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## LEGAL, REGULATORY AND TAX OBSTACLES TO SOCIAL ENTREPRENEURSHIP

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### ABSTRACT

After a brief introduction on social entrepreneurship and its place in the modern world a brief analysis of the various legal, regulatory and tax obstacles faced by current and future social entrepreneurs will be drawn.

There are many factors that can potentially help or hinder the development of social entrepreneurship in a country.

These include social attitudes, beliefs and prevailing cultural factors. In addition to those factors legal, regulatory and tax policies play a crucial role in the decision of a potential social entrepreneur. One of the main challenges for governments wishing to positively encourage social entrepreneurship is that legal, regulatory and tax environment may, at the end, have more restrictive or inhibiting effect on its development.

Throughout this report will be traced the specifics of several countries, including Bulgaria, in the field of legal, regulatory and tax characteristics. As a result of this study will be given a short review of significant differences and organisational characteristics in different countries and successful solutions which support and facilitate the development of social entrepreneurship.

**Key words:** Social enterprise, legal status, tax incentives, organisational characteristics

Social entrepreneurship is the recognition of a social problem and the use of entrepreneurial principles to organise, create and manage a social venture to achieve a desired social change. While a business entrepreneur typically measures performance in profit and return, a social entrepreneur also measures positive returns to society. Thus, the main aim of social entrepreneurship is to further broaden social, cultural, and environmental goals. Social entrepreneurs are commonly associated with the voluntary and not-for-profit sectors, but this need not preclude making a profit. Social entrepreneurship practised with a world view or international context is called international social

entrepreneurship. Nevertheless as every business orientated company a social enterprise needs a proper strategy planning based on well elaborated analyses.

### What is Social Entrepreneurship?

Social Entrepreneurship is the product of individuals, organisations, and networks that challenge conventional structures causing inadequate provision or unequal distribution of social and environmental goods by addressing these failures and identifying new opportunities for better alternatives.

Social entrepreneurship must display all three of the following key characteristics:

- **Sociality:** a context, process and/or set of outputs that are for public benefit.
- **Innovation:** the creation of new ideas and models that address social or environmental issues This can be manifested in three ways: a new product or service (institutional innovation); the use of existing goods and

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services in new, more socially productive ways (incremental innovation); and/or the reframing of norms to redefine social problems and suggest new solutions (disruptive innovation).

- **Market orientation:** the performance-driven, competitive, outlook that drives greater accountability and co-operation across sectors. Market-orientation can include anything from conventional competitive markets to the exchange of social and/or environmental value.

No official definition has been standardised to define social entrepreneurship. Diverse understandings of the term exist across the world. Due to different local context, based upon diverse socio-historical, political, and economic foundations, various nuanced definitions of social entrepreneurship have naturally emerged.

The European Union includes the social economy in its entrepreneurship pillar. Social economy represents, through its four large families a major activity sector. Quantitatively, the sector is important as to its economic weight: 8% of the European enterprises and 10% of the European employment and covers a wide range of activities such as: social protection, health social services, banking, insurance, agricultural growth, crafts, employee ownership, supplying, proximity services, education and training, cultural, sport and leisure activities, insertion through work of disabled persons, etc.

Social entrepreneurship overcomes the gap between the business and the public sectors, as it is connected to the “non-profit” or the “third” sector, as well as to the concept of the “social economy”, with emphasis on objectives to serve communities and society rather than generating a company’s profit.

The first major economic value that social entrepreneurship creates is the most obvious one because it is shared with entrepreneurs and businesses alike: job and employment creation. Secondly, social enterprises provide employment opportunities and job training to segments of society at an employment disadvantage (long-term unemployed, disabled, homeless, at-risk youth and gender-discriminated women).

Social enterprises develop and apply innovation important to social and economic development and develop new goods and services. Issues addressed include some of the biggest societal problems such as HIV, mental ill-health, illiteracy, crime and drug abuse, which are confronted in innovative ways.

Next to economic capital one of the most important values created by social entrepreneurship is social capital. Social capital refers to the institutions, relationships, and norms that shape the quality and quantity of a society's social interactions. Increasing evidence shows that social cohesion is critical for societies to prosper economically and for development to be sustainable. Social capital is not just the sum of the institutions which underpin a society – it is the glue that holds them together.

Social entrepreneurship fosters a more equitable society by addressing social issues and trying to achieve ongoing sustainable impact through their social mission rather than purely profit-maximization.

### Social Organisations Characteristics

It can be stated that social enterprises have three common characteristics:

- **Social Aims** – they have explicit social aims such as job creation, training and provision of local services. They have ethical values including a commitment to local capacity building. They are accountable to their members and the wider community for their social, environmental and economic impact;
- **Enterprises Focused** – they are directly involved in the production of goods and the provision of local services to a market. They seek to be viable concerns, making a surplus from trading;
- **Local Ownership** – they are autonomous organisations with governance and ownership structures based on participation by stakeholder groups (users or clients, local community groups etc) or by trustees.

Profits are distributed as profit sharing to stakeholders or used for the benefit of the community.

Further on we will see what the main differences in four European countries are – Bulgaria, Austria, Lithuania and Portugal. Thos EU

member states are all on different levels regarding their approach on Social Entrepreneurship.

### **Legal Framework**

#### **Bulgaria**

In the Bulgarian legislation there is no legal definition of social enterprise, nor are there any rules that regulate their status, form and activities. A Bulgarian legal act where the term “social enterprise” is used still does not exist. Despite the lack of normative regulation, the practice in Bulgaria shows that organizations developing social entrepreneurship exist and they declare themselves as social enterprises.

Two are the main premises for development and enhancement of SE in Bulgaria:

- ✓ Non-Profit Legal Entities Act which has been in force since 1<sup>st</sup> of January 2001 gives the opportunity of NGOs to develop profit activity.
- ✓ The reform in the social legislation foresees partial decentralization and development of alternative social services.

The amendments of the Social Assistance Act which are in force since January 2003 provide a good ground for valuable partnership between the state and third sector. It guarantees a legal opportunity and mechanism for delegation of social services from the municipalities to social services contractors. Undoubtedly the contractors, mostly non-profit organizations, have the resources needed for increase of the opportunities for social inclusion of people from vulnerable groups through provision of different social services addressed to specific needs.

The existing forms of Social Enterprises (SEs) in Bulgaria for the moment are non-profit organizations which perform profit activities and use that profit for financing of the social mission of the organization. Another model of SEs organisation is a non-profit organisation which provides employment of people with disabilities or provides training services (for, example trainings for development of labour abilities). The third popular model of SEs is non-profit organisations engaged with social assistance. The fourth form of SEs that exists in Bulgaria and that has the longest history, although it is rarely considered a SE, is the cooperative.

#### **Austria**

In Austria there is an ongoing process of initiating the Law on Social Enterprises, which would encompass currently active Regulations of the Austrian Public Employment Service which is in close relationship with financing socio economic enterprises and regulations of the Ministry of Labour, Social Affairs and Consumer Protection of enterprises for integrating the permanently unemployed on the labour market. There are different types of organisations in Austria, each regulated by its own regulatory rules. What needs to be emphasized in Austria is the opportune and motivating tax system and legislation, according to which all enterprises, cooperatives and independent entrepreneurs that undertake their activities for common good, benefit from certain privileges (which is justified by the fact that these subjects undertake activities and accomplish goals which the country should undertake and realize anyway).

The legal forms of social welfare associations and/or non-profit organisations are usually based on the Association Act (Vereinsgesetz). This Act regulates the registration procedures, some tax exemptions and general rules on accountability, compulsory function and basic rules.

#### **Lithuania**

Lithuanian official definition rather stresses that social enterprises provide employment opportunities especially for the disabled and the long-term unemployed who produce goods and services according to commercial principles.

The official definition in Lithuania is, “an independent small or medium-sized enterprise [where] the employees classified as target groups account for at least 40% [of the workforce] and there are at least 4 such employees . . . ; [where] the enterprise is engaged in the development of employees’ working and social skills and social integration; [and] the enterprise’s income from activities [are] not eligible for support account for not more than 20%.”

Lithuanian social enterprises have already accumulated some experience. In the June 1, 2004 the Lithuanian Parliament, Seimas, adopted the Law on Social Enterprises developed by the Ministry of Social Support and Labour. The

purpose of the law coincides with the purpose stated in the NAP/inclusion, i.e. to employ persons who lost the professional and general working capacity, as well as persons, who are socially inactive and cannot equally compete in the labour market, encouraging their return to the labour market, their social integration and extenuating social disjuncture.

### **Portugal**

The Portuguese SE is legally present as: mutual, cooperatives, foundations, Particular Institutions for Social Solidarity (IPSS), charities, other non-profit association. The legal framework of SEs sector is inadequate, including pioneers companies of social economy, particular firms for social insertion. There are missing legal figures more appropriate.

The concept of SE is still relatively absent from the mainstream policy and scientific debate in Portugal. In the last few years, this debate has revolved almost around SE, namely, around the Social Employment Market (Mercado Social de Empleo), which aims at the work integration of disadvantaged persons. Most third sector organizations, to which SE belongs, have been traditionally oriented to the supply of social service, namely to children, elderly people and people with disabilities. This work out from the Portuguese system of social security which is based on a model in which responsibilities are shared between the State – through public bodies, including local authorities – and the non-governmental and non-profit sector.

### **Regulatory specifics**

#### **Bulgaria**

The lack of a specific legal regulation of Bulgarian SEs activity results in frequent problems with representatives of the state and local control authorities because they don't understand their organizational structure, there is no template for implementing such kind of activity and the control institutions doubt in corruption schemes or an attempt for personal profit.

The organizations that are mainly involved in community development and are the closest to the concept of social enterprises are NGOs with different profiles, social service providers, *chitalishtas* (public organizations that combine

different functions, for example, library, theater, school for dancing, music, foreign languages, various interest-based clubs, etc.) and cooperatives.

Social service providers owned by NGOs have seen the opportunities for labour therapy, production of goods by their clients, combined with the need for additional funds and are now looking at social entrepreneurship as a way to improve the financial and integration performance of their organizations.

Most of the SEs engaged in providing social services /frequently as state delegated services/ implement their social activities separately from the economic activity which is set up as a company. The most frequent form of company – SE is sole trader or Limited Liability Company. These two forms are easy to be established; they are the most commonly used and both types retain the responsibility for the economic risk to the social services provider (the organization that has established the SE).

The other type of SEs – providers of educational and training services, are established by foundations or associations registered as non-profit legal entities according to the Bulgarian Non-profit legal entities Law. After the amendments made in 2002 these entities have the right to develop an additional economic activity as part of their regular activity. This is possible in case that the precondition of the profit activity being related to the purposes of the NGO is fulfilled. Otherwise, the association is obliged to establish a company similarly to the above mentioned example.

#### **Austria**

As there are basically no restrictions or incentives to take a specific legal form, Austrian social enterprises may choose their legal form according to their requirements. Nevertheless, the following legal forms are commonly used by social enterprises in Austria:

- Associations
- Private limited liability companies (Ges.m.b.H.)
- Registered societies (Gesellschaft bürgerlichen Rechts)
- Co-operatives

In Austria there also exists the so called *gemeinnützige GmbH* with some tax alleviations, but so far, this form does not closely relate to the concept of a social enterprise and is very much focused on traditional non-profit organisations. However, recent trends in tax legislation seem to broaden several aspects of the *gGmbH*, and it seems that this form may once become a viable legal form for social enterprises in Austria.

Moreover Austrian social enterprises state as their biggest problem the “revolt” of other enterprises due to unequal competition. But the concern about economic/commercial goals is often disregarded due to finding solutions for employing the socially marginalized groups, and therefore understanding of such functioning can justify the “privileged” position on the market. Cost and competitive pressures, and certain management concepts hold the risk that distinctions could be made between different beneficiary groups. In the social economy the same service can give rise to different costs.

### **Lithuania**

Throughout Lithuania, social enterprises that (re-)integrate disadvantaged persons into the labour market or provide work places for people with special needs (disabled, long-term unemployed etc.) seem to be the type of social enterprise that receives most attention by policy makers. The measures under the activities of this type of social enterprises can be categorised as follows:

- income transfers in form of subsidised services targeted to the persons of low income or bad labour market position
- sheltered work in various forms
- subsidising work in the open labour market (subsidies allocated either to the disabled or to the employers)

Over a period of two and a half years, six business encouragement centres for disabled people have been established in the main cities of Lithuania. Specially trained consultants provide a range of services in these centres. The counselling service includes business planning, development of social enterprises, information on financial sources for business and advice on the physical adaptation of premises for people with disabilities. The centres also offer administration services and training courses, as

well as job-searching techniques and mediation regarding employing people with disabilities.

### **Portugal**

An important factor was, in 1998, the launch within the framework of the Social Employment Market (1996), namely, a specific scheme of Integration Companies (*Empresas de Inserção*). They may be promoted by different types of SE organisations: *Misericórdias* (charitable organizations closely related to the Catholic Church), mutual benefit, associations, private institutions of social solidarity (IPSS) and cooperatives, mainly from the social solidarity branch. They are practically the only form of organization in Portugal combining social and economic purposes. The Social Employment Market was launched by the Government in 1996, as being part of a set of measures aiming an active intervention towards the promotion of employment among socially disadvantaged or vulnerable groups (disabled people, long-term unemployed, drug addicts, young looking for a first job). This measure was included in a strategy for the eradication of poverty and social exclusion.

Work under this measure could be done in specific Centres (The Sheltered Employment Centers – *Centros de Emprego Protegido* or CEPs) or in a normal work environment (the so called Enclaves – small or large groups of people, developing their professional activity in special conditions but in a normal work environment).

Only 25% of the total number of jobs can be occupied by workers not covered by CEPs aims. Also it was launch a program on-the-job training in a probation regime foreseen for up 9 months, this training was accredited by the Institute of Employment and professional Training (IEFP).

### **Tax differences**

#### **Bulgaria**

There is statistical information on the figures of corporate tax paid by NGOs for doing businesses activities. This information can be used to indirectly understand the financial vitality of social business in Bulgaria. The tax on revenues in Bulgaria from 2005 onwards is 10%. The figures are the 10% paid by NGOs as a result of their income from business activities. This

means that for 2009 the total income of all NGOs in Bulgaria is 40 816 399 BGN (or 20 837 313 EUR), 10% tax of which is 4 816 399 BGN or approx 2 400 000 EUR.

In 2007 the income and tax paid by NGOs is considerably higher than any other year (increases almost 300 %). According to the experts in the Bulgarian Centre for not-for-profit law (BCNL), this might be a result of Bulgaria's accession to the EU when the corporate tax was reduced to 10% and many of the organisations have come out into the regular economy, paying all their taxes. In 2009 though there is a big decrease (figures are still higher than the years before 2007) in numbers which, according to the experts at BCNL, might be due to a few reasons:

1. Some of the business activity is transferred to a separate company (in the form of a social firm)
2. The economic crisis has hit the services sector and has decreased the income
3. Contracts with organisations from EU are more frequent – Bulgarian organisations issue documents valid in Europe but not valid in Bulgaria, which results in lower figures accounted for.

Looking at the history of cooperatives in detail, we can say that the long history of cooperatives in Bulgaria has resulted in full recognition of their importance on state level, leading to specialized legislation (Law of Cooperatives, 1996), and state support for the cooperatives.

1. The state regulated that cooperatives pay 30% less social insurances and tax, compared to regular companies.
2. Support from the state comes as preferential public procurement procedures for cooperatives (Art. 40 from the Public Procurements Act). Directors of co-operatives report that this public procurement regulation has great potential, but is practically inapplicable because of widespread disloyal competition/black market products on the part of competing companies.
3. Although there is legislation about the status of cooperative, it is considered inadequate and restrictive for their market activity, although this restriction is less rigid compared to other organizational forms of community enterprises.

SE Cooperatives have completely social character and support the prosperity, the interests and necessities of its members. Cooperatives may receive funds or incomes through different ways, most of them are even officially recognized by the law, according to Art.30 of the Cooperatives Act

Different sources of funding may be divided in two main groups which reflect the two main directions of its activity: incomes from membership, as the cooperative is a kind of association of people with a joint mission or interest, and incomes from trade or production activity, as it functions as an enterprise. The cooperative may have an economic activity as well as it has a property and it is able to operate with it – other profitable activity.

### **Austria**

According to the law the tax-privileged status of a public benefit organisation benefit is not fixed by the Feststellungsbescheid (official recognition of the body), but is decided in the “Besteuerungsverfahren” (taxation process), i.e. the taxation authorities review whether the organisation is really acting in a manner that qualifies for relief.

Benefits are:

- Reduced tax rate (e.g. for VAT, capital gains tax)
- Exception from corporate income tax
- No profits may be withdrawn (by owners), any profits must be either re-invested or used as reserves for the employees.

### **Lithuania**

In Lithuania, since 1 July 2006 the previous individual income tax rate of 33% was reduced to 27%, and since 1 January 2008 this rate was set to 24%. Proportional decrease of tax rate on wages decrease social cohesion and the chance to reduce social exclusion was missed. In 2005 in order to ensure funding of social programmes and measures reducing poverty and social exclusion, the Republic of Lithuania Law on Social Tax was adopted setting out the social tax rates of 4% (for 2006) and 3% (for 2007) for legal entities paying corporate income tax. From 1 January 2008 the social tax is no longer imposed on legal entities. Refusal of social tax on profit does not strengthen social inclusion. All together, the renouncement of social tax on

profit, the reduced personal income tax, and transfers from Social Insurance Fund to private pensions fund reduce Government's opportunity to finance social protection and social inclusion measures in the threshold of economic decline.

The Law of the Republic of Lithuania on Social Enterprises has provided better opportunities for setting up of social enterprises and creating financial incentives for employers setting up jobs for vulnerable people.

### Portugal

The Misericórdias decided to address a study because the period (seven years) of funding of the first Integration Companies was coming to an end. The study pretended to evaluate the outcomes and drawbacks of this measure. The report concluded that Integration Companies would be able to survive after the end of subsidized stage, but several reforms were point out, namely, a better definition of the fiscal and legal framework of Integration Companies, the opening of the possibility to create Integration Companies with a minimum of three workers (the minimum of five workers currently imposed by law was considered excessive), and a longer training period for the workers in integration process.

CEPs and Enclaves are juridically and economically autonomous but they are subject to the tutelage of the Ministry of Social security and Labour, namely in evaluation of the working conditions, fiscalisation and control of the initiatives as well as of the supports they receive and in the respect of the defined rules. Most Enclaves and CEPs have a high degree of financial autonomy, depending on state subsidies in an average about 30%, being the selling of products and services the main source of resources.

### CONCLUSIONS

To wind up, despite all difficulties, it is plausible to assume that there is potential and future for community enterprises (be it social firms, cooperatives or other forms of enterprise) to thrive. When the legal and tax issues have been solved, and when the states agrees on state policy for social enterprises, and when the NGOs actually become more business oriented, then we have a good basis for fast growth of social

enterprises. The reasons for this conclusion are as follows:

- High capacity of NGOs and human capital
- Evolving coordination of activities in the field
- Diversification of community social services
- Evolving experience of entrepreneurship
- Good European practice for truly sustainable social services
- EU funding available
- Some good examples of successful social businesses

There are many experienced organizations in the non-for-profit sector with years of practice and capacity. When the conditions are favourable, social entrepreneurship will be the next way for them to go, especially because it provides independence from the irregularity of sporadically and more and more bureaucratic projects and external donors, it thus provide long-term sustainability.

The diversification of community social services is another factor that influences more business ventures and more business opportunities for business development. Moreover, good European practices are fast in reaching non-for-profit organizations, setting an example of sustainable social businesses, inspiring people to venture into this new business model themselves. All this backed up by right legislation and state policy, plus EU funds and other income sources, starts to shape a better looking future for community firms in Europe and Bulgaria as well.

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