testament. The same provision also seems to bar the foundation from subsequently accepting more subjects in the role of founders.

The requirement with respect to assets follows from that. When the entity is established, it must meet the minimum established by article 7 of the Proposal, without relying on the possibility of adding assets later. In fact, although Italian law does not currently set a minimum monetary threshold, the administrative authorities consider the adequacy of funds in the act of recognizing the institution as a legal person.

Also, whereas some clauses allow managers to change the statute of a foundation with virtually no limits, article 20 of the Proposal makes it clear that the foundation, by contrast to the association, is a stable entity with a purpose—not immovable or perpetual, but stable. The Proposal correctly distinguishes the common changes to the statute (§ 1 art. 20) from those changes that affect the purpose. The purpose “may only be changed if the current purpose has been achieved or cannot be achieved or where the current purpose(s) have clearly ceased to provide a suitable and effective method of using the [foundation's] assets” (§ 2). In any case, the decision to change the purpose must be adopted unanimously by the governing board and approved by the supervisory authority.

Defining the foundation's ability to alter its purpose would be great news for the Italian legislative scenario. Often, especially in relation to ancient foundations, the purpose is no longer

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<sup>11</sup> Cf. C. CASTRONOVO and S. MAZZAMUTO, *Manuale di diritto privato europeo*, vol. I, *Fonti, persone e famiglia*, Giuffrè, Milano, 2007, p. 13.

<sup>12</sup> P. RESCIGNO, *Persona e comunità*, Cedam, Padova, 1987, p. 98.

relevant to the needs of contemporary society. Under the Italian Civil Code (art. 15), the foundation results from an act that becomes irrevocable when the institution obtains recognition as a legal entity or starts its business. Amendments to the statute are permitted only if they do not affect the original purpose. Otherwise the event of conversion must be arranged by the public authorities (art. 28 c.c.).<sup>13</sup>

The proposed European Foundation offers a balanced solution between, on the one hand, the need to respect the will of the founder combined with the need for stability of the institution—so that resources earmarked for a particular purpose are not diverted to a different purpose—and, on the other hand, the need to ensure that the institution can evolve to reflect changes in the needs of beneficiaries. The control by the supervisory authority gives a guarantee, to the founder and to subsequent donors, that the change strikes the proper balance.

Finally, article 34 of the Proposal (*Transparency and accountability*) is interesting for the Italian private law scholar. Currently in Italy, the Civil Code does not require non-commercial entities to keep accounting records unless they run business activities.<sup>14</sup> Only the tax law requires preparation of an annual report and a financial statement that provide information on the institution's management. Currently the founder, if he or she is not a member of the board of directors, has no special rights of inspection, given that article 15 of the Civil Code provides that the entity is detached from the founder. The provisions of article 34 read in conjunction with article 4 (*Disclosure*) appear to provide the transparency that is appropriate, in light of the often significant size of not-for-profit organizations. Moreover, making the accounts of a foundation accessible can increase its reliability and enhance the trust of the public, thus helping it raise funds and pursue public purposes.

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<sup>13</sup> M. COSTANZA, *I soggetti: gli enti non commerciali*, in *Trattato di dir. civ. del C.N.N.*, diretto da P. Perlingieri, ESI, Napoli, 2012, p. 74.

<sup>14</sup> Art. 20, co. 1, D.P.R. 600/1973.

*Article*

## **The Swiss Legal Framework on Foundations and Its Principles About Transparency**

**Lucas R. Arrivillaga**

**Georg von Schnurbein\***

*“Sunlight is said to be the best of disinfectants.”*

*This article deals with issues of transparency applicable to grant-making foundations in Switzerland and analyzes the legal regime in this regard. This analysis is contextualized by functional aspects typically affecting the performance of foundations.*

*The article concludes that the Swiss regime is minimalist and that it might not be sufficient in terms of setting standards on transparency. However, we identify positive developments in the self-governing rules included in the Swiss Foundation Code (SFC). This Code provides a very effective complementary tool. It constitutes a laudable effort on the part of Switzerland’s philanthropic sector to reinforce self-regulation by setting transparency standards.*

### **Introduction**

Transparency is a contested issue in the regulation of grant-making foundations. In principle, one might argue that transparency should be the norm under which foundations operate. After all, grant-making foundations are institutions established by and for civil society. Therefore, by definition, foundations themselves ought to be interested in opening access to the flow and democratization of information within the philanthropic sector.<sup>1</sup> Yet vehement criticism has been voiced against foundations owing to their lack of compliance with transparency rules, managerial omissions, and their tax-exempt status—failings perceived by many critics as unjustifiable privileges.<sup>2</sup> But at the same time, one must be cautious in dispensing criticism<sup>3</sup> so as to avoid false conclusions and unwarranted generalizations.<sup>4</sup>

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<sup>1</sup> Third sector institutions engage civil society in their activities, such as advocacy, charitable assistance, higher education, health care, arts performance, residential nursing, and religious ceremonies. Steinberg, R. & Powell, W., Introduction, in *The Nonprofit Sector: A Research Handbook*, 2nd ed. (New Haven: Yale University Press, 2006), pp. 1-9.

<sup>2</sup> Indeed, non-profit and tax-exempt status do not entail a withdrawal from economic activity. Posner, R. and Philipson, T., “Antitrust in the Non-Profit Sector,” NBER Working Paper Series, March 2006, p. 2.

<sup>3</sup> Foundations, as legally tax-exempt institutions, have often been under threat for financial or political reasons. Hammack, D., “American Debates on the Legitimacy of Foundations,” in *The Legitimacy of Philanthropic*

The need to formulate a legal regime<sup>5</sup> aimed at increasing transparency across the third sector is now seen as essential, not only by the government but also by these institutions themselves.<sup>6</sup> In this article, we focus on the legal regime of Switzerland.

In order to contextualize the rest of the article, we shall outline some preliminary assumptions: (a) The revolution in digital technology is constantly diminishing the distance between institutions, both private and public, and the community. (b) There has been an increase in the amount of self-regulation undertaken, in the number of legislative reforms issued, and in the scholarships awarded, all of which are aimed at improving transparency in grant-making foundations' managerial activities. This might indicate a greater need to adopt standards within this sector.<sup>7</sup> (c) The Civil Code reform<sup>8</sup> does not appear to have satisfactorily addressed transparency issues. (d) The Swiss philanthropic sector has autonomously adopted newer and stricter rules on transparency standards with its introduction of the Swiss Foundation Code (SFC).<sup>9</sup>

The article is structured in four parts. Part I provides a picture of the Swiss grant-making foundation today. Part II categorizes the elements, tools, and limits of the grant-making foundations. Part III deals with the issue of transparency and its limits from different functional and socio-political angles: technological limits, limits of international legislation, limits imposed by the internal legal structure of foundations, limits defined by the legislation on gift-giving, and functional limits to the implementation of transparency standards. Part IV comments on Swiss legislation relevant to foundations and relates these points to the provisions in the Swiss Foundations Code.

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*Foundations: United States and European Perspective*, Prewitt, K., Dogan, M., Heydemann, S., & Toepler, S. (eds.) (Russell Sage Foundation, 2006), p. 49.

<sup>4</sup> Examples of well-established organizations in the third sector are the Red Cross and the Salvation Army. Although they might be considered standard organizations for this sector, they operate under very different strategic management principles from most other institutions in this sector. Hansmann, H., "The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation," *Yale Law Journal*, Vol. 91: 54 (1981), p. 65.

<sup>5</sup> The legal regime applied to foundations is complex and often diversified. Grant-making foundations normally straddle different branches of the law: Private Law and Public Law; Federal Law and Local (Cantonal) Law; Tax Law; Canon Law; Constitutional Law. Dr. Peter Lex, "Die Grundzüge des Stiftungsrechts," in *Stiftungen in Theorie, Recht und Praxis: Handbuch für ein Modernes Stiftungswesen*, Graf Strachwitz, R., & Mercker, F. (eds.) (Duncker & Humblot, Berlin, 2005), pp. 205-209.

<sup>6</sup> To assess the relevance of the discussions on the operation and management of grant-making foundations in this regard, see, for example, "Public Policy for Nonprofits: A Report on ARNOVA's Symposium of October 2010," <https://netforum.avectra.com/eWeb/DynamicPage.aspx?Site=ARNOVA&WebCode=symposium>.

<sup>7</sup> In 2011, the European Foundation Centre (EFC) issued the report *Exploring Transparency and Accountability Regulation of Public-Benefit Foundations in Europe* (2011).

<sup>8</sup> The Swiss Civil Code was reformed in 2007. The issue has become more relevant, since it is expected that new tax-estate reforms are likely to introduce more changes to the sector, increasing the amount of capital channeled to foundations annually. See Breitschmid P., "Sale": *Schlussverkauf für die Erbschaftssteuer* (NZZ-23.11.11).

<sup>9</sup> Numerous codes of conduct issued by European countries for the third sector deal expressly with the issue of transparency. See EFC, *Exploring Transparency*.

## **I. The Swiss NPS and Foundations at a Glance**

Given the size of the country and its population, Switzerland has a large nonprofit sector. Some 90,000 nonprofit organizations exist, accounting for 4.7 percent of GDP. When the value of volunteering work is included, this figure rises to 6 percent of the GDP.<sup>10</sup>

The foundation sector in particular plays a unique role. By contrast to the Anglo-American definition, a foundation in the Swiss legal context can be a grant-making, an operating, or an organizing institution. Of the 12,715 charitable foundations in total, two-thirds are grant-making.<sup>11</sup>

Over the past twenty years, more than half of charitable foundations have been less than ten years old, and total foundation assets have risen from CHF 30 billion (USD 32 billion) to CHF 70 billion (USD 75 billion). As a consequence of this enormous growth, public interest in the foundation sector is increasing.<sup>12</sup>

Besides the statistical increase, the foundation sector has been subject to changes in managerial and structural organization.<sup>13</sup> Two associations that serve foundations currently exist, covering activities such as lobbying, convening, and publications. In terms of management, the Swiss Foundation Code has gained international attention; it is the first foundation governance code in Europe.<sup>14</sup>

## **II. Location, Tools, and the Bottom-Line Foundations Today**

In a civil law system such as the Swiss regime, a foundation is normally defined as legal entity established by the endowment of assets for a specified purpose.<sup>15</sup> In theory, this purpose must be one of public interest. Besides the fundamental civil-law requirement that the founder has an autonomous will (i.e., possesses legal capacity), a foundation's constitution contains two formation requirements: the endowment, as the material element; and the purpose, as the subjective element. The endowment is what distinguishes a foundation from other institutions within the non-for-profit sector<sup>16</sup> (or civil society<sup>17</sup>), such as associations and advocacy groups.<sup>18</sup>

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<sup>10</sup> Cf. Helmig, B., Gmür, M., Bärlocher, Ch., & Bächthold, St., "Statistik des Dritten Sektors in der Schweiz," in Helmig, B., Lichtsteiner, H., & Gmür, M. (eds.), *Der Dritte Sektor der Schweiz* (Bern, 2010), p. 174.

<sup>11</sup> Cf. Purtschert, R., von Schnurbein, G., & Beccarelli, C., "Switzerland," in Anheier, H.K., & Daly, S. (eds.), *The Politics of Foundations* (London, 2007), p. 310.

<sup>12</sup> Cf. Eckhardt, B., Jakob, D., & von Schnurbein, G., *Der Schweizer Stiftungsreport* (Basel, 2012).

<sup>13</sup> Von Schnurbein, G., & Timmer, K., *Die Förderstiftung* (Basel, 2010).

<sup>14</sup> Sprecher, Th., Egger, Ph., & Janssen, M. (eds.), *Swiss Foundation Code 2009: Principles and Recommendations for the Establishment and Management of Grant-Making Foundations* (Basel, 2011).

<sup>15</sup> Art. 80 of the Swiss Civil Code: "A foundation is established by endowment of assets for a particular purpose."

<sup>16</sup> This distinction comes from Roman law, which differentiates between foundations (*Universitas Rerum*), as institutions based on assets, and associations (*Universitas Personarum*), as institutions based on membership. Prewitt, K., "Foundations," in *The Nonprofit Sector: A Research Handbook*, 2nd ed., Powell, W. & Steinberg, R. (eds.) (New Haven: Yale University Press, 2006), p. 355.

<sup>17</sup> The term *civil society* is used to describe associations of public interest that involve a nexus between the family, the state, and the market. Departing from the notion of citizenship, the concept of civil society has been defined by philosophers since the time of classical liberalism. See the definition in Anheier, K. H. *et al.*, *A Dictionary of Civil Society, Philanthropy, and the Nonprofit Sector* (Routledge, 2005), p. 54.



Thus, foundations belong to an economic sector that emerges independently of markets and states. But the tools of this sector differ considerably from the resources available to the other sectors. While governments generate their incomes by exacting taxes (compulsory payments), and markets generate their incomes by creating financial surpluses (profits), foundations are not directed at generating income. The structure of society itself is a consequence of government, as there would be no civil order without centralized power, and anarchy would reign.<sup>19</sup> Markets work properly when private initiative and individual ambitions can flourish.<sup>20</sup> The government, markets, and society act interdependently. The third sector, by contrast, does not exist on the basis of a social mandate, nor do its institutions compete in a market. However, it nevertheless realizes a purpose that may belong either to the government or to the market.<sup>21</sup>

But the pursuit of these objectives is not *per se* a warranty of a foundation's survival. If a government considers that a foundation's role is not being performed adequately, the government might try to take over the task of the foundation or even eliminate it.<sup>22</sup> Similarly, if a company sees an opportunity for financial profit in any of the foundations' activities, it might seek to pursue them itself.

Therefore, foundations exhibit singular characteristics. First, they operate by performing activities that originally belong to the public sector, yet they cannot obligate society. Second, foundations can canvass for sponsors, resources, and popular support, but without offering profit in return. Therefore, although they can attract resources, they cannot function like classical investment schemes by offering a return on capital.

This commitment to delivering public goods without being subject to the controls of a centralized power or for-profit incentives raises questions as to how foundations can exist and sustain themselves over time.<sup>23</sup> These considerations lead us to ask what essential criteria allow

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<sup>18</sup> Together, these institutions form part of what is known as "the third sector." The term was introduced by Amitai Etzioni and later adopted by the International Society for Third-Sector Research (ISTR) as a unifying label. The term highlights the fact that this sector emerged independently of the market (the first sector) and the State (the second sector). Anheier *et al.* suggest that the term "the third sector" is being replaced by "the third system." This latter expression is used to identify an array of organizations that are neither governmental agencies nor for-profit firms. The term is deemed broader than the third sector, as it includes elements of the informal economy. Anheier, K. H. *et al.*, *A Dictionary of Civil Society, Philanthropy, and the Nonprofit Sector*.

<sup>19</sup> "When governments no longer provide public goods or services, failure looms." Rotberg, R., "Failed States in a World of Terror," *Foreign Affairs*, vol. 81, no. 4 (July-August 2002), p. 131.

<sup>20</sup> Applying also to John Locke's views on freedom and the granting of property rights, the absence of which would menace the freedom of human beings to achieve social and economic development. For example, the Universal Declaration of Human Rights (UNHRD), Article 27 (2), states: "Everyone has the right to the protection of the moral and material interests resulting from any scientific, literary or artistic production of which he is the author." UNHRD adopted in December, 1948.

<sup>21</sup> Prewitt, "Foundations," p. 356.

<sup>22</sup> Or conversely, due to a foundation's high level of performance, a government might find its legitimacy threatened vis-à-vis society.

<sup>23</sup> We are not suggesting here that either the public sector or market players have a guaranteed survival. When a majority of the people turn against their government, they usually cause it to fail. At the same time, markets work properly when some players win while others fail. See Prewitt, "Foundations," p. 357.

institutions to be defined as grant-making foundations and to investigate whether transparency plays a role in establishing these criteria.

In principle, the fundamental assets that constitute a foundation are its dedication to its purpose and the value of its endowment. Do other characteristics constitute a foundation's specific identity? The answer is yes: A foundation depends on the goodwill and financial support that it receives from both public and private sources.

The various legal frameworks that govern foundations demonstrate the government's interest in ensuring that their status is protected by its regulations. These regulations support foundations by granting them status as independent legal entities, by exempting them from the tax regimes, and by introducing tax waivers on gifts and donations that may be capitalized. In addition to these benefits, governments can support foundations directly by contracting with them, granting them funds, and outsourcing certain public activities to them. Companies can also support foundations by donating tax-exempt funds and by directly contracting with them to develop charitable activities.

In fact, if a foundation is able to exploit a favorable legal framework, its activities can be both permitted by the government and supported by the private sector. This privilege implies that the foundation conveys its message to society and that society endorses its credibility. Reputation is therefore important to foundations. It functions as a kind of "moral credit," which can generate resources and help establish a favorable regulatory environment.

Furthermore, foundations are normally not alone in their domain. They are compelled to monitor the memberships and responsibilities of other foundations.<sup>24</sup> Thus, the philanthropic sector, like the for-profit sector, is driven by a kind of competitive dynamic.<sup>25</sup> Because foundations must strive to survive, this competitive dynamic must be embedded in their founding criteria.

Therefore, in addition to the endowment, foundations need a strong relationship with the public and the private sectors of society in order to function. The endowment gives the foundation a kick-start, but its relationship with the community is what sustains it in the long run.

Consequently, if foundations rely on reputation to function successfully, it can be logically assumed that rules and principles on transparency will play an important role. However, this role must also be contextualized. Part III outlines the issues relating to transparency and its limits in this context today.

### **III. Transparency and Its Limits**

Here, we discuss the general aspects of transparency and its limits with regard to the constitution and operation of foundations. These issues are of a functional character, and therefore apply equally to Swiss- and non-Swiss-based foundations.

#### ***A. Transparency and Access to Information Today***

First of all, it seems undeniable that today's unprecedented access to information can trigger changes in the relationship between economic actors and the community. Communication

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<sup>24</sup> Prewitt, K., "Foundations," p. 355.

<sup>25</sup> Posner, R. and Philipson, T., "Antitrust in the Non-Profit Sector," NBER Working Paper Series (March 2006), p. 2.

technologies matter more than ever before. Never before has the human being enjoyed such an abundance of available information. The challenge is not about looking for the information; it is rather about processing it.<sup>26</sup> Although this surfeit of information does not necessarily result in “improved” knowledge, it renders traditional cases of secrecy almost impracticable.

Issues such as digital technologies, the convergence of media, and the architecture for distributing information—both legal and illegal—have dramatically changed with the introduction of Internet Web 2.0.<sup>27</sup> Furthermore, devices to process information are inexpensive, and sophisticated skills are not required to operate, edit, and distribute information. This has provoked a radical shift in the way society and its institutions communicate with each other. Traditional practices based on secrecy are no longer acceptable. Foundations should follow this trend and avoid old-fashioned strategies based on scarcity of information.<sup>28</sup>

### ***B. Transparency as an Integral Component of the Current International Legal and Economic Order***

Today, transparency has an increasing role to play across different sectors. In the converging dynamic that has existed since the early 1990s, national governments seem to “cede” sovereignty, economic integration takes place,<sup>29</sup> and private players progressively adopt business models that operate across several jurisdictions.<sup>30</sup> Issues of transparency are of particular importance in intergovernmental operations and public-private sector relations<sup>31</sup> where it is essential to avoid any secrecy that might undermine the business climate, sociopolitical opportunities for change, or global security.<sup>32</sup>

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<sup>26</sup> Capurro, R., “Towards an Information Ecology,” in Wormell, I. (ed.), *Information and Quality* (London: Taylor, Graham, 1990), 122-139.

<sup>27</sup> An iconic example of this was the decrypting and releasing of a video, entitled CollateralMurder.com., which shows the murdering of civilians, journalists, and children in Iraq. Sifry, M., *Wikileaks and the Age of Transparency* (New Haven: Yale University Press, 2011).

<sup>28</sup> For example, a Spanish study provides a model that allows the level of transparency of different NGOs to be assessed online. Gálvez Rodríguez, M., Caba Pérez, M., & López Godoy, M., “Determining Factors in Online Transparency of NGOs: A Spanish Case Study,” *Voluntas*, International Society for Third-Sector Research and Johns Hopkins University, 2011.

<sup>29</sup> The conclusion of the GATT Uruguay Round and the establishment of the WTO are part of this trend, which, in fact, can be traced back to the Bretton Woods Agreement in 1944 and the founding of the World Bank and the International Monetary Fund, whose aim was to build a more integrated economic order. See Bhagwati, J., *Protectionism* (Cambridge: MIT Press, 1989), ch. 1.

<sup>30</sup> For a critical view from the perspective of global economic regulation, see Braithwaite, J., & Drahos, P., *Global Business Regulation, Part I* (Cambridge University Press, 2000).

<sup>31</sup> Transparency also plays a role in the financial sector, although it has been said that: “The money markets rely more on trust than transparency, because transactions are so quick that there is little time to assess information.” “Full Disclosure: The Case for Transparency in Financial Markets is Not Clear-cut,” *Economist*, Feb. 19, 2009.

<sup>32</sup> For example, within the WTO System, transparency is a fundamental principle of the organization that aims to regulate information flows among trading partners. Hoekman, B., & Kostecki, M., *The Political Economy of the World Trading System: The WTO and Beyond*, 2nd ed. (New York: Oxford University Press, 2001), p. 61. Likewise, International Standards of Supreme Audit Institutions (ISSAI) of the International Organization of Supreme Audit Institutions (INTOSAI) sets transparency standards for public finance at Principles of Transparency and Accountability ISSAI 20. [www.issai.org](http://www.issai.org).

The third sector is also affected by this. For example, after the terrorist attacks of September 11, 2001, financial regulations were among the first to be affected<sup>33</sup> in order to trace movements of capital by private players, especially in the recommendations of the Financial Action Task Force (FATF) of October 2003 and its nine<sup>34</sup> supplementary recommendations.<sup>35</sup> The eighth recommendation addresses the regulation of non-profit organizations:

Depending on the legal form of the NPO and the country, NPOs may often be subject to little or no governmental oversight (for example, registration, record keeping, reporting and monitoring), or few formalities may be required for their creation (for example, there may be no skills or starting capital required, no background checks necessary for employees). Terrorist organizations have taken advantage of these characteristics of NPOs to infiltrate the sector and misuse NPO funds and operations to cover for or support terrorist activity.<sup>36</sup>

In an economically integrated world, this recommendation constitutes a strong warning call for the global philanthropic sector. The need for instruments and regulations aimed at avoiding secrecy, albeit for different reasons, is just as clear for the third sector as it is for other key economic areas, such as trade and public finance.

### ***C. Transparency and the Essence of the Legal Structure of Foundations***

If transparency is considered a key asset in the theoretical constitution of a foundation, this must be reflected in its actual operations. Yet well-accepted legal principles are not necessarily self-explanatory. However well accepted these principles are in theory, their formulation does not easily translate into practice. Historical and structural factors can conspire against the straight execution of accepted principles.

In the case of foundations, it might even be argued that, as legal institutions, they do not appear to have any immediate connection with transparency issues. This might be because foundations are not publicly associated with a democratic ethos that categorically requires transparency. The fact that wealthy people can divert resources—which would otherwise have to be contributed through taxes to the public budget—in order to satisfy what *they* personally and independently determine to be an unmet need of public character, is hardly aligned to any democratic axiom.<sup>37</sup>

In fact, the philosophical underpinnings of foundations reveal a *laissez-faire* heritage. That is, this sector's principles have little to do with public policy issues.<sup>38</sup> The architecture of third-sector institutions omits to identify precise beneficiaries who can assert rights against a

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<sup>33</sup> Pieth, M., *Financing Terrorism* (Kluwer Academic Publishers, 2002), p. 158.

<sup>34</sup> [http://www.fatfgafi.org/document/28/0,3746,en\\_32250379\\_32236920\\_33658140\\_1\\_1\\_1\\_1,00.html](http://www.fatfgafi.org/document/28/0,3746,en_32250379_32236920_33658140_1_1_1_1,00.html).

<sup>35</sup> Of 2001, incorporating all subsequent amendment until 2008. [http://www.fatfgafi.org/document/9/0,3746,en\\_32250379\\_32236920\\_34032073\\_1\\_1\\_1\\_1,00.html](http://www.fatfgafi.org/document/9/0,3746,en_32250379_32236920_34032073_1_1_1_1,00.html).

<sup>36</sup> [http://www.fatfgafi.org/document/22/0,3746,en\\_32250379\\_32236920\\_43757718\\_1\\_1\\_1\\_1,00.html](http://www.fatfgafi.org/document/22/0,3746,en_32250379_32236920_43757718_1_1_1_1,00.html).

<sup>37</sup> Consequently, it is not astonishing at all that foundations have been labeled “quasi-aristocratic institutions.” Anheier, H. K., & Daly, S., *Politics of Foundations*, p. 4; Prewitt, K., “Foundations,” p. 374.

<sup>38</sup> Brody, E., “The Legal Framework for Nonprofit Organizations,” in *The Nonprofit Sector: A Research Handbook*, 2nd ed., Powell, W. W., & Steinberg, R. (eds.) (New Haven: Yale University Press, 2006), p. 243.

foundation—an approach adopted by many people who establish charities using a foundation. These factors conspire against transparency.

For example, when contrasting the structure of a foundation to that of a company, one marked difference is that the latter is vested with a board that is obliged to submit a periodic account of its actions to its principal—that is, its shareholders.<sup>39</sup> This requirement has a tremendous impact on the field of corporate law.<sup>40</sup> The structure of a foundation has no such internal control mechanism. Once a foundation has been established, it operates by following the directives of its board of management. As the foundation board does not have the duty to distribute periodic benefits to stakeholders, there are no parties entitled to demand accountability for the foundation's actions. The foundation is not required to report on the size of gifts and donations, for example, or on the use of the dedicated assets.<sup>41</sup>

Thus a foundation operates solely under the management of the board. The board's main duty is to fulfill the founder's will (the foundation's purpose). In this sense, the will of the founder attains a sort of legal character *vis-à-vis* the authority before the foundation is registered, and sometimes even in face of the tax authority. But as foundations are normally expected to continue their existence beyond the life of the founder, the task of determining who has the right to enforce the will of the founder is not simple. Of course, to some extent the public authority has the right to monitor the functions of a foundation. But once a foundation has been established, the supervisory vigilance of the state is not mandatory.

At the same time, if the government were to introduce an aggressive supervisory policy over the foundations registered within its jurisdiction, there would very likely be a strong reaction in defense of the foundation's independent status. Beyond the standard accounting rules common to all economic actors vested with a legal personality, foundations are not legally compelled to provide information to the regulatory authority. In this sense, it can be said that, even though the will of the founder has some legal character, and the status of legal entity ensures that a framework exists to fulfill that will, there is no legislation to ensure that foundation funds are handled systematically. Moreover, even in cases where the public authority obliges funds channeled through foundations to undergo closer scrutiny, this is normally done to identify dishonest tax avoidance, not to shed light on the foundations' management activities.

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<sup>39</sup> Milton Friedman: “[T]he whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interest of the principal.” Friedman, M., “The Social Responsibility of Business is to Increase Its Profits,” *New York Times Magazine*, September 13, 1970.

<sup>40</sup> “Much of corporate law can be understood as an effort to control the agency problems that arise from the opportunist managers *vis-à-vis* shareholders, controlling shareholders *vis-à-vis* minority shareholders, and the company *vis-à-vis* its non-shareholders' constituencies such as creditors and employees.” Hertig, G., Kraakman, R., & Rock, E., “Issuers and Investor Protection,” in *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Kraakman, R., Davies, P., Hansmann, H., Hertig, G., Hopt, K., Kanda, H., & Rock, E. (eds.) (New York: Oxford University Press, 2004), p. 195.

<sup>41</sup> Albeit that active fundraising operations actually trigger some regulatory duties *vis-à-vis* the public authority.

#### ***D. Transparency and the Privacy Aspect of the Act of Giving***

Apart from the initial endowment, foundations are nourished by gifts and donations. It would therefore be reasonable to track not only where these funds originate, but also where they go.<sup>42</sup>

In principle, a philanthropic gift in the form of a contribution or a donation constitutes the voluntary, irrevocable transfer of an asset (money, property, rights of exploitation, etc.) by one person to an organization dedicated to a public purpose. Generally, this act is made without an expectation of receiving something in exchange. The only condition normally attached to this transaction is that the assets given be dedicated to the purpose for which they were transferred.<sup>43</sup> Moreover, when a foundation ceases operation after receiving a gift, then the gift will most likely be channeled to another charitable institution with a similar purpose rather than returned to the donor. Gifts, once given, do not find their way back to the giver.

The act of giving anonymously can be especially revered. The reason for this is rooted in religious traditions and other beliefs as well as in psychological motivations. From this perspective, confidentiality may be important enough for the philanthropic sector to want to protect it against hostile regulation or operating rules.<sup>44</sup> However, anonymity certainly contributes toward obfuscating the sector.

New trends in philanthropy suggest that the sector is being modernized. Donors are increasingly assisted by well-established financial planners specialized in this sector, who can provide a more holistic view of a charitable portfolio.<sup>45</sup> However, nothing suggests that old and new approaches to philanthropy cannot coexist.

#### ***E. The Work of Foundations and the Limits of Transparency***

Rules on transparency are normally understood as a bulwark against institutional abuses relating to trade, taxation, or other economic activities—that is, situations in which pernicious private interests pursue objectives that undermine the market or the public.

Banks and foundations differ considerably, yet they perform similar roles. Banks reduce the transaction costs between lenders and borrowers of money. Beyond their own endowment, foundations perform a similar role in the philanthropic market, by gathering contributions and donations to be channeled to the different social programs. Just as banks are intermediaries between lenders and borrowers of credit, foundations are intermediaries between funders and

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<sup>42</sup> In Spain, for instance, there is a foundation that tracks the transparency of NGOs as a guide for donors. See: <http://www.fundacionlealtad.org/web/home>

<sup>43</sup> See also Anheier, H. K. *et al.*

<sup>44</sup> For an economic analysis of the different reasons that prompt people to donate and provide gifts for charitable purposes, from hedonistic motives to normative reasons, see Kolm, S., “Introduction to the Economics of Giving, Altruism and Reciprocity,” in *Handbook of the Economics of Giving, Altruism and Reciprocity: Foundations*, Vol. 1, Kolm, S., and Ythier, J. M. (eds.), Handbooks in Economics (Elsevier, 2006), pp. 52-90.

<sup>45</sup> Havens, J. J., O’Herlihy, M. A., Schervish, P. G., “Charitable Giving: How Much, By Whom, To What, and How?,” in *The Nonprofit Sector: A Research Handbook*, 2nd edition, Powell, W., and Steinberg, R. (eds.) (Yale University Press, 2006), p. 560.

beneficiaries of aid. In the end, both institutions mediate the problems created by information asymmetries.<sup>46</sup>

Notwithstanding these similarities, banks are subject to far more regulation than foundations. Banking regulations are substantially stricter in the realm of transparency. This is related to the banking business model expressed in the deposit contract, by which the depositor keeps the upside of the business (which is limited) and assumes the whole downside loss.<sup>47</sup> This context highlights why transparency is so important in this industry.<sup>48</sup>

However, transparency can at times undermine the banking business model. Particularly in times of financial stress, full transparency can reduce a bank's flexibility. Depositors may withdraw their funds at once.<sup>49</sup> This may worsen the crisis and potentially induce a market collapse.

In the foundation sector, the general trend towards transparency is facilitated by new technologies and contemporary approaches to communication, as well as by recent international legal recommendations. On their own, some foundations have started to provide detailed information about their organization and activities on their websites.<sup>50</sup> It is in the foundation's interest to implement transparency rules in all its operations. Improved transparency helps attract funding, volunteers, and permanent memberships. It also communicates a message to society that foundations warrant people's trust. Such trust is a foundation's most valuable asset.

Nonetheless, as illustrated by the banking regulation case, caution is appropriate. Foundations undertake activities of a public character that are not addressed by the State or the private sector.<sup>51</sup> In pursuing their objectives, sometimes foundations need to operate under a veil of discretion. This is because their activities often relate only to a small segment of society, whose members do not have the opportunity or the skill to form a powerful democratic presence.<sup>52</sup> Furthermore, foundation activities can draw a harsh reaction. Examples of charitable acts that might arouse public concern include attempts to integrate potential terrorists into society, studies on the benefits of euthanasia, research on gender change, and help for asylum seekers. In an open society, foundations should have the freedom to pursue social change<sup>53</sup> and

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<sup>46</sup> As in the case of "lemons," where the "the purchaser's problem is to identify quality," elaborated by Akerlof, G., "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," *Quarterly Journal of Economics*, vol. 84, no. 3 (August 1970), p. 495. We can suggest that the primary problem people face when lending or giving away money is identifying the most efficient institutions in which to place their assets.

<sup>47</sup> Allenspach, N., "Banking and Transparency: Is More Information Always Better?", Swiss National Bank, Working Papers (2009/11), p. 3.

<sup>48</sup> However, it has been said that the banking sector needs disclosure more than transparency. Since financial information tends to be very complex, only the disclosure of relevant items of information by top managers to rating agencies and insurance firms really has an effect on the market. See Healy, P. M., Krishna, G., Palepu, K.G., "Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature," *Journal of Accounting & Economics*, 31 (2001), pp. 405-440.

<sup>49</sup> Allenspach, N., p. 3.

<sup>50</sup> See for example <http://www.grstiftung.ch/en.html>.

<sup>51</sup> Or sometimes activities differently undertaken, either by the state or the private sector.

<sup>52</sup> Otherwise these groups would be able to force the state to act on their behalf.

<sup>53</sup> Prewitt, K., p. 355.

to challenge established limits.<sup>54</sup> They must have sufficient autonomy to undertake unpopular tasks.<sup>55</sup>

A foundation may also need privacy when it operates outside its jurisdiction in undemocratic countries. A requirement at home that it fully account for its actions can produce devastating consequences for the people it is trying to help and protect.<sup>56</sup> Therefore, transparency legislation must not obstruct the foundation's mandate, its manager's strategy, the assignment of its assets, or any other aspect of its work.<sup>57</sup>

To strike the optimal balance, a strategy should distinguish between structural transparency and performance-related transparency. Structural transparency relates to the internal framework of the foundation, including the purpose, quantity of assets, board members, and rules on the destination and the granting of funds. Performance-related transparency relates to the activities of the foundation, including their relationship to its purpose.

Arguably, the public wants principally to be able to assess the individuals responsible for administering the foundation assets. Structural transparency is likely to suffice in establishing credibility. By contrast, transparency regulations that focus on the activities of the foundation can jeopardize its ability to fulfill its purpose.

As will be explained below, Switzerland's transparency regulations deal predominantly with a foundation's structure rather than its activities.

#### **IV. Swiss Legal and Institutional Framework for Foundations**

Swiss law establishes three main forms of foundation: classic foundations, known also as charitable foundations, which are regulated primarily in the Swiss Civil Code (SCC); family and ecclesiastical foundations, which are not specifically regulated in the SCC; and foundations consisting of retirement schemes for employees, which are regulated under other special legal regimes. In addition, there are business foundations, which, though "unregulated" by the SCC, seem to be recognized in jurisprudence.<sup>58</sup>

In Switzerland, the law applicable to foundations is laid down in Articles 80 through 89bis<sup>59</sup> of the Swiss Civil Code,<sup>60</sup> whose last reformed version<sup>61</sup> entered into force on January 1,

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<sup>54</sup> *Id.*

<sup>55</sup> An example of this is the work of the Ford Foundation and the African-American civil rights movement during the 1960s. Berman, H. E., "The Foundations' Role in American Foreign Policy: The Case of Africa, Post-1945," in *Philanthropy and Cultural Imperialism: The Foundations at Home and Abroad*, Anove, R. F. (ed.) (Boston: G. K. Hall & Co., 1980), p. 205.

<sup>56</sup> For example, German foundations that are extensively involved in efforts to democratize foreign countries since 1960 include the Friedrich Ebert Foundation, the Konrad Adenauer Foundation, the Henrich Boell Foundation, the Hanns Seidel Foundation, and the Rosa Luxemburg Foundation. However, these foundations no longer exist as foundations; in fact, today, they are associations. Alexander Mohl analyzes their work in Mohr, A., *The German Political Foundations as Actors in Democracy Assistance* (Boca Raton, FL: Universal-Publishers, 2010).

<sup>57</sup> For example, for decades U.S. Government aid was not welcome in China, the Soviet Union, and many developing countries, whereas U.S. foundations were allowed to operate in them. Berman, H. E., p. 205.

<sup>58</sup> See the study by [Würmli, M., Das gemeinnützige Unternehmen, \(s. 901\). Pratique Juridique Actuelle, Dike Verlag AG, AJP \(2010\).](#)

<sup>59</sup> Article 89bis is not analyzed in this paper, as it concerns employee benefits schemes.



2006,<sup>62</sup> pursuant to Article 1 of the Concluding Section of the SCC.<sup>63</sup> A legal regime applicable to the auditors of foundations is stipulated in the Federal Ordinance of August 24, 2005.<sup>64</sup> The Swiss Confederation, through the Federal Supervisory Authority on Foundations of the Secretariat of the Federal Department of Home Affairs (FDHA),<sup>65</sup> exercises oversight authority over foundations registered in Switzerland which have a national (or sometimes international) purpose.<sup>66</sup> This supervisory authority is based on Article 84.2 of the SCC, by which “The supervisory authority must ensure that the foundation’s assets are used for their declared purpose.”<sup>67</sup> (Foundations are also supervised locally at cantonal level, a topic that lies beyond the scope of this article.)

### ***A. Transparency and the Law***

Few legal provisions directly address transparency; instead, provisions of this kind are implicitly included within the different sets of legal regulations. Basically, the transparency-related regulations applicable to grant-making foundations can be divided according to two implementation phases: when the foundation is formed, and when the foundation is administered.

The scope of regulation dealing with the formation of foundations can be extended to investigate two issues. First, regulations seek to trace and determine the origin of gifts and donations which are incorporated into the endowment, but which do not form part of the original endowment itself. The purpose is to ensure that foundations do not host illegal assets and do not get used to divert assets. Second, regulations may come into play when the foundation’s purpose is changed, including upon the request of the founder. Such a change will alter the subjective aspect of a foundation.

The scope of regulation dealing with the administration of the foundation covers three areas. First is the management process for ensuring that grants are allocated on an objective and systematic basis. Second, regulation addresses the obligations and duties associated with annual reporting and accounting. These managerial functions aim to ensure predictable levels of expenses and to provide a rational approach to administration that will help secure the foundation’s long-term survival. A third category of regulations concerns the rules, duties, and assignment of managers, as well as the organization of the foundation’s managerial bodies in their relations with external auditors. These specifications seek to address and avoid the so-called

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<sup>60</sup> Swiss Civil Code (SCC), Part One: Law of Persons, Title Two: Legal Entities, Chapter Three.

<sup>61</sup> It is the first reform of Swiss foundation law since 1907.

<sup>62</sup> It is worth noting that the reform of the Swiss Civil Code provisions related to foundations occurred independently, and not as part of any attempt to harmonize the Swiss Regime with European legislation. Sprecher, T., *Die Revision des Schweizerischen Stiftungsrechts* (2006), p. 81.

<sup>63</sup> Final Title: Commencement and Implementing Provisions.

<sup>64</sup> [www.bk.admin.ch/ch/f/as/2005/4555.pdf](http://www.bk.admin.ch/ch/f/as/2005/4555.pdf).

<sup>65</sup> Art. 3, al. (alinéa) 2, let. A, de l’ordonnance sur l’organisation de Département Fédéral de l’intérieur (Art. 3, Abs. 2. Bst. a, Organisationsverordnung vom 28. Juni 2000 für das Eidgenössische Departement des Innern (OV-EDI)) SR 172.212.1.

<sup>66</sup> <http://www.edi.admin.ch/esv/index.html>.

<sup>67</sup> <http://www.edi.admin.ch/esv/00465/00466/index.html?lang=fr>.

agency problem. The structural problems of a foundation's management do not relate directly to agency problems, but rather result from a lack of agents<sup>68</sup>

### ***B. The Swiss Foundation Code***

Beyond the SCC and related federal and cantonal regulations, the philanthropic sector has formulated the Swiss Foundation Code in an effort of self-regulation.<sup>69</sup> Self-regulation by private parties can offer advantages over state compulsory regulation.<sup>70</sup> Perhaps the most obvious advantage that private-sector participants have over public authorities is specialized know-how and experience. This permits them to more easily spot the weaknesses in stewardship that need to be regulated. Nonetheless, self-imposed standards can have a downside if they are drafted by better equipped players in the philanthropic sector, such as large foundations. The imposition of sophisticated standards can cause small players to default without being culpable of any transgression *per se*, simply because they lack the means to fulfill the standards. It is therefore advisable to gather opinions from different members of the sector when fashioning self-regulation. Another point to consider concerns the relationship between the sector's regulatory body and the regulated parties. Parties within the sector are likely to have common interests. In this regard, problems related to capturing regulatory omissions may arise between the sector's players and *ad hoc* regulators, as happens between regulated parties and the public authority.<sup>71</sup>

In the case of the SFC, Swiss foundations (the Association of Swiss Grant-Making Foundations<sup>72</sup>) commissioned a working group of experts in 2004. The aim was to prepare recommendations on the formation and management of Swiss foundations.<sup>73</sup> The first version appeared in 2005 under the heading Code of Best Practices, which was discussed and reviewed by members of Swiss foundations, the public authority, academia, organizations related to the philanthropic sector, and the private sector. The text was finally published under the name Swiss Foundation Code. It includes three main principles and 26 recommendations. The SFC is a

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<sup>68</sup> Although certain voices suggest that foundations should adopt a "principal/agent" structure akin to the organization of a company. See the section Discussion in EFC, *Exploring Transparency and Accountability Regulation of Public-Benefit Foundations in Europe* (2011), p. 9.

<sup>69</sup> Other European countries also have a panoply of self-regulations involving transparency. See Breen, O., "Through the Looking Glass: European Perspectives on Non-Profit Vulnerability, Legitimacy and Regulation," *Brooklyn Journal of International Law*, vol. 36, no. 3 (2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1932653](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1932653), p. 969.

<sup>70</sup> Brody, E., "The Legal Framework for Nonprofit Organizations," in *The Nonprofit Sector: A Research Handbook*, 2nd ed., Powell, W. W., & Steinberg, R. (eds.) (New Haven: Yale University Press, 2006), p. 257.

<sup>71</sup> *Id.*

<sup>72</sup> Grant-making foundations are those foundations that have the means either to develop their own projects or to finance the projects undertaken by other parties. These are foundations which, in their essence, can develop independently.

<sup>73</sup> Even though the foundations targeted by the SFC are the so-called "large" foundations, the introductory part of the Code includes the caveat that its recommendations should not be applied too rigorously in the case of smaller foundations, in order to prevent them from being overwhelmed by its provisions, and yet allow them to profit from the Code guidelines. See SFC, p. 13.

guideline for the activities of foundations formed in Switzerland.<sup>74</sup> It is not a management guide,<sup>75</sup> and its recommendations are not mandatory.<sup>76</sup>

The SFC is divided into four chapters, which address the foundation's establishment,<sup>77</sup> leadership,<sup>78</sup> grant-making,<sup>79</sup> and finances.<sup>80</sup> The code sets forth "three General Principles, which must always be observed simultaneously by the management of any modern foundation. These principles relate to: (1) the Effective Implementation of the Foundation's Purpose; (2) Checks and Balances; and (3) Transparency."<sup>81</sup> The first principle aims to ensure that a foundation's work is executed pursuant to its legal purpose. The second principle addresses the foundation's managerial structure. The third principle focuses on the relationship between the foundation and society in general.

### ***C. The Swiss Legal System at Work***

The rest of this article deals with the Swiss legal framework on foundations. It primarily deals with the provisions of applicable federal law, such as the Swiss Civil Code, and presents these in the context of regulated acts over the life of a foundation. Where relevant, the article notes the interplay between the recommendations of the SFC and the provisions of the SCC. A brief comment on the applicability of the principle of transparency closes the analysis of each piece of regulation.

#### ***1. Formation and Registration of Foundations***

##### **a. Swiss Civil Code**

Article 80 of the SCC (on formation)<sup>82</sup> lays down the basic principle that defines the foundation as being "established by the endowment of assets<sup>83</sup> for a particular purpose."<sup>84</sup> The act of allocating an endowment to a particular purpose and registering it in the commercial register gives the foundation its legal personality.<sup>85</sup> Article 81, para. 1, of the SCC stipulates that a foundation can be established by a public deed—*inter vivos*—or by a testamentary

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<sup>74</sup> In its introductory section, the Code also contemplates the adjustment of its principles and recommendations applicable to foundations that are initially established under a foreign jurisdiction. See SFC, p. 13.

<sup>75</sup> See also SFC, p. 14.

<sup>76</sup> See SFC, pp. 14-15.

<sup>77</sup> Including Recommendations 1-3.

<sup>78</sup> Including Recommendations 4-15.

<sup>79</sup> Including Recommendations 16-19.

<sup>80</sup> Including Recommendations 20-26.

<sup>81</sup> Swiss Foundation Code 2009, Foundation Governance, vol. 9 (Helbing Lichtenhahn Verlag).

<sup>82</sup> Article 80 A. Foundation I. In General.

<sup>83</sup> In some countries, the law stipulates that the endowment must have a minimum threshold value. This is not the case of Switzerland, though in practice the Swiss authority requests a minimum amount before registration.

<sup>84</sup> In some European countries, the law requests that the purpose be published and expressly defined as being of a public-benefit. See EFC, *Exploring Transparency and Accountability Regulation of Public-Benefit Foundations in Europe* (2011). This level of precision is absent from the SCC.

<sup>85</sup> Thus, in Switzerland, registration functions as a state approval for grant-making foundations; whereas in other European countries, such as France, registration is not required. Alternatively, registration is achieved subject to judicial approval and not by state approval. See *id.*, pp. 12-13.

disposition.<sup>86</sup> A foundation can also be established by contract of inheritance (*pacte successoral*)<sup>87</sup> under the jurisprudence developed by the Swiss Federal Tribunal.<sup>88</sup> Article 81, para. 2, of the SCC stipulates that a foundation must be entered in the commercial register, pursuant to its charter, in accordance with any directions issued by the supervisory authority, and naming the members of the board of trustees. Finally, Article 81, para. 3, stipulates that the probate authority shall inform the commercial registrar of the creation of a foundation by testamentary disposition.<sup>89</sup> Upon subsequent notification of the supervisory authority, the registrar will exercise supervision.<sup>90</sup>

### **b. Swiss Foundation Code**

The first recommendation of the SFC concerns the examination of the founder's intent. In particular, the recommendation seeks (a) to ensure that the founder's intent corresponds to a societal need, and that that an independent foundation is an appropriate vehicle to deal with this need, taking into account its assets; (b) to determine whether the foundation is to have a permanent or limited existence, and, if permanent, to set up a framework for electing or replacing board members; and (c) to ensure a level of coherence in terms of the foundation's will, purpose, organization, and assets disposed.<sup>91</sup>

The second recommendation of the SFC deals with the legal domicile of the foundation. In principle, the recommendation states that the foundation should be established where its main grant-making activity takes place. However, geographic proximity is not the only concern; a foundation's domicile determines its legal framework and supervisory authority. In addition, the recommendation states that tax issues should be evaluated when setting the domicile of the foundation.<sup>92</sup>

The third recommendation deals with the internal documents and bylaws of the foundation.<sup>93</sup> The purpose of the foundation should be stated in the charter. Ancillary rules concerning the work of the foundation, which need to be adaptable, can be established in other documents or guidelines. In cases where the purpose is broadly defined, the founder should add a

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<sup>86</sup> The rules of formal testamentary disposition are governed by Article 498 A. Wills, I. Drawing up a will, 1. In general, Article 499 et seq. governs the requirements of testament established by public deed. The rules of hand-written testaments are governed by Article 505 (on Holographic will). Article 506 (on Oral will, dispositions) et seq. govern the rules on oral declarations of testamentary nature.

<sup>87</sup> The requirements for contracts of succession are set forth in Article 512 et seq. of the SCC. In order to be valid, the contract of succession must be vested with formal requirements of a will executed as a public deed and the intention of the parties must be declared before the public authority.

<sup>88</sup> Sprecher, T., *New Features in Swiss Foundation Law* (2006), p. 9.

<sup>89</sup> Art. 81.3 of the SCC.

<sup>90</sup> Sprecher, T. *New Features in Swiss Foundation Law* (2006).

<sup>91</sup> See the Swiss Foundation Code 2009, with commentary. Sprecher, T., Egger, P., and Janssen, M., *Foundation Governance*, vol. 6., Helbing Lichtenhahn, Swiss Foundations (2009).

<sup>92</sup> See *id.*

<sup>93</sup> As the law does not have provisions on the bylaws of the foundation, this recommendation is very useful for newly formed foundations.

mission statement to serve as a strategic guideline for the board, which can be periodically revised.<sup>94</sup>

## **2. Challenges by Heirs or Creditors**

Article 82 of the SCC<sup>95</sup> states that the foundation can be challenged by the heirs or creditors in the same way that a gift may be challenged.

## **3. Organization of Foundations**

### **a. Swiss Civil Code**

The charter stipulates the governing bodies of the foundation and its method of administration.<sup>96</sup> If the authority of the commercial register sees a lack of coherence between the way in which the foundation has been organized and its legal mandate, the authority will notify the pertinent supervisory authority of the foundation, which will need to redress these deficiencies.<sup>97</sup> The supervisory authority may set a deadline by which the foundation must establish its legal status, appoint an executive body (assuming this is vacant), or appoint an administrator (permanent or not) together with an assignment of competence. If the situation cannot be redressed and uncertainties persist regarding the feasibility of the foundation's organization, the foundation's assets can be donated to another institution that has a similar purpose.

This is to be done irrespective of whether the deed of the foundation authorizes it or not.<sup>98</sup> This provision constitutes a departure from the established Swiss legal regime on foundations, which did not give this power to the authority. Under such circumstances, the new regime even allows the authority to transfer the assets against the will of the founder and the members of the board, regardless what is stated in the deed.<sup>99</sup>

### **b. Swiss Foundation Code**

The second cluster of recommendations of the SCF deals with organizational issues. The last of the 12 recommendations stipulates that the foundation should share information on its principles, grant-making activities, and procedures with the public. The recommendation aims to inform the public about the purpose of the foundation, its structure, and its areas of activity. The SFC advises that foundations make their "goals, guidelines and procedures governing grant-making activities" accessible to the public via a website. The recommendation states that the foundation should share this information with its beneficiaries, the public authority, and the public in general.

Recommendation 4 provides rules for the functions of the board of trustees, which should be included in the foundation charter. The first recommendation states that the board should

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<sup>94</sup> See the Swiss Foundation Code 2009, with commentary.

<sup>95</sup> SCC, Article 82 III., Challenge by founder's heirs or creditors.

<sup>96</sup> SCC, Article 83B, Organisation, I. In general.

<sup>97</sup> The foundation bears the cost of these diligences. Article 83d, IV, para. 3, of the SCC.

<sup>98</sup> SCC, Article 83d, IV. Organisational defects, point (2)

<sup>99</sup> Sprecher, T., *New Features in Swiss Foundation Law* (2006), pp. 9-10.

possess discretionary authority over its judgments and be free to hold independent opinions. Even if the founder is a member of the board, the other board members must remain autonomous. The board is entrusted with setting up the foundation's short-, medium-, and long-term strategies to achieve its purposes. Taking into account the foundation's charter, the board also has the power to periodically evaluate strategies of managers along with performances and policies of the foundation.

Recommendation 5 states that in the absence of stipulations in the foundation's charter, the board of trustees should draft procedures regarding the election of its members, their terms of office (two to five years per term), and rules governing their succession. Recommendation 6 deals with the number of members of the board of trustees (ideally five to seven). It suggests rules ensuring that foundation employees and board members receive adequate time to perform their functions and opportunities to benefit from training courses.

Recommendation 7 suggests rules on board members' remuneration, which ought to be commensurate with individual skill and experience, expended time, and performance. Although the recommendation indicates that board members will optimally perform their duties on a voluntary basis, it recognizes that members may require remuneration for their professional services. In this regard, the terms must be agreed in writing.

Recommendations 8, 9, and 10 deal respectively with the board's organization, the role of its chairperson, and the role of its committees. Meetings of the board should take place at least twice a year; they must be announced; decision-making procedures should be easy to comprehend; and minutes should be recorded. If necessary, the board should determine when to consult external experts. Recommendation 9 specifies the tasks entrusted to the chairperson *vis-à-vis* the board and the management of the foundation. The chairperson moderates board meetings and communicates timely information to board members so that they are appropriately informed before each meeting. The chairperson's duties, areas of competence, responsibilities, and term of office should be laid out in the foundation's regulations or guidelines. Recommendation 10 outlines cases where the board might decide to set up permanent or *ad hoc* committees for specific tasks, such as overseeing finance, investments, grant-making, human resources, and remuneration. The board must ensure that the external members of these committees are independent and in no way associated with the people they must evaluate. The board of trustees should lay down the committee's tasks in the foundation's regulations and guidelines.

Recommendation 11 deals with the rules governing potential conflicts of interest between a person's role as a foundation board member or management member and his or her other professional or personal activities. The board is charged with drafting the rules on this. As a matter of principle, any situation presenting a potential conflict of interest should be avoided. Should such a case occur, it must be disclosed to the board. It may also have to be disclosed in the annual report.

Recommendation 12 outlines the foundation's tasks regarding public communication. The foundation has a duty to provide its members, its beneficiaries, the government, the public, and the media with information concerning its purpose and structure, along with its grant-making policy, strategies, and activities. It should purvey this information using modern media channels, such as a website.

The function of management is addressed in Recommendation 13. The board of trustees should determine the skills, experience, duties, responsibilities, and compensation that its management should have and hire the management. Once hired, management should run the foundation's operations under the supervision of the board of trustees.

Recommendation 14 seeks to ensure that the auditing agency is not assigned any task other than what is required by statutory obligation. In particular, the board of trustees is cautioned against entrusting the auditing agency with the responsibility of managing foundation assets. The board must also make sure that the auditing agency or at least the head auditor is periodically replaced.

Recommendation 15 deals with the appointment of permanent or ad hoc advisors and consultants. When the board needs new skills or simply assistance, it can employ an external work force. The foundation's regulations or guidelines should state the task, areas of expertise, and responsibilities of such external workers. The rules on independence and remuneration of board members should apply equally to advisors, advisory committees, and other foundation bodies.

#### ***4. Recommendations on the Work of Grant-Making Foundations***

##### **a. Swiss Civil Code**

The Swiss Civil Code is silent about the work undertaken by grant-making foundations in practice.

##### **b. Swiss Foundation Code**

SFC Recommendation 16 advises the board of trustees to document foundation policy in writing in order to serve as a reference framework. Grant-making and investment policies should be coordinated, and strategies should periodically be reevaluated in consideration of both society's needs and the activities of other private and public grant-making institutions. The board should set midterm goals as well as possibilities for collaboration.

Recommendation 17 addresses grant-making. In accordance with its investment strategies, the board of trustees should determine distributable foundation income and disburse available funds in a timely manner. A foundation should conduct grant-making activities in a professional, business-like fashion. There must be communication with other private and public institutions to operate efficiently and to avoid duplicate granting. There should be an optimal ratio between administrative costs and grant-making activities. The foundation should have established criteria to determine its efficiency.

Recommendation 18 advises that projects be evaluated and selected pursuant to the grant-making guidelines. The foundation should ensure that competent persons are in charge of such evaluation, and that it is done in an objective and timely manner. External committees or consultants may be used as well.

Recommendation 19 recommends that once a grant has been awarded, the foundation enter into a contract with the beneficiary for the duration of the project. The foundation should define the terms of the contract. A foundation can attach conditions to the funding and monitor the fulfillment of those conditions.

## **5. Recommendations on the Financial Management of Grant-Making Foundations**

### **a. Swiss Civil Code**

Article 83a (1) of the Swiss Civil Code on Foundations' Accounting obliges the board of trustees to maintain the foundation's accounts pursuant to the Code of Obligations on commercial accounting.

Article 83a (2) addresses the situation where a foundation conducts a commercial operation in order to pursue its objects. In such a case, the foundation is required to follow the provisions in the Code of Obligations<sup>100</sup> in respect to presenting public annual financial statements *mutatis mutandis*.<sup>101</sup>

The obligations to submit annual financial statements and to keep accounts apply even to foundations that have been exempted from the obligation to designate an external auditor.

### **b. Swiss Foundation Code**

Whereas the Swiss Civil Code (SCC) and Swiss Code of Obligations (SCO) provide standard rules on accounting and auditing applicable to grant-making foundations, the SFC provides rules on financial management specifically drafted to deal with a grant-making foundation's daily activities. Recommendations 20 to 26 deal with finance.

Recommendation 20 entrusts the board of trustees with the duty to guard against improper funds—those derived from money-laundering, terrorism, corruption, or any other criminal activity. Such funds must not constitute either the original endowment or the income from foundation activities. The board should also ensure a sound balance between the cash flow of the foundation's assets and its grant-making activities.

Recommendation 21 deals with investments. The board of trustees should prepare an explicit policy covering the investment process. Then the foundation should follow this policy in determining the investment strategy, implementing the strategy, and overseeing the results.

Recommendation 22 states that the board should evaluate the foundation's "risk-carrying capacity." The foundation's assets should be invested pursuant to a strategy consistent with the foundation's purpose and its investment capacity, regardless of the personal preferences of the board.

Recommendation 23 stipulates that the board should use a competitive and open submission procedure to determine what entity will implement its investment strategy.

Recommendation 24 advises that the board of trustees systematically review investment results twice a year. Also, the investment strategy should be reviewed every two to three years. Results from the examination of investment returns and investment strategy should be recorded in writing.

Recommendation 25 deals with the foundation's investment plan. It advises that the board establish a plan for investing the foundation's assets efficiently. The components of the plan should be specified in the investment regulations. In addition, the plan should mandate that investment and oversight are strictly independent of one another. If the foundation holds stock,

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<sup>100</sup> SCO, Arts. 957 to 962.

<sup>101</sup> SCC, Article 83a II. Accounting



the investment regulation of the board of trustees should establish rules for exercising rights on stocks.

Recommendation 26 advises that the board of trustees administer the financial management of asset investment, budget planning, and the rendering of accounts. The annual financial reports should provide a complete, accurate, and transparent picture of the financial standing of the foundation. In addition, the board of trustees should generate a budget on the basis of its investment and disbursement plan. The foundation's board should use the annual budget as well as financial reports as tools for management and supervision.

### **6. Audit of Foundations<sup>102</sup>**

In principle, classic foundations must undergo a normal audit. Article 83b (1) of the Swiss Civil Code on Foundations' Auditors mandates that the board of trustees appoint external auditors.<sup>103</sup> However, this obligation can be waived by the supervisory authority. Article 83b (2) states that the Federal Council determines the conditions for such a waiver.<sup>104</sup>

If there are no special provisions applicable to foundations, the rules of the Swiss Code of Obligations concerning external auditors of public limited companies are applicable *mutatis mutandis*.<sup>105</sup> If the foundation has the duty to carry out a limited audit, the supervisory authority can order a full audit in order to obtain a reliable financial assessment of the foundation's finances.<sup>106</sup> The external auditors must provide the supervisory authority with a copy of the audit report as well as all important communications it had with the foundation.<sup>107</sup>

Thus, in principle, the law stipulates that foundations must have auditors, and this is understood as a fundamental rule of transparency that increases credibility and offers confidence to donors.<sup>108</sup> Nonetheless, the board of a foundation can request that the supervisory authority exempt it from the duty to designate an external auditor.<sup>109</sup> The supervisory authority can agree, subject to the fulfillment of conditions specified by the Swiss Federal Council and stipulated by Article 1 of the Ordinance on the Audit of Foundations. These are:

- The foundation has a balance sheet that amounts to less than CHF 200,000.-, in two successive business years (subpara. (a)), and
- The foundation refrains from raising capital either through public calls for donations or other contributions (subpara. (b)).

These conditions are cumulative. The first condition demands that a foundation seeking to obtain this waiver must have undergone an external audit for at least two years prior to application,

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<sup>102</sup> This part on Audit of Foundations is based on Sprecher, T., *New Features in Swiss Foundation Law* (2006), pp. 10 ff.

<sup>103</sup> SCC, Article 83b III. Auditors (1).

<sup>104</sup> SCC, Article 83b III. Auditors (2).

<sup>105</sup> SCC, Article 83b III. Auditors (3).

<sup>106</sup> SCC, Article 83b III. Auditors (4).

<sup>107</sup> SCC, Article 83c 2. Supervisory authority.

<sup>108</sup> Sprecher, T., *New Features in Swiss Foundation Law* (2006), p. 10.

<sup>109</sup> This request by the foundation's board implies that the exception is not granted *ex officio* by the supervisory authority.

which is thus a mandatory step in the case of newly formed foundations. The second condition implies that exemption can only be granted to foundations that are not seeking donations.<sup>110</sup> Although this waiver is unlimited in duration, it may be revoked by the supervisory authority if the requisite conditions change or if an audit is necessary in order to make a reliable assessment of the financial situation of the foundation.<sup>111</sup>

Since an auditor might be a legal entity, a foundation might act as auditor for another foundation. This act must be pursuant to the foundation's charter, and the requirements of independence must be satisfied "under the law governing audits."<sup>112</sup>

One of the innovations introduced by the law is the requirement that auditors be independent of the foundation. Sprecher points to four cases where independence can be questioned:<sup>113</sup>

- The persons commissioned to undertake the audit must not be members of another executive body of the foundation which is to be audited. If the auditors are members of an associated body, the obligations and responsibilities of the foundation executive bodies should be strictly divided from each other.
- Where the person commissioned to undertake the audit is an employee of the foundation, independence is jeopardized.
- In principle, cases where the persons in charge of the audit are also beneficiaries of the foundation's activities should be avoided.
- In principle, cases where the persons in charge of the audit have a close relationship with members of the foundation's executive bodies (e.g., family ties) should be avoided.

In view of the above issues, Article 2, para. 1, of the Ordinance on the Audit of Foundations instructs the foundation to engage a qualified auditor:

- if the foundation is raising funds and has received as gifts, donations or other contributions amounts exceeding 100,000 CHF in each of two successive business years; or
- if the foundation's finances exceed "any *two* of the following parameters" (subpara. *b*) during two successive business years:
  - 1) an overall balance sheet total of CHF 10 million, or
  - 2) a cash flow of CHF 20 million, or
  - 3) an annual average workforce of 50 full-time employees.

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<sup>110</sup> Sprecher, T., *New Features in Swiss Foundation Law* (2006).

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

### **7. Supervisory Authority and Oversight of Foundations**

The Swiss Confederation itself, the Cantons, and within them, the Communes are entitled to supervise foundations. In principle, a foundation is supervised by the public authority to which it has been assigned. Nonetheless, the Swiss cantonal authorities can demand that a foundation supervised at communal level be supervised by the respective canton.<sup>114</sup> This provision allows the cantonal public authority to supervise the activities of the foundation. The supervisory authority must make sure that the assets of the foundation are used for their declared purpose.<sup>115</sup>

### **8. On the Over-Indebtedness and Insolvency of Foundations**

If a foundation is about to fall into insolvency or there are serious doubts about its financial capacity to meet its obligations, the board of trustees must draw up an interim balance sheet at liquidation values and submit this to the external auditors or, in the absence of external auditors, to the supervisory authority. If the external auditors identify such circumstances, they must notify the public authority directly. The supervisory authority must then command the board of trustees to take the necessary steps to redress the situation. If the board fails to do so, the supervisory authority will take these measures itself. As a last resort, the supervisory authority can take legal enforcement measures. The provisions of company law on commencement or deferral of compulsory dissolution apply to the foundation *mutatis mutandis*.<sup>116</sup>

The “revocation of the foundation as a matter of civil law” does not represent a financial restructuring measure. This might also not be possible if the foundation is over-indebted or if it runs counter to the will of creditors. Revocation is possible only if the legal enforcement process has been concluded and a surplus remains.<sup>117</sup>

A foundation may fall into bankruptcy. If financial restructuring is no longer feasible, the Swiss Debt Enforcement and Bankruptcy Law (DEBL) will apply to the foundation, *mutatis mutandis*, as it does in the case of corporate bankruptcy.

Finally, a foundation can issue a self-declaration of insolvency, pursuant to Article 39, para. 1, clause 12, of the DEBL.

### **9. Bookkeeping**

Article 84b of the SCC<sup>118</sup> sets the rules on bookkeeping for foundations. Foundations are subject to the duty to keep accounts, which is essential for auditing annual accounts as mandated by Article 83a, para. 3, of the SCC.<sup>119</sup> The provisions on commercial bookkeeping of the Code of Obligations also apply here.<sup>120</sup>

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<sup>114</sup> SCC, Art. 84 C. Supervision 1bis.

<sup>115</sup> SCC, Art. 84 C. Supervision 2.

<sup>116</sup> SCC, Art. 84 Cbis, 4, Measures in the event of overindebtedness and insolvency.

<sup>117</sup> Sprecher, T., *New Features in Swiss Foundation Law* (2006), pp. 16-17.

<sup>118</sup> SCC, Article 84b.

<sup>119</sup> SCC, Article 83a II. Accounting.

<sup>120</sup> SCO, Arts. 957 et seq.

## **10. Changes in the Purpose of the Foundation**

Under Swiss law, the purpose of a foundation can be changed by the federal or the cantonal authority pursuant to a proposal made by the overseeing authority or by the board of trustees of the foundation.<sup>121</sup>

## **11. Changes in the Foundation's Object at the Founder's Request**

Traditionally, foundations have been conceived of as being institutions that pursue perennial objects. When establishing a foundation, founders devote a good deal of wealth to the pursuit of an object that they expect will survive them. This intent of the founder is the motivational force underlying the foundation's charter. The SCC recognizes the force of the founder's will in Article 86a, which introduces the right of the founder to amend the foundation's object by request, subject to the classical legal framework of foundations.

The request to change the purpose of a foundation can be made by the founder directly or by testamentary disposition. However, some conditions have to be fulfilled:

- At the time of setting up the foundation, the founder must have reserved the right to amend the purpose of the foundation.
- The request should be directed by the founder to the competent public authority. This request can be made directly or by testament. If the request is by testament, the authority disclosing the testament should inform the relevant authority of this request.
- This right to change the purpose of a foundation is personal. It cannot be passed to heirs or acquired by third parties. Therefore, if it is not exercised, it will end with the life of the founder.
- In the case of several founders, the request for change of purpose may only be exercised jointly by all the co-founders.
- In order to request the change, at least ten years must have elapsed since the creation of the foundation or the last change in the purpose of the foundation requested by the founder. This period of ten years ensures stability in the foundation's activities.
- If the founder is a legal entity, the right to change its purpose lasts for 20 years and is subsequently extinguished. This rule is aimed at preventing misuse of the right to change the foundation's purpose and abuse of the foundation as a legal entity.<sup>122</sup>
- If the purpose of the foundation which is to be changed is of a public or charitable nature in the sense of Article 56, subpara. G, of the Direct Federal Tax Act,<sup>123</sup> the

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<sup>121</sup> A change in the purpose of the foundation might take place when the foundation's original object has changed to such a degree that it is necessary to redirect the foundation's purpose to the founder's original intention in a more coherent way. SCC, Art. 86 II. Amendment of objects, 1. Request by the supervisory authority or the board of trustees 75.

<sup>122</sup> Sprecher, T., *New Features in Swiss Foundation Law* (2006), p. 20.

<sup>123</sup> DBG, Article 56, let. g, de la loi fédéral du 14 décembre 1990 sur l'impôt fédéral direct, Art. 56, Bst. g, Bundesgesetz vom 14. Dezember 1990 über die direkte Bundessteuer; Art. 56, lit. g, Federal Income Tax Statute of 14 December 1990; SR 642.11.

new object of the foundation must also be a “public or charitable object” under the terms of that law.<sup>124</sup>

Whereas Article 86 assigns the federal authority the competence to amend the foundation’s purpose, Article 86a assigns the supervisory authority the task of ensuring that the request for the foundation’s change of purpose has been executed according to the requirements of the law. Once the supervisory authority has ascertained this to be the case, it must order the change of purpose and notify the Commercial Register Office. The authority, however, has no mandate to make subjective evaluations of the new purpose or to suggest alternative purposes.<sup>125</sup>

### ***12. Dissolution of the Foundation and Deletion from the Register***

Article 88 gives the federal or cantonal authority the right to dissolve a foundation if its object has become unattainable and the foundation cannot be maintained by following the deed, or if the objects of the foundation become illegal or immoral.<sup>126</sup> Any interested party has the right to apply to the public authority for the dissolution of a foundation. Once this request has been granted, the commercial registrar must be informed so that the foundation can be deleted from the register.<sup>127</sup> Finally, courts have the power to terminate family or ecclesiastical foundations.<sup>128</sup>

## **V. Concluding Remarks**

This article has provided an account of the current Swiss legal regime applicable to foundations from a pro-transparency point of view. We began with a summary of the sector as it exists in Switzerland today. Our analysis focused on the legal provisions of the Swiss Civil Code and the Swiss Code of Obligations, together with the Swiss Foundation Code. We have also illustrated our analysis with functional aspects that are applicable to foundations beyond the borders of Switzerland. As a general conclusion, we hold that, in terms of the principles and practices related to transparency, the SFC provides a highly important self-regulation tool for Switzerland’s philanthropic sector.

We close with comments on the analyzed provisions:

[A] On formation of a foundation: A foundation can be established by an act *inter-vivos* or an *agreement as to succession*. An issue of transparency might arise if the heirs of the testator do not fulfill the will expressed in the testament. However, the SCC permits the formation of

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<sup>124</sup> Sprecher points out that this was a highly disputed issue during the drafting of the law, as there were concerns that the new right to alter the purpose of a foundation could become a loophole for tax abuse and give the founder an opportunity to repatriate assets. On the other hand, this limitation is aimed at guaranteeing that the individuals who contributed to the foundation by donations or other instruments are reassured that their assets remain devoted to a “public or charitable” purpose, even if the new purpose is not the same as the original one. Sprecher, T., *New Features in Swiss Foundation Law* (2006), p. 21.

<sup>125</sup> SCC, Article 86b gives the right to the supervising authority—upon hearing the board of trustees—to provide ancillary modifications to the foundation charter, if these are demanded for objective purposes and do not affect third parties’ rights. These minor changes provided by the supervising authority aim to simplify the procedures for establishing a foundation. SCC, Art. 86b III. Minor amendments to the charter.

<sup>126</sup> SCC, Article 88 F. Dissolution and deletion from the register. Dissolution by the competent authority.

<sup>127</sup> SCC, Article 89 II. Right to apply for dissolution, deletion from the register.

<sup>128</sup> SCC, Article 88 F. Dissolution and deletion from the register. I. Dissolution by the competent authority.

foundations by testamentary disposition. This ruling reflects the institution's regard for individual freedom.

The SCC addresses this issue, albeit not in the section expressly dedicated to the regulation of foundations. So the duty of the heir to submit the will to the SCC<sup>129</sup> must be read in conjunction with the provisions on "Reading the will" of the SCC, Article 557.<sup>130</sup> The authority in charge of opening the testament must therefore notify the competent commercial register. The performance of this duty is the key to ensuring the fulfillment of the founder's will.

The more specific recommendations of the SFC address the functionality of the grant-making foundation. First, the recommendations suggest a kind of proportionality test to evaluate the feasibility of a foundation's achieving its objects given its means and organization. Recommendations 2 and 3 specify the level of coherence expected between the laws that are applied to foundations—including the tax regime—and the activities that foundations engage in. By anchoring the regulatory authority to the foundation's legal domicile, the SFC intends to discourage forum shopping. At the same time, however, given today's globalized economy, this provision should not limit foundations from operating across borders.

Recommendation 3 of the SFC outlines essential documents that a foundation should provide regarding its internal organization, which should remain valid for the first five years of the foundation's existence. Other documents include the foundation's constitution, its internal organization, and its mission statement. This material provides fundamental, *prima facie* evidence of the new foundation's objectives and principles.

The first three SFC recommendations relate to regulatory requirements for the formation of foundations: the founder's intent, the foundation's legal domicile and regulatory authority, and the founding documentation. Although none of these recommendations directly address transparency, they deal with issues that are central to it.

**[B]** On Article 82 of the SCC (Challenges by Heirs or Creditors): The SCC provision seeks to prevent foundations from being used as depositaries for assets diverted from their original legal destination by dishonest means: diluting assets entailed to a legal inheritance, or simulating a situation of insolvency by transferring assets to a foundation. Since these abuses do not directly concern to the functionality of foundations, the SFC does not refer to them specifically.

**[C]** On Article 83d of the SCC (IV. Organizational defects of foundations): The Swiss Civil Code provides the public authority with the power to intervene and directly restore situations where a foundation fails to organize itself pursuant to requirements of the authority. Under some circumstances the authority might even dispose of the foundation's assets, assigning them to another foundation of similar purpose. In theory, this is a way to ensure that foundations registered with the authority are internally structured pursuant to the law and supervisory regulations. But at the same time, such a disposition imposes a more compelling level of responsibility on the authority when assessing and endorsing any foundation in its registry. This provision does not concern issues of transparency *vis-à-vis* the public as such. However, it is not

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<sup>129</sup> SCC, Article 556 (on Duty to submit the will) mandates that a will be submitted to the public authority; the public authority can afterwards release the estate to the statutory heirs on a provisional basis or designate an estate administrator.

<sup>130</sup> SCC, Art. 557 II. Reading the will.

detrimental either. Conversely, Recommendation 12 expressly addresses the issue of sharing information on a foundation's organization, activities, grant-making procedures, and purposes. This provision constitutes a plausible approach aimed at enhancing transparency between the foundation and the public, so that in conjunction with the ensemble of Recommendations 4 through 15 on Leadership, it provides for a level of transparency.

**[D]** With regard to the recommendations aimed at providing a framework of rules and conditions for the granting of funds, taking into account cost-analysis and the fact that foundations are not alone in the sector: Although these recommendations are directed more toward implementing a rational management of the foundation's funds than transparency as such, the fact that the SFC recommends that these policies be stipulated in writing provides grant-making applicants with a set of instructions drafted *ex ante*, which should help enhance grant permissions and at the same time reduce arbitrary refusals.

**[E]** On the finance of grant-making foundations: One of the responsibilities imposed on board members is the duty to check the origin of the assets introduced to the foundation. In general, the recommendations relating to this duty of care do not deal with issues of transparency directly. Nevertheless, they do provide foundations with principled guidelines that help the sector to function smoothly.

**[F]** On the accounting procedures of foundations: The Swiss Civil Code does not provide any rules specifying accounting procedures for foundations. This omission leaves numerous options open to the managers who are charged with fulfilling the foundation's purpose. The SCC regulations together with the rules and procedures for extending grants, as well as the SCF's general rules on finance, should help foundations offer a clearer picture of their activities. Recommendation 26 of the SFC constitutes a valued tool for achieving this.

**[G]** On auditing procedures for foundations: The authority has the power to exempt a foundation from the obligation to appoint external auditors. This potentially undermines the credibility of the authority in cases where the foundation becomes insolvent. In this sense, the Code's conditions might not always suffice to shield the authority from this risk. To address this risk, Sprecher presents a case where a group of foundations could create a foundation whose sole purpose would be to independently audit that group of grant-making foundations. Provided that the sector has sufficient resources for this purpose, the creation of an independent auditing foundation would promote transparency by giving specialists in the sector the opportunity to provide clear accounting procedures for foundations.

**[H]** On the supervisory authority and the oversight of foundations: Supervision should become more coherent throughout Switzerland. A highly confederated country, composed of 26 independent cantons, can only welcome such a provision. The SFC recommendations on the supervision of foundations therefore contribute to the sector's transparency.

**[I]** On insolvent or over-indebted foundations: None of the provisions concerns the transparency of grant-making foundations. At the same time, the fact that the law applies corporate rules on insolvency and bankruptcy to foundations shields the philanthropic sector from being hijacked by spurious financial maneuvers exercised by either local or foreign players.

**[J]** On bookkeeping: This legal aspect is not directly linked to transparency, but it is an instrumental item for achieving high standards in transparency.

[K] On changes in the foundation's purpose: In principle, the intervention of the public authority in providing clearance for a change in the foundation's purpose is likely to contribute favorably to transparency issues.

[L] On changes in the foundation's object at the founder's request: Whereas the SFC is markedly silent on this issue, SCC commentators suggest that the purpose should be defined as broadly as possible. However, the public authority has virtually no power to decide on the new purpose. Once the conditions required for changing the object have been met, the authority can do nothing in order to object. In this sense, the legislature clearly considers the legal requirements sufficient to ensure that the system is not abused. While this is possibly a disputable approach, the alternative would be to grant the public authority the right to designate a new purpose, which would conflict with the nature of the foundation as a legal, liberal institution. Moreover, if the authority does not have the right to determine the foundation's purpose at the moment of its registration, why should it acquire such a right later on?

[M] On the dissolution of foundations and deletion from the register: This provision also contributes to the transparency of this sector. It provides the public authority and interested parties with the right to request the liquidation of a foundation that has become estranged from its initial purpose over time due to changes in the purpose or the deed's restrictions.

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**Article**

# **Debating Civil Society: Contested Conceptualizations and Development Trajectories**

**Jussi Laine<sup>1</sup>**

*The concept of civil society is back on the agenda. However, ambiguity still surrounds the concept. While there is no need to strive for a universal understanding of civil society, it is nevertheless essential to scrutinize the concept thoroughly, for what is understood by it defines largely what can be expected from it. This article conceptualizes civil society as an arena, a public space with blurred borders, where diverse societal values and interests interact. It argues for a framework that is better able to take into account the entire range of civil society actors, by placing less emphasis on organizational forms and a stronger focus on the functions and roles of informal associations, movements, and instances of collective citizen action.*

## **Introduction**

During the last two decades, the concept of civil society has been, once again, on the rise. Today, it is on various agendas. As a concept it is much used, perhaps overused, certainly misused if not abused. Few political speeches, action plans, or program documents go without reference to civil society. But this presents a problem. Are we all talking about the same thing? As Grimond notes, it is universally talked about in tones that suggest it is a Great Good, but for some people it presents a problem: What on earth is it? All the talk with little action has downgraded the concept into a fashionable buzzword, a sort of an attention-directing device with limited usability. Such a development is deleterious, for it overshadows many of the ideas and accomplishments stemming from civic action.

Defining what is meant by civil society is a political project in itself. However, it is essential to scrutinize the concept thoroughly, for what is understood by it defines largely what can be expected from it. Using the term “civil society” in a global sense obscures as much as it illuminates. The basic premise here is that what is meant by civil society remains open to diverse interpretations (Cohen & Arato 1992; Wiarda 2003; Edwards 2004). Its definitions have changed over time, but even in the current use the concept means very different things in different countries and languages (Kocka 2004, p. 65). Certainly, civil society is a product of the “West,” but that tells us little, for there are several models of civil society in the West: the French one differs from the British; the American conception is quite different from that of, say, Germany.

In order to get to the root of the issue, one is forced to deal with some of the major divisions in social and cultural studies, and trace how the utilization of different traditions and

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models have led to different manifestations of civil society. This article aims to show that the frame of interpretation and the related assumptions about civil society vary greatly, depending on the tradition that is followed and the conception or model that is applied. The article outlines the historical premises for the formation of civil society and then discusses the current usage of the concept. It concludes by presenting an interpretation of civil society as an arena, with an argument that instead of fixating on civil society's organizational form, the focus needs to be on what is actually being done.

## **Bringing History Back In**

### ***Classical Civil Society as Partnership of Individuals***

Even though the contemporary understanding of civil society refers commonly to the public sphere, as set apart from the state and the market, it has not always been so. Many of early European political thinkers saw civil society as a synonym for a type of political association whose members are subject to laws which ensure peaceful order and good government (Keane 1989). The origins of the concept of civil society trace back to the communal life in the *polis*, the Greek city-state. Socrates proposed that “dialectic,” a form of public argument to uncover truth, was imperative to ensure “civility” (in contrast to barbarity) in the *polis* and “good life” of the people (O'Brien 1999). This rational dialogue was to test the individual's arguments against societal arguments in order to find the proper balance between the needs of the two (Setianto 2007). For Socrates' prized student, Plato, the ideal state was a society that was just and allowed people to dedicate themselves to the common good and to practice civic virtues of wisdom, courage, moderation, and justice (Ehrenberg 1999, pp. 5–6).

Aristotle was the first to use the term *koinonía politiké*, a political association. For him, *koinonía politiké* was an independent and self-sufficient association of free, equal, and like-minded persons united by an *ethos*, a common set of norms and values approved and honored by its members (Barker 1946). As Cohen and Arato (1992, p. 84) bring forth, *koinonía politiké* was, however, only a *koinonía* among many; the term *koinonía* was used to designate all forms and sizes of human association, the members of which were held together by something they had in common and could share with each other. However, while all associations have an end, the political association has the highest: it channels the collective pursuits to serve the common goal of attaining a good society.

Whereas today a political association or a community is often understood as being a state, for Aristotle the state was a foreign concept. For him, *koinonía politiké* designated above all a politically united community, a city as a political “partnership” of individuals coming together not for the sake of social life but rather for the sake of performing good actions and attaining self-sufficiency (Barker 1946, p. 5). Aristotle thus saw that contiguity and consanguinity, as well as the social life arising from these ties, are the necessary basis, but that the essence is cooperation in a common scheme of good life, and the ultimate form of such cooperation is the *polis*, on which individuals are dependent. Individuals are by nature political animals; when perfected, they are “the best of animals” who engage in political pursuits because they are “furnished” with capabilities such as speech, which allows for communication and the ability to perceive and determine what is just (ibid. p. 7). Thanks to these capacities, human beings can be habituated to virtue, which can be best done through participation in the communal life in the *polis*, the civil society.

Cicero in turn referred to a civilized political community, which was the equivalent of *res publica* (commonwealth), “an assemblage [of men] associated by a common acknowledgment of right and by a community of interests” (Cicero 1966). It includes groups, communities, and individuals united by laws and institutions, which organize their activities in such a way as to create a flexible equilibrium among them. Because justice and reason are rooted in man’s natural “social spirit,” such organizations induced individuals to forgo a measure of self-interest in the interest of the common good (Islamoglu 2001, p. 1891).

### ***Community with Virtues Derived from Natural Laws***

Willem van Moerbeke used *communicatio politica* and *civilis communitas* as translations of *koinonía politiké* in approximately 1260. It was not, however, until the fifteenth century that Leonardo Bruni, a Florentine humanist, challenged the earlier translation with *societas civilis*, a term that would famously enter into all European languages (Hallberg and Wittrock 2006, p. 30).

In the sixteenth century, Jean Bodin built upon Aristotle by arguing that the state is a natural fact: “The state is the civil society that can exist on its own without associations, and other bodies, but it cannot do so without family” (Bodin in Bobbio 1989, p. 35). Bodin claimed that there are various forms of the political ethos (*mores*), which affect the shaping of various forms of government: monarchy, aristocracy, and democracy. Bodin’s main idea was to create an ethos of pacification, peaceful coexistence, and cooperation between citizens, which would secure the stability of public goods and institutions even in a society lacking consensus on its highest values. In Bodin’s eyes, the best way to guarantee this was through the absolute sovereignty of state power (Rhonheimer 2005, p. 21).

The Aristotelian logic of a society as a work of nature was not challenged until the seventeenth century, when most notably Thomas Hobbes and John Locke argued that societies are *formed* as the *result* of a social contract between human beings. Hobbes believed that in their original state of nature, people lived in a society of “all against all” and had to compete for scarce resources. This, he argues in *Leviathan*, creates a war in which every person is governed by his own reason and has a natural right to do anything to preserve his own liberty or safety (Hobbes 1909). As constant war and insecurity allowed no development and made the life “solitary, poore [*sic*], nasty, brutish, and short,” Hobbes saw that people needed agreements based on the natural precepts and the general rules of reason among each other in order to create peace and, hence, improve their lives (*ibid.*).

Through such mutual contracts between individuals, the state of nature could be left behind and the formation of a common power, the *Leviathan*, the civil government, the state, could become possible. Whereas individuals in the state of nature fought against each other, in civil society the impartial state maintained peace in a community of people acting in a civic manner (Hobbes 1909, pp. 105–109). The motive to come together was not that people were naturally inclined to do so, as Aristotle had asserted; they were driven by the fear of coercive common power (*ibid.* p. 101). The existence of such a power, the state, thus created a condition in which the state of nature gave way to civil society; i.e., it became rational for people to act in a civil manner and to cooperate rather than fight for their vested interest.

Skinner (1996) suggests that Hobbes actually repudiated the entire classical theory of eloquence and its ideal of the *vir civilis*, the good citizen, the virtuous, wise, rational man. Instead, according to Skinner’s interpretation (1996, p. 291), Hobbes had claimed that reason unaided by eloquence would be sufficient to persuade others of the truths of civil science,

that eloquent men would have not sustained but destroyed civil life, and that the most important duties of citizenship are grounded in the private sphere.

Whereas Hobbes wanted all lawmaking, both judicial and executive powers, to be exercised by a single body and to have authority even over the individual's religious doctrines and beliefs, Locke made a separation between the legislative and executive powers in order to prevent the power of government from threatening the rights of the society (Locke 1965). Locke's ideas were grounded in the doctrine of a God-given Natural Law, which posits that individual citizens have certain natural rights as human beings that cannot be taken away from them (Locke 1965; Laslett 1960).

Locke promoted the civic virtue of tolerance and advocated that individuals be allowed to meet together, to form associations, and to enter into relations of their choice – the government being a unitary outgrowth of the freedom to form an association. He saw that communities are formed when people unite in order to further their own and their community's interests. By agreeing to form a legislature, people give their individual power up to the community. Like Hobbes, Locke did not generally hold that the state and civil society would be separate realms but rather that they would coexist. In *Two Treatises of Government*, he did, however, inconsistently assert that the dissolution of legislative power does not necessarily mean the end of society, whereas if society is dissolved its government cannot remain.

### ***Enlightenment Ideal and the Epistemological Centrality of Morality and Reason***

During the Age of Enlightenment, a number of thinkers contributed to the advancement of the concept of civil society. Human beings were rational and capable of shaping their own destiny without an absolute authority exerting control over them. Montesquieu further developed the distinction between a nonpolitical civil society (*l'état civile*) and the state (*l'état politique*). Largely under Bodin's influence, he came to believe in the "rule of law" within a civil society. Whereas governments use laws to influence and steer human conduct, civil society uses *moeurs* (nonlegal, internalized restraints established by custom) and *manières* (conduct not regulated by law or religion) (Montesquieu 1949; Richter 1998). Rousseau maintained that Locke's idea of expanding individual rights ignored common goods and would ultimately lead to a war among people. Instead he proposed a new social order that would maintain harmony and provide equality and freedom for all. The State, as a supreme power, would govern, enact laws, and define the common good (Colás 2002). Civil liberty would emerge when all people were willing to abide by the general will out of a belief that it would lead to common good.

It was first and foremost the Scottish Enlightenment thinkers David Hume, Adam Ferguson, and Adam Smith who began to refer to civil society clearly as a network of human relationships separate from the State. The distinction, according to Ferguson (1995), was necessitated by the rise of state despotism, i.e., the state's endeavor to "cover" society by forcing its way through it "from above" (Holenstein 2009, p. 16). Hume suggested that people set their goals on the basis of morality but use reason in achieving them. By using reason to follow their self-interests in an enlightened manner, people would eventually achieve the interests of society as a whole. While rejecting the social contract theory, Ferguson presented civil society as a developed and redefined society, where civil liberties were safeguarded by the government and a certain level of social, political, and particularly economic advancement has been reached. He saw civil society as opposed to a rude nation (Pietrzyk 2001) and believed that through

governmental policies, education, gradual knowledge, and development, rude society might be transformed into civil society (Setianto 2007).

Smith agreed with Ferguson that the binding principle of civil society is a private morality predicated on public recognition by one's peers, joined through bonds of moral sentiment (Smith 1976). He laid the foundation for civil society as an economic society separate from but protected by the State and mediated by a social order constituted by private property, contracts, and "free" exchanges of labor (Smith 1993, p. 36). For Smith, civil society was not only a refuge from the economic realm but also a wellspring of economic abilities. In Smith's view, liberal commercial society both required and encouraged civic virtue. Inspired by Ferguson and Smith, the firm distinction between the civil society, family, and the state became key to the German conception of civil society later advanced by Hegel.

Whereas Smith understood individuals to be motivated mainly by self-interest, for Immanuel Kant this was an inadequate basis upon which to construct a moral order because it was not grounded in a sense of mutual obligation and respect (Calabrese 2004, p. 318). Instead, for Kant, civil society meant that the ends sought by one should not be won at the expense of the wellbeing of another (Kant 1997, 28). For him, the public sphere was the place where the private interests of members of civil society could be reconciled with the universal moral obligations; he believed that individuals need to accept a political authority (the State) in order to achieve a condition of justice and rights (Kant 1991, pp. 54–55). Accordingly, the main purpose of civil society is to force human beings to respect one another's rights (Setianto 2007). Kant was ahead of his time by suggesting that civil society would not need to be nation-bound but rather could be universal.

### ***Classical Modernity and the Distinction between State and Civil Society***

Whereas the classical thinkers emphasized the identity of the state and society, during the modern era the two began to be seen as independent entities. G. W. F. Hegel, the leading thinker of Romanticism, saw human needs, the satisfaction of individual interests, and private property as the defining features of civil society. He treated civil society as a "system of needs" in which individuals reconcile their particular private interests with social demands and expectations, which are ultimately mediated by the universal state (Hegel 1991).

For Hegel, the significance of civil society is that individuals find satisfaction only in relation to other free individuals who are not family members but rather independent persons (Peddle 2000, pp. 118–120). Hegel argued that civil society is well suited to balancing the diverse range of human needs and interests, but that the state, as the highest form of ethical life, gives order to the system of needs by ensuring the stability of private property, social class, and the division of labor. Occupying the realm of capitalist interests, civil society was not necessarily civil and without conflict. The state's task was thus to correct the faults of civil society. In short, a well-functioning civil society cannot exist without the guidance of the state.

Hegel's modern understanding of civil society changed the meaning of civil society entirely: whereas for Kant "*bürgerliche Gesellschaft*" and "*Staat*" had been synonyms, for Hegel they became antonyms (Zaleski 2008, p. 264). He used the German term "*bürgerliche Gesellschaft*" (bourgeois society) to denote civil society as "civilian society"; i.e., a sphere of economic and social arrangements regulated by civil code rather than directly dependent upon political state itself (Honderich 2005, pp. 367–368). In contrast to the preceding *dyadic* models, Hegel provided a *triadic* scheme, in which civil society as an intermediate moment of ethicity

(i.e., being ethical) became situated between the macro-community of state and the micro-community of the family (Bobbio 1989, p. 31). Whereas both the family and state had well-defined categories, Hegel's civil society was a fuzzier concept that encompassed practically everything outside those two realms.

Hegel's followers split based on their political leanings. To the right, Hegel's theory led to a liberal distinction between political society and a civil society that encompassed all non-state aspects of society, including culture, society, and politics (Zaleski 2008, p. 263). Alexis de Tocqueville followed Hegel's perception of social reality in general terms by distinguishing between political society and civil society but contested Hegel by putting weight on the system of civilian and political associations as a counterbalance to both liberal individualism and centralization of the state. According to his liberal stance, the effectiveness of civil society as an "independent eye of society" depends upon its organizational form (Tocqueville 1969). Building on Montesquieu's template, Tocqueville used the term *mores* to denote the totality of intellectual and moral state of a nation, the totality of customs, public opinion, and beliefs, which he saw as having a greater influence upon democracy than laws and the physical environment (*ibid.*).

On the left, Hegel's ideas became the foundation for Karl Marx's civil society as an economic base, in contrast to the "superstructure" of the political society, the state (Marx 1977). Marx gave civil society a more politically charged name, "bourgeois society," as for him it was a product of a historical subject, the bourgeois, which legitimated its struggles against the absolutist state in the language of the rights of man and citizen, whereas in reality it served only the particular interests of the bourgeois (Richter 1998, p. 33). He rejected the positive role of the state put forth by Hegel, as he believed that under capitalism, the state functions as a repressive apparatus, an instrument of class domination (Bobbio 1989, pp. 27–29; Marx 1970). He agreed with Hegel that civil society was where the real action is, yet he conceived it to be so robustly shaped by class antagonism that it could not ensure the common good among competing interests (Brown 2001, p. 74). In a bourgeois society, people treat one another as a means to their own ends and, in so doing, are isolated from other people (Anheier, Glasius and Kaldor 2001, pp. 12–13).

Gramsci (1971) followed Hegel in distinguishing civil society from the State, but preferred the Marxian thought that the historical development of society occurred in civil society and not in the State. However, whereas Marx had considered civil society as coterminous with the socioeconomic base of the state, Gramsci located it in the political superstructure and made it the locus of the formation of ideological power. For him, civil society was a sphere wherein ideological apparatuses operated and whose task it was to exercise hegemony and through hegemony to obtain consensus (Bobbio 1989, p. 29). While in Marx's writings civil society is portrayed as the terrain of individual egotism, Gramsci described civil society as a sphere of both the individual and organizations with the potential for rational self-regulation and freedom.

Even though Gramsci portrayed civil society as the arena, separate from state and market, he specified that the distinction between the state and civil society was only methodological, for even a policy of non-intervention like *laissez faire* is established by the state itself (Gramsci 1971). He presented a fully developed civil society as a system able to resist the "incursions" of economic crises and to protect the state (*ibid.* p. 238). The state, narrowly conceived as government, is protected by hegemony organized in civil society, while the coercive state apparatus fortifies the hegemony of the dominant class. However, while Gramsci accepted a role for the state in developing civil society and in shaping public opinion, he warned against



perpetuating state worship (ibid. p. 268). Civil society, he came to believe, explained why a communist revolution had been much easier in Russia than in Italy. Whereas “[i]n Russia the state was everything..., in the West, there was a proper relationship between state and society, and when the state trembled, a sturdy structure of civil society was at once revealed” (ibid. p. 238).

As Fleming (2000) notes, Gramsci’s work drove twentieth-century analysts to add three crucial components to the understanding of civil society. First, it was understood that civil society was more than a mere transmitter of established practices or beliefs; it formed a site of social contestation, in which collective identities, ethical values, action-orienting norms, and alliances were forged. Second, the dynamic, creative side of civil society became emphasized in the formation of informal networks, initiatives, and social movements, which transcended the framework of formal associations. Third, largely thanks to Habermas (1991), civil society came to be seen as “public sphere,” a coercion-free arena for discussion and mutual learning, detached from the systematizing effects of the state and the economy, where people come together to form a common discourse, the public, and in doing so compel the state to legitimate itself before public opinion.

### ***Postmodern Influences***

Just as the French Revolution had fueled an adjustment of the concept of civil society in the early nineteenth century, so did the emergence of political opposition to the authoritarian regimes in the former Soviet bloc in the late 1980s. While civil society had been in limbo for decades, the concept was suddenly revived in the early 1990s as its role in democracy, democratization, and development became understood (Jensen and Myszlivetz 2005, p. 3). Since then, globalization and the related formation of a “global civil society” have been the leading forces behind the civil society development. The 1990s witnessed not only a multiplication of NGOs but also a globalization of New Social Movements (NSMs). Kumar (2000) explains that even though the NSMs had linked people together to bring about a social change at the regional or national level since the mid-1960s, with the help of global or international organizations, these movements were able to establish cross-border linkages and operate at international level, thus becoming mega-movements or trans-national social movements (TSMs).

Along with NSMs, postmodernism brought along, inter alia, a heavy emphasis on transformation theory (Collard & Law 1989), organization theory (Greenwood & Hinings 1996), social capital (Coleman 1988; Putnam 1995), political opportunity structures (Kitschelt 1986; Kriesi 1995), and resource mobilization (McCarthy & Zald 1987). Furthermore, New Public Management (Osborne & Gaebler 1992; Borins 1994; Hughes 1998) became an increasingly dominant paradigm for public sector reform. The “Washington Consensus” of the early 1990s, which combined neoliberal economic strategy with an emphasis on liberal representative democracy (Edwards & Hulme 1995), portrayed the state more as a problem than a solution, which in turn had a significant influence on the theoretical debate. The new conditionality presumed by the related funding mechanism portrayed civil society as a sort of panacea, the “magic bullet” (ibid.), replacing the state’s service provision and social care.

The Tocquevillean line of thought, which placed citizens’ associations in the core of civil society and thus of democracy, was famously refreshed by Putnam (1995), who stressed the production and accumulation of social capital. For him, social capital is an essential element of good performance of any society, for civic virtue is most powerful when embedded in a sense

network of reciprocal social relations. Putnam's basic thesis was not, however, altogether new. Social capital had already been elaborated on by Bourdieu (1986) and Coleman (1988), both of whom stressed the less normative aspect of civil society, the importance of civic participation and the various social benefits generated by it. Nevertheless, Putnam popularized its utilization and fueled further interest on the topic. Forming associations—the coming together of people for a common purpose—is thought to teach the “habits of the heart” (Bellah et al. 1996) of social behavior and to bind individual citizens to an idea of unity larger than selfish desires, thus forming a self-conscious and active political society as well as a vibrant civil society functioning independently from the state.

### **Current Understanding**

While the twentieth century, in aggregate, was about the neglect and even the systematic destruction of civil society through statist ideologies, the twenty-first century has so far allowed its rediscovery and restoration. Such a civic renaissance was an outcome of fresh outpouring of social entrepreneurship and civic reinvention, lost faith in centralized systems of government, and increased efficiency and credibility of CSOs, as well as a renewed quest for values and interest in volunteerism (Eberly and Streeter 2002, p. 3). Also, increased new and inherited wealth has made unprecedented resources available for charitable investment (Havens and Schervish 1999, p. 1). As a result, civil society has become understood as to form an essential mediating structure not only because it stands as a buffer between the individual and the large impersonal structures of the state and the market but also because it plays a crucial role in cultivating citizenship as well as generating and maintaining values in society. Without civil society, “values become another function of the megastructures, most notably the state” (Berger & Neuhaus 1977, p. 2).

That being said, the growth of the anti-globalization movement and obvious bumps on road towards democracy, for instance in Russia, caused the universality and legitimacy of civil society to be questioned. The neoliberal Washington Consensus became replaced by a “post-Washington Consensus” that now acknowledged that the state does indeed play an important role in democratic development (Öniş & Şenses 2005). As apparent particularly in times of challenging crisis, state-centered policies became again very en vogue and civil society relegated to the role of a supporting actor at best (Freise, Pyykkönen & Vaidelyte 2010). What also stands out is that the current use of civil society has been moving away from the field of politics and state building. It has become a sphere, an arena operating beyond the confines of national societies, politics, and economies. What hold it together are not the borders of a nation-state but rather ideas, values, networks, and social capital.

### ***Toward Social Economy***

Social economy (SE) has become a major institution of civil society, contributing to the organization of its associative fabric and the development of participative democracy but also of a potent economic and societal actor. As an activity, the SE is historically linked to grassroots associations and cooperatives, which make up its backbone (European Economic and Social Committee 2007, p. 7). In general, the *social* economy refers to the part of the economy proper that is neither private nor public but consists of constituted organizations, with voluntary members, undertaking activities for the greater good of local communities and marginalized groups, a possible surplus of which is used for the good of the community of members or for society. (Social Economy Lisburn 2012.) It can be further broken down into three sub-sectors:

- 1) **Community sector** (usually small, local, modestly funded, dependent on voluntary effort)
- 2) **Voluntary sector** (formal, independent, not-for-profit and strong volunteer input)
- 3) **Social enterprise sector** (businesses with primarily social objectives, surpluses principally reinvested for that purpose in the business or in the community)

In this view, the SE is interpreted in the broader sense of civil economy and constitutes a key component of the broader economy and not a parallel or niche market or a dependent sector (Restakis 2006, p. 10). According to the prominent definition of SE, it includes those organizations that are animated by the principle of reciprocity for the pursuit of mutual economic or social goals, often through social control of capital (ibid. p. 12).

What is noteworthy is that this definition includes also those for-profit businesses that share their surpluses and benefits with their members (and/or the wider community) in a collectively owned structure. However, the definition would exclude those non-profit and voluntary organizations that are entirely dependent on grants or donations (Restakis 2006, p. 12). Its applicability stems from the fact that it recognizes the central role of reciprocal (non-commercial and non-monetary) transactions as economic activities in their own right (Ninacs & Toye 2002). The various organization of the social economy can thus be seen as a sort of hybrid enterprises that perform a blend of commercial activities (sale of goods and services), non-commercial but monetary activities (public funding, donations), and non-monetary activities (volunteer work) to achieve their goals (Restakis 2006, p. 9).

The conceptual delimitation of SE has been presented in the Charter of Principles of the Social Economy promoted by the European Standing Conference of Co-operatives, Mutual Societies, Associations and Foundations (CEP-CMAF). The principles in question are (1) the primacy of the individual and the social objective over capital, (2) voluntary and open membership, (3) democratic control by the membership, (4) the combination of interests of members/users and/or the general interest, (5) the defense and application of the principle of solidarity and responsibility, (6) autonomous management and independence from public authorities, and (7) most of the surpluses have to be used in pursuit of sustainable development objectives, services of interest to members or the general interest.

In its review on the evolution of Social Economy in Europe, the European Economic and Social Committee (EESC), a EU consultative body that proclaims itself as a “bridge between Europe and *organized* civil society” [emphasis added], acknowledges that the concept of the SE is closely linked to the concepts of social cohesion, local and regional development, innovation, and employment, as well as with the project of building Europe (European Economic and Social Committee 2007, pp. 29–33). SE has demonstrated its capacity to increase the levels of social cohesion by complementing and, above all, paving the way for public action. The SE has contributed to the social and work integration of clearly disadvantaged people and geographical areas, but it has also increased the entire society’s democratic culture, boosted its degree of social participation, and managed to give a voice and negotiating capability to social groups previously excluded from the economic process and from the process of drafting and applying public policies.

The SE also constitutes a strategic motor for local and regional development by contributing to endogenous economic development, restoring competitiveness to extensive areas

and facilitating their integration at the national and international level as well as rectifying significant spatial imbalances. The SE's capacity for innovation stems from its direct contact with the broader society, which endows it with a special capacity for detecting new needs, channeling them into the public administration and traditional profit-making private enterprises, and, where appropriate, coming up with creative innovatory responses.

“To reach the levels of welfare and progress that the ‘Western’ countries of the European Union enjoy,” the EESC (2007, p. 33) explains, “the European social and economic model has needed the contribution of the SE, which has proved capable of occupying a space that balances economic and social aspects, mediates between public institutions and civil society and evens out social and economic imbalances in a plural society and economy.” At the European level, Social Economy Europe, the EU-level representative institution for the social economy, has represented and promoted social economy in Europe since 2000. The European Parliament’s “Social Economy Intergroup” provides a forum for a dialogue between all social economy players and members of the European Parliament. The social economy is also represented in the European Economic and Social Committee through the “Social Economy Category” that brings together members from cooperatives, mutual societies, associations, foundations, and NGOs with social aims (Social Economy Europe 2012).

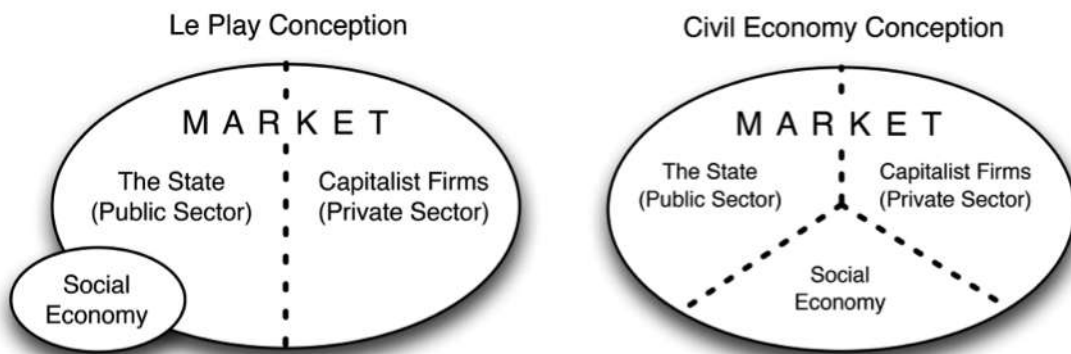
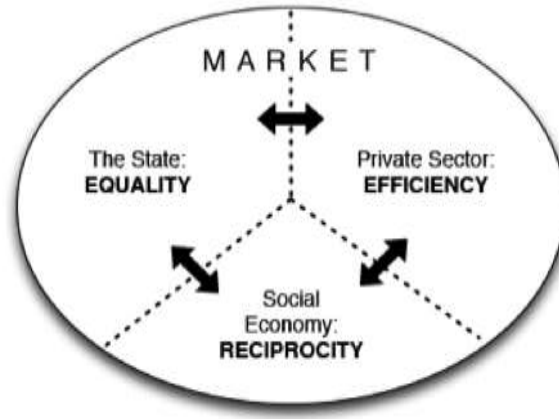


Figure 1

As Restakis (2006, p. 5) notes, there are two broad currents of thought in the debate on the defining elements of the social economy (**Figure 1**). The first is commonly traced back to the French sociologist Frédéric Le Play, who saw the social economy as functioning *apart* from the market, which he interpreted to mean the economic sector that was populated by capitalist firms and the state. For him, the social economy was a niche, a sort of a parallel market that was also dependent on the state for its survival. It was needed in order to create an institutional order to correct the undesired effects of the market. The objective that Le Play was pursuing was not welfare or wealth, but social peace that is the reconciliation of morality and economics through the moralization of individual behavior.

According to Restakis (2006, p. 6), the second current reaches back to the idea of the civil economy, which is conceptualized as a *dimension* of the market. In this view, the market is not identified exclusively with private enterprise but rather as an open domain in which the state, the commercial sector, and the social economy all play a role. Within this current, the recent neoliberal attitudes that direct and restrict the social economy to utilitarian and economic

purposes have brought the term into closer association with the operations of the conventional market. The apparent outcome of this has been the equation of the social economy with “social enterprises” understood as revenue generating, non-profit activities that are meant to serve social or community purposes (ibid. p. 8.).



*Figure 2*

The three sectors of the overall market are distinct above all in that the institutions within them operate on different economic principles (**Figure 2**). The first sector is the domain of governments of various levels, and as such its central economic goal is greater equality. The economic principle central to the private sector is, in turn, efficiency, while social economists are working towards the reinsertion of social goals, reciprocity/solidarity, into economic thinking and decision-making. Even though distinct, these sectors are not hermetically sealed off from each other; there are incalculable transfers and borrowings. Moreover, certain organizations operate at the boundaries of these distinctions (Restakis 2006, p. 12; Lewis 2006, p. 3).



*Figure 3*

Pearce (2003) prefers to use the word “system” instead of “sector,” as the latter implies to him a homogeneous economy that can be divided in to three parts. Otherwise his vision parallels closely with Restakis’s ideas. He argues there are three main ways of thinking about how to manage our economic life, each sector essentially stemming from a different way of managing the economy, from a different mode of production (**Figure 3**).

The first sector/system is about redistribution and planning, whereby it has come to be viewed by many as bureaucratic, paternalistic, centralized, and inefficient, and as such counterproductive to the profit-driven and competitive private sector seeking to maximize financial returns to individual owners. The third sector/system is about citizens working together to meet and satisfy needs themselves (Pearce 2003, p. 26).

### ***Who's Making Whom?***

It is hard to define civil society without defining its relationship with state. Chambers and Kopstein (2008) have made an important move beyond the binary traditional division by suggesting that civil society does not have to be either against or in support of the state, but depending on the context it may also be apart from, in dialogue or partnership with, or even beyond the state. As a result, civil societies, Miller et al. (2009) propose, can be depicted as being contentious, manipulated, disciplined, competitive and interest-oriented, repressed, or normative.

All that is certain is that civil society is not a stand-alone concept. As the discussion above shows, it is paired historically with the concept of the state; they are not just linked but help define each other. Bobbio (1989, p. 42) argues that two processes, the state-making-society and the society-making-state, are contradictory. The completion of the former would lead to a state without society, i.e., the totalitarian state; the completion of the latter would lead to society without the state, i.e., the extinction of the state. As they are indeed contradictory, the two processes are unattainable. Society and state act as two necessary elements that are separate but contiguous, distinct but interdependent, internal articulations of the social system as a whole (Bobbio 1989, p. 44).

The weaker the layer of civic association, the stronger the vertical relationship of the individual and the state becomes—a relationship characterized not by voluntary action and cooperation but by power, authority, and dependence (Eberly and Streeter 2002, p. 8). The reciprocal, interdependent, and constantly realigning interaction between civil society and the state is well explained by Putnam's (1988) two-level game theory. It admits a reciprocal interaction between the domestic and the international arenas affecting the foreign policy construction in a given country. At the national level, the domestic groups pressure the government to adopt politics favorable to their interest and the politicians seek power while constructing these coalitions. At the international level, the national government seeks to maximize its own ability to satisfy domestic pressures, while minimizing the adverse consequences of the actions developed abroad (ibid.).

Increased transnationalism on the one hand and international agreements and coalitions on the other can make the game more complex. In the EU context, for instance, the two-level game model can be inserted in the relation between the member states and their domestically organized civil society. On the other hand, Putnam's model can be applied in the relation between the European-level organized civil society and the EU. Civil society no longer acts only at the national level but has become more transnational and asserted its role as an independent actor in the world society. As the EU increases its supranational mechanisms, it also increases the importance of organized civil society in the EU multi-level governance system.

### ***Plurality of Civil Society***

Recognizing that civil society does mean different things to different people is one of the keys to moving forward, because it gets us beyond false universals and entrenched thinking (Edwards 2004). Civil society is equally traditional and modern (Kocka 2007, pp. 85–86). As described above, its meaning has changed on a number of occasions. Despite its opposite origins, in everyday contemporary practice civil society is assumed to form the antithesis of the state. If civil society is defined in opposition to the state then it is difficult to provide a positive definition of “civil society” because it is a question of listing everything that has been left over after limiting the sphere of state (Bobbio 1989). It is, however, even more important to acknowledge, as Giner (1995, p. 304) has done, that “[t]here is no such thing as *the* classical conception of civil society. There is a Lockean interpretation, but there is also a Hegelian one; and then there are Hobbesian, Marxian and Gramscian theories of it.” Different conceptions are based on different interpretations of classical traditions. These interpretations lead to different outcomes and expectation on what can be expected from civil society.

Wiarda (2003, p. 137) makes the valid observation that in theory civil society sounds wonderful, yet in reality it is often less than that. Civil society cannot be seen as a magic formula that will inevitably lead to democratic and socially just outcomes and save the world. It can be seen to include also less civil actors, operations, and objectives that are, for instance, disintegrative, clientelistic, unrepresentative or otherwise biased, divorced from power realities, or even illegal. It is beneficial where it works; yet it has also been conceived in statist and corporatist terms or as an arena of elitist competition rather than self-sustaining cooperation underpinned by a strong popular base (*ibid.*).

Civil society is a product whose origins are inherently and distinctly Western (Kocka 2004, p. 76). Western, particularly Western European and North American, urban societies are regarded to have been better suited to the development of a stable pluralist civil society than others, yet even there the development might have occurred as an “unintended outcome” of the efforts of state-makers as argued by Tilly (1975, p. 633). Be it as it may, this type of ethnocentric account overlooks the great diversity of the concept of civil society, and fails to see its different manifestations in different (non-Westerns) societies.

Being fundamentally Western ought not to be taken to suggest that civil society cannot exist elsewhere. Rather an analysis has to acknowledge and address this bias (Warkentin 2001). It has become palpable that transplanting a workable model from its original context to another with dissimilar history, economy, societal structure, and political culture is a problematic task. Recognizing that civil society does indeed mean different things to different people provides us with the keys to move forward for it gets us beyond broad generalizations and normative thinking.

In general terms, “Western” is used to refer to an emphasis on individualism, absence of feudal and semifeudal restraints, freedom of association, liberty, and participatory and pluralist politics, along with middle-class, entrepreneurial, and free-market economics (Wiarda 2003, p. 13). Most frequently, it refers to the Montesquieuan understanding of civil society as a multitude of independent citizens’ associations that mediate between the individual and the state and, if needed, defend the freedom of the individual against usurpation by the state. The logic stressing the civil society’s associational core and the development of individual meaning and identity was then promoted and developed further by Tocqueville and fuelled the contemporary

communitarian theorists, such as Etzioni, Bellah, Taylor, and Putnam, in their critique of the presentation of humans as atomistic individuals put forth by Locke, Hobbes, and more recently Rawls (1971).

Edwards (2004) suggests that in addition to civil society as “associational life” or as “the good society,” its function as the “public sphere,” as the arena for argument and deliberation as well as institutional collaboration, ought not to be forgotten. Edwards, acknowledging that all of these three schools of thought have something to offer, yet none of them provide complete and convincing picture of civil society by themselves, calls for integrating these different perspectives into a mutually supportive framework. In all three schools civil society is an essentially collective, creative, and value-based action, providing thus an essential counterweight to individualism, cynicism, and overbearing influence of state authority (ibid.).

### **Civil Society as an Arena**

A number of conclusions can be drawn from what is described above. From civil dialogue come great ideas that can lead to important solutions. While not all civil society organizations are necessarily civil nor do they necessarily pursue the common good, the democratizing role of civil society as a whole cannot be denied. By virtue of their mere existence as *autonomous* actors, the various types of CSOs have pluralizing effect and consequently strengthen the institutional arena and the entire society. As Mercer (2002, p. 8) explains, “more civic actors means more opportunities for a wider range of interest groups to have a ‘voice,’ more autonomous organizations to act in a ‘watchdog’ role vis-à-vis the state, and more opportunities for networking and creating alliances of civic actors to place pressure on the state.” Given that many CSOs work at the grassroots level and include marginalized groups, they not only widen but also deepen possibilities for citizen participation (ibid.).

This being said, civil society remains one of the most misunderstood and misused concepts there is. The reason is obvious. What has been meant by the term has fluctuated considerably through time. In addition, the concept continues to mean very different things in different countries and languages. Using it in a global context easily obscures more than it illuminates. As a concept, it remains normative, loaded, complex, and context-dependent. The liberal democratic assumptions that often shine through Anglophone literature on civil society only restrict the exploration of this complexity and limit the extent to which these studies may actually engage with broader debates about the politics of development. A less value-laden and more contextualized approach is needed to better understand the role that various civil society organizations play in different contexts.

Looking back to the very beginning and going back to the basics, the concept of civil society is very revealing in this respect. The largely undisputed linkage to the concept of the state, which has formed the very basis of the Western (post-Hegelian) thought, should be rethought or at least broadened as to allow for more innovative solutions to issues commonly restricted within the national frame. After all, civil society is a social construct invoked not just in debates on democracy and governance but also with respect to intercultural understanding, progress, and social cohesion.

Civil society preceded the state. Aristotle knew no concept of state as we know it today. His *koinonía politiké* was a coercion-free association that channeled the collective pursuits to serve the common goal of attaining a good society. Not until the Scottish Enlightenment thinkers, most notably, was a clearer distinction developed between a nonpolitical civil society



and the state. No matter what the linkage is—be it juxtaposition, symbiosis, or something in between—it restricts the concept of civil society within the frame of a particular nation state. In so doing, it limits civil society’s characteristic intent of building an association of free, equal, and like-minded persons united not by a citizenship but by *ethos*.

The commonly used concept of the third sector is misleading in two crucial respects: It is not the third and it is really not even a sector. Through recent years, the borders between the public, private, and the community sectors have become increasingly blurred. A substantial range of practices and new organizational arrangements that blend their own missions either with business practices or public service production have emerged, creating something that is now referred to as a “fourth sector.” While the three-sector model surely helps us to make sense of society, the boundaries it implies remain arbitrary. Civil society is not so much embedded in the third sector as it is linked to the processes that that produce social capital and common action. As Gilbert (2004, p. 116) suggests, “[i]f state-supported nonprofit groups enlarge the social capital of civil society, then why not for-profit, company sponsored bowling teams.”



Figure 4

Inspired by the model put forth by CIVICUS, the World Alliance for Citizen Participation, this article aims to conceptualize civil society as an arena, a public space or realm where diverse societal values and interests interact. The borders of this space are complex, fuzzy, blurred, negotiated and yet easily penetrable as people come together to discuss and seek to influence the broader society. As such, it does not belong to the distinct arenas of the market, state or family but exists where these amalgamate (**Figure 4**). There are clear overlaps and incalculable transfers between the different arenas. For some organizations located at or near the

border, these distinctions form the very core of their existence. Social economy organizations that have both value and profit-based goals are good examples of this.

Civil society is the arena that occupies the space where the other arenas of the society—namely the family, the state, and the market—interact and overlap and where people associate to advance common interests. To associate refers to uncoerced and self-generating collective action that is not part of the formal political decision-making process, controlled directly by state institutions, or dependent on the state interests. While it is true that voluntary associations form the basic building blocks of Western notions of civil society and the Putnamian idea of their ability to foster social capital is by now well established, one cannot but ponder whether participation in associations really makes individuals more “civic” and active. Could it simply be that active citizens tend to join associations more often their less-engaged counterparts?

The civil society arena more generally is part of a complex dual transition from industrial to postindustrial society and from national state to transnational policy regimes (Anheier 2008). The further it develops, the further it comes to compose not just an increased number and range of groups and organizations but also increased linkages between them. This only amplifies the corrective voices of civil society as a partner in governance and the market (Connor 1999). Civil society should not be seen only passively, as a network of institutions, but also actively, as the context and product of self-constituting collective actors (Cohen and Arato 1992). It occupies the space reserved for the formation of demands (input) for the political system and to which the political system has the task of supplying answers (output) (Bobbio 1989, p. 25). A framework that places less emphasis on organizational forms and allows for a broader focus on the functions and roles of informal associations, movements, and instances of collective citizen action makes it more difficult to dictate strictly who is in and who is out. Only such an action/function-oriented definition is able to take into account the entire range of civil society actors.

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