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## Legal Myth on Emergence of Social Enterprises in China

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### **Abstract**

Is social enterprise a new form of organization, differ from for-profit ones and not-for-profit ones? The article tries to answer this question. The social enterprises seem blur the boundary between for-profit and not-for-profit in the objects, while they don’t break though the distinction between for-profit organization and not-for-profit organization, and the rules applied respectively. However the social enterprises can enjoy some special treatment, not base on the form of organization, but on the social benefit of their mission. We should deal with social enterprises and pure business enterprises differently, and shouldn’t ask the later to offer what they needn’t.

### **Key words:**

Social Enterprises; Corporate Social Responsibility; Community Interest Company; the Triple Bottom Line

### **Part I . Introduction**

While “corporate social responsibility” is broadly concerned by the public, a new term “Social Enterprise” has been introduced and is gaining its popularity. There are quite a few incubators for social enterprises in practice, and some foundations have put

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social enterprises at their priority list of their grantee.<sup>1</sup> The term “Social Enterprise” is first used in a report of Organization for European Economic Co-operation,(OECC) in 1994, indicating the organization aiming to provide job opportunities for low-skilled workers and using both market and non-market resources. Nowadays, social enterprises are widely recognized as entities that pursue both economic and social goals.<sup>2</sup> In USA, the scholars use a broader definition of this term: for-profit companies that providing a social service, organizations that seeking both business achievement and social benefit, and Non-profit Organizations (NPOs) that doing commercial activities can all be included in the term of social enterprise; while most practitioner only use the term indicating the NPOs that gaining profit from their commercial activities, emphasizing the commercializing tendency of NPOs. The situation is somewhat different in European countries. There are opposing opinions upon whether social enterprises must take the legal form of NPO; and meanwhile, it is commonly acknowledged that social enterprises shall have both economic and social goals, pursuing surplus by providing goods and service and promoting social and environmental benefits.

The emergence of social enterprise definitely brings a new conception of business: the social entrepreneur are trying to use their management expertise to realize social goals, a perfect example is Muhammad Yunus who won Noble Peace Prize 2006 for his excellence effort in small amount loan to poverty population. A typical commercial entity has only one bottom line: profit seeking; and now a social enterprise has double bottom lines, or triple bottom lines as some people believed.<sup>3</sup> A social enterprise does seek profit via commercial activities, but financial growth is never its only bottom line. The second bottom line is to achieve social benefits; the forms vary

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<sup>1</sup> Such as China Social Entrepreneur Foundation, which founded in 2007, to declare that its purpose is to “takes the building of a harmonious society as its goal, and encourages groups of entrepreneurs to participate in philanthropic work and fulfill their social responsibility.....”

<sup>2</sup> According to the EMES (The Emergence of Social Enterprise in Europe Project) defining characteristics of the social enterprise “ideal type” include: 1. A continues activity producing goods and/or selling services; 2. A high degree of autonomy; 3. A significant level of economic risk; 4. A minimum amount of paid work; 5. An explicit aim to benefit the community; 6. An initiative launched by a group of citizen; 7. A decision-making power not based on capital ownership; 8. A participatory nature, which involves the persons affected by the activity; 9. Limited profit distribution. See Janelle A. Kerlin, “Social Enterprise in the United State and Europe: Understanding and learning from the Difference”, *Voluntas*, (2006) 17, p 249.

<sup>3</sup> Johanna Mair and Ernesro Nobro, “The Emergence of Social Enterprises and Their Place in the New Organizational Landscape”, Working Paper of IESE Business School, University of Navarra.

from training and employing the disabled and the long-term unemployed to directly providing community services. Some people also claim a third bottom line for social enterprises: environmental continuity and culture integration; however this could be incorporated into the content of the second bottom line. This is how we use the term “Double Bottom Line” or “Triple Bottom Line”. With the “Triple Bottom Line”, social entrepreneur is such a good approach that merging financial and social goals at the very inception of their social enterprises.

The emergence of social enterprises followed the Crisis of Welfare State. In the US, social enterprises are defined as NPOs that provide job opportunities to disadvantaged via commercial activities. In 1970, the NPOs suffered a lot from fund inadequacy, since the federal government has cut down grants in poverty relief, education, health care, community development, environment and arts. The NPOs was pushed to find new resource to cover the difference of government subsidy, and many of them have chosen to raise money from commercial activities. Thereafter, the word “social enterprise” has been broadened with new content, and today, it can be used on any entity that doing business for a public interest, not matter the entity is a NPO or for-profit corporation in legal form. The situation has been slightly different in Europe in 1970s-1990s. The slow-down of economy growth and raise of unemployed rate has brought numerous social problems that the government could hardly cope with. The new form of business rose to face some of the challenges, like population aging, unemployment and housing problems of the disabled and the long-term unemployed. Therefore, social enterprises were founded to cover the inadequacy of welfare policy of the state; since the inadequacy area differ among the countries, the most active area of social enterprises also vary in the continent.<sup>4</sup>

In Chinese legal contest, there is no term of “social enterprise”; however, it does not mean that China lacks the similar practice. Actually, China has a long practice of social enterprise if we look into the characteristics rather than title. The most typical

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<sup>4</sup> See Janelle A. Kerlin, “Social Enterprise in the United State and Europe: Understanding and learning from the Difference”, *Voluntas*, (2006) 17, p 248-250.

legal forms of social enterprise are “social welfare enterprises” and “civil non-enterprise units”. Social welfare enterprises focusing in providing job opportunities to the disabled has flourished once in China, but are now decreasing, while civil non-enterprise units has been greatly promoted in the past few year and are embracing its golden days. The <Provisional Regulation on Administration and Registration of Civil Non-enterprise Units> came into force in 1998, and by the end of 2006, there had been more than 160,000 units registered. In nature, the social welfare enterprises are for-profit enterprises with social goal, and civil non-enterprise units are NPOs doing business.

Hence, the legal myth arisen: the practice has laid out the following legal issues for the legal professionals to deal with: 1) Are social enterprises NPOs or for-profit organizations? If both legal NPOs and for-profit organizations can be social enterprises, does this mean that the distinction between NPO and for-profit ones has been break through? 2) How to regulate the establishment of social enterprises and what kind of tax policy shall be imposed? 3) What differences will the entrepreneurs face when they choose to start a social enterprise than a conventional commercial business? The first question focuses on the choice of legal form; the second is relevant to policy making; and the third is mainly about internal management. We shall try to answer these questions respectively in the following chapters.

## **Part II, Social Enterprises: Non-profit or For-profit?**

Modern society theory divides the society into three sectors: the politics, economy and society; and all the entities can be categorized into governmental organizations, for-profit organizations (i.e. conventional commercial companies) and non-profit organizations (i.e. foundations and “social organizations” in China) in respect to the three sectors, among which NPO is, as commonly believed, founded to regain social balance from Market Failure and Government Failure. Some scholars has pointed out that the emergence of social enterprises has blurred the boundaries among the three

sectors, especially between the non-profit sector and the for-profit sector.<sup>5</sup> Is this claim true? Answers might be different if we carefully look into the practice of different countries where social enterprises did not share the similar history.

The first thing we should be clear is that it is not right to disqualify a NPO just because it conduct commercial activities. The criteria of being a NPO should be: 1) the objective of the organization is neither distributing profit to investor nor enlarging itself, but to promote public interest or a common benefit at certain level; 2) the organization does not distribute its profit to members or investor, known as principle of “Inurement Ban”; 3) the property of the organization shall not, by any means, be privatized, even upon its termination, the property of the organization can not be dispatched to shareholder as a conventional company do, but shall be assigned to other NPOs with similar goals, public entities or the government.

The distinction between for-profits and non-profits is very essential for legal regulation. Establishing a for-profit organization will be deemed as an investment, non-profit organization a donation. The shareholder of a for-profit organization can claim his profit, which member of a non-profit organization could not. Non-profit organizations may enjoy preferential treatment in tax but have to be the obligor of information disclosure and accountability.

The connotation of the term “social enterprises” does not indicate whether it should take the form of for-profit organizations or non-profit organizations; no matter in which legal form, an entity with both social and financial goal can be defined as a social enterprise. However, an interesting thing is, in a certain country, whether the social enterprises should take the form of for-profit organizations or non-profit organizations are highly related to the country’s attitude toward non-profit organizations’ commercial activities. In countries where non-profit organizations are permitted to conduct commercial behaviors, the social enterprises could take the form

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<sup>5</sup> See Johanna Mair and Ernesto Nobro, “The emergence of Social Enterprises and Their Place in the New Organizational Landscape”.

of non-profit organizations; whereas in countries where such behaviors is prohibited, as in most of the European countries, the social enterprises can only take other forms rather than non-profit organizations, like cooperatives and corporation in Sweden and Spain. In Finland, there is no form limit for social enterprise, entrepreneur can choose corporation、 cooperatives、 nonprofit associations and even partnership. By April 30, 2006, there were 49 social enterprises registered in Finland; 26 of which take the form of corporation, 4 in associations, 1 in foundation, 3 in cooperatives, 15 in other forms like partnership, sole-shareholder company etc.<sup>6</sup> Italy also has a new piece of legislation enable social entrepreneurs to choose the form of corporation, nonprofit associations, foundation, and cooperatives for their proposing social enterprises. In UK, the newly-introduced “Community Interests Company” is another orthodox model of social enterprises, and this model was created to avoid the regulatory prohibitions which forbid charities to do commercial activities irrelevant to their objective. In China, both “social welfare enterprises” and “civil non-enterprise units” are social enterprises; the former is for-profit one, while the latter is not-for-profit.

**Table: social enterprise legislation in China compared to EMES criteria**

EMES criteria (www. Emes.net)	social welfare enterprises	civil non-enterprise units
Continuous production of goods and/or services	yes	yes
A high degree of autonomy	no	no
A significant level of economic risk	yes	yes
A minimum amount of paid work		no
A initiative launched by a group of citizens	no	yes
A decision-making power not based on capital ownership	no	yes

<sup>6</sup> See Pekka Pättiniemi, “Case Find: Development on Legal Framework for Social Enterprises in Finland”, Zagreb 28. 9. 2006.

A participatory nature, which involves the person affected by the activity	yes	yes
Limited distribution of profits	no	yes
An explicit aim to benefit the community	yes	yes

Social enterprise could, at a certain level, support the sustainable development of NPOs: when the conventional resources as government subsidy and public donation are cutting down, social enterprise would reduce the dependency of non-profit organizations on grants and donations.<sup>7</sup> On the other hand, the model of social enterprise enabled the entrepreneur to pursue the financial objective as well as the social goal. However, the distinction between non-profits and for-profits has justified the tax preference for NPO and disclosure responsibilities thereof, how shall these policy apply on social enterprises, which have both characteristics?

### **Part III. Regulation upon Social Enterprises**

#### 3.1 Conditions and Procedure of Establishment

Whether there should special procedure for establishment of a social enterprise depends on scope of the term. In US, social enterprises is used only for the NPOs doing commercial activities, therefore special regulation is not necessary; while insome other countries do apply special rules upon social enterprises establishment. For example, in UK, an enterprise shall obtain an approval from Department of Trade and Industry (DTI) to be a Community Interest Company; social enterprises in Finland shall register in their Ministry of Labor, and Italy also has similar requirements.

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<sup>7</sup> See Sid Gould, "Social Enterprise and Business Structures in Canada", Discussion Paper of Fraser Valley Center for Social Enterprise, February 2006. "...educing the dependency of non-profit organizations on grants and donations can increase self-sufficiency and the organization's own level of self-determination in meeting their mandates."

Certain conditions shall be fulfilled when a social enterprise being established. Although the rules vary from different jurisdiction, the core requirements are very alike: 1. the organization shall have a social objective; 2 the organization shall provide production or service to the market; 3. profit distribution limited or forbidden

Specific rule may apply in each jurisdiction. In Finland, *the Finish Act on Social Enterprises 2003* stipulates the following requirement besides special registration in Ministry of Labor: 1) the enterprise shall aim to provide job opportunities to the disabled and long-term unemployed; 2) the enterprise shall be a market-driven organization, providing production or service to the market; 3) at least 30% of the total employee shall be the disabled or long-term unemployed; 4) the enterprise shall pay all the employee the due salary set forth in the collective labor contract, no matter an individual is disabled or not. Italy passed a piece of legislation in 2006 stipulating the following requirements for social enterprises: 1) social enterprises shall be an organization under private law, natural person or organization controlled by single individual can not be social enterprise. 2) Social enterprises shall conduct enterprising behavior to provide production or services which help promote the public interest; according to art.2082 of Italian Civil Code such “enterprising behavior” shall be productive, professional, financial oriented and organized, which naturally exclude pure grant-giving organization, like a conventional foundation. The business scope shall be within the welfare, health care, education, culture and environment protection, or at least 30% of the total employee shall be the disabled or from the poverty population. 3) The objective of the social enterprises shall be public interest promotion rather than profit.

In UK, the <Community Interest Company Regulations 2005> did not create a new legal form of corporation distinguished from the existing ones. Social enterprises can be registered as companies limited by shares, companies limited by guarantee. Any enterprises can apply for a verification of “Community Interest Company”; after enterprises obtaining this verification, both the company laws and the <Community

Interest Company Regulations 2005> shall be applied. We should note that, a community interest company can not be a “charity” at the same time. If a charity wishes to transform itself to a community interest company, it would have to give up its figure as charity. “Public interest test” and “Asset Locked” are applied to all community interest companies, which guarantee the organization, as well as its property and surplus thereof, is devoted to the public interest promotion. A “public interest test” is to consider whether the objective of the company is for public interest from the prospective of a common reasonable individual. The test is rather loose and flexible comparing with the standards for charities. “Asset Locked” is to assure the capital invested in the companies is used for public interest purpose only, if been transferred, the assignee shall only be organizations which are also under the “Property Locking” regulation, like charities or other community interest companies. Normally a community interest company can not distribute dividend to its shareholders; however, dividends might be distributed in certain cases providing: 1) there is a maximum cap for dividend; 2) the shareholder is also an “Asset Locked” entity, like a charity.<sup>8</sup>

While in China, according to regulations, disabled employees in a “social welfare enterprise” shall be at least 25% of the total number and shall be no less than 10. After registered in State Administration for Industry & Commerce (SAIC) or its local branches as a normal enterprise, the entrepreneur shall submit an application for “social welfare certification” to Ministry of Civil Affairs (MCA) or its local branch. The enterprise will be recognized as “social welfare enterprise” after obtaining the certificate from MCA system.<sup>9</sup> “Civil non-enterprise units” is defined as organizations founded by enterprises, public institution, social organizations, other entities and individuals without state-owned capital. The “civil non-enterprise units” shall be registered in MCA system, and profits distribution is strictly prohibited.<sup>10</sup>

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<sup>8</sup> According to the *The Community Interest Company Regulations 2005*, asset locked body means a community interest company, charity or Scottish charity.

<sup>9</sup> See Regulation of Social Welfare Enterprises.

<sup>10</sup> See article 21 of Provisional Regulation for the Registration and Management of Civil Non-enterprise Institution.

Article 21: A civil non-enterprise institutions’ capital resources must be lawfully obtained; no institution or individual may seize, secretly divide or divert the popular non-enterprise work unit’s capital.

Civil non-enterprise institutions’ legal income must be used for activities stipulated by the charter of the unit.

### 3.2 Preferential treatment for social enterprises

Although social enterprises are not recognized as a new legal form of organization by the European countries, they do apply different rules. However, registration as social enterprises does not automatically bring special tax policy. In UK, community interest companies can not obtaining tax exemption merely by the registration, the tax policies only go with specific plans or projects. Take “Community Investment Tax Exemption” plan as an example, this plan will provide tax exemption to individuals or corporations who invested in community financial institutions; and these institutions would further loan the fund to community enterprises that could hardly do financing from the principle finance market. In Finland, social enterprises enjoy special treatment in many ways. When registration, social enterprises may apply public loans which common companies can not; registered social enterprises may apply simplified procedure when applying subsidies no matter whether relating their employees. For example, for certain subsidies, social enterprises shall apply once for 3 years, while common companies shall do that every 6 months or annually.

In US, there are no special establishing procedures for social enterprises; as stated above, US laws do not prohibit the NPOs to do commercial activities. We should note there is a distinction between “Related Business activities” and “Unrelated business activities” for NPOs. The former notion indicates the activities that closely related to objective of the NPO, as a gallery selling postcard and other stationery with paintings on, or an university selling textbooks; the latter notion indicates the loosely or non related activities, as museums running a coffee shop within for fund raising. According to Art 511-514 of Internal Revenue Code (IRC), unrelated income shall be subject to income tax. However, it will not affect the NPO’s figure as tax-exemption organizations. Therefore, the emergence of social enterprises in US has not blur the

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Contributions or donations to civil non-enterprise institutions must be used in compliance with the principles and areas of work laid down in the organization's charter, and in compliance with purposes, methods and timescale as agreed with donors. civil non-enterprise institutions must report to their professional leading unit on the receipt and use of contributions and donations, and must use appropriate means of publicising relevant information to society at large

border of for-profit organizations and non-profit organizations, neither has the regulatory rules changed. In China, both social welfare enterprises and civil non-enterprise units can enjoy tax benefits.

To sum up, the emergence of social enterprises did not create a new legal form of organizations. Based on the existing forms, no matter for-profits or non-profits, the conception of social enterprises enabled the recognition of the organizations that pursue both social and financial goals. Such recognition shall not affect the legal nature or form of the enterprises, yet shall bring certain preferential treatment including special tax policies.

#### **Part IV. Objective Restriction of Social Enterprises (semi finished )**

At very beginning of establishment, the entrepreneur shall be aware of the double bottom lines of their social enterprises: the financial goal and social benefit. This shall be explicit in the relevant legislation and the charter / articles of association of any social enterprises.

##### 4.1 Social enterprises as non-profit organizations.

If a social enterprise runs as an NPO, as the case in US or the civil non-enterprise units in China, the prohibition upon profit distribution shall be strictly applied. There shall be no shareholder for NPOs, but stakeholder, and the capacity of the organization shall be restrained by the charter / articles of association.

##### 4.2 Social enterprises as for-profit organizations.

“Corporate social responsibility” may have various interpretations. As widely accepted, a corporation shall not over-emphasize the interest of shareholders, and should also be responsible to other stakeholders in society, including employee, creditor, consumer, community residents and general public. The legal scholars could hardly achieve an agreement upon whether should we regulate corporate social

responsibility in legal system. In China, *Company Law 2005* sets forth the requirement of corporate social responsibility, yet never stops the debate. The new conception of “social enterprises” even adds spice to this non-stopping controversy, for these enterprises are just intended for both financial and social objectives.

Some scholars consider that over-emphasis of corporate social responsibility may shake foundation of market economy, and ignore the nature of the corporation form. A commercial enterprise is a profit-oriented organization, pursuing maximum interest for shareholders, yet the notion of corporate social responsibility requires the corporations to care about other stakeholders. This voice could be heard since the early “Berle—Dodd” debate and now the objection can be analyzed into 3 major reasons: 1) corporate social responsibility is against the nature of corporation; 2) the connotation of corporate social responsibility is not clear and could hardly be defined; 3) the responsibility has no obligor. On the other hand, the advocates for corporate social responsibility tried their best to justify this conception with a better definition, and insist that there should be a balance between social benefit and corporation’s financial objective. It is clear that this is a response for the serious social problem caused by enterprises’ profit maximizing behaviors.

The opposing voice of corporate social responsibility got its support from Friedman. He argued that there is one, and only one social responsibility for commercial enterprises to utilize all the possible resource to increase its profit within the scope of law, i.e. participating the fair, free competition without fraud and cheating.<sup>11</sup> And on the other hand, sustainable social innovation is the key issue to resolve social problems, which can’t be the goals of the commercial enterprises, but can be the social enterprises’.

#### 4.3 Social enterprises as for profit organizations can find the approach to clarify CSR

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<sup>11</sup> See Friedman, Milton, *Capitalism and Freedom*, University of Chicago, 1962, p.133.

## **Conclusion**

The emergence of social enterprise is in the ascendant. Different from the conventional commercial enterprises, social enterprises merge the financial and social goal into one. It is not a new form of corporation, yet recognition for all the organizations, whatever legal form they take, that are doing business, gaining profit and ploughing the money back to the society promotion. The legal feature of the organizations shall not be affected, but naturally they shall enjoy some preferential treatment including special tax policies.

The paper did not mean to criticize the voice and opinion of corporate social responsibility; the existing regulation has significantly prevented enterprises from seeking surplus without others' interest. The model of social enterprise shall be chosen at free will of entrepreneur; they may have some "pain": they have to hire a certain percentage of the disabled, and will have to do required disclosure; yet they would have obvious "gain": policy support for their commitment into public interest.

Hence, social enterprise is just a new option for business: to pursue a public interest via a path of professional business management. It does not strike the existing legal form of organizations; neither confused the border of the three sectors.