



# Success of Crowd-based Online Technology in Fundraising: An Institutional Perspective



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## ARTICLE INFO

### Article history:

Received 23 June 2013

Received in revised form 17 March 2015

Accepted 17 March 2015

Available online 11 April 2015

### Keyword:

Institutions

Crowd-based online technology

Crowdfunding

Legitimacy

Philanthropy

Thin trust

Trade associations

## ABSTRACT

The use of crowd-based online technology for raising funds is gaining popularity and credibility. This paper seeks to provide a better understanding of the effects of formal and informal institutions on the success of a crowdfunding project. It also analyzes how the effects of different types of institutions are likely to vary across the four different types of crowdfunding projects: (1) crowdlending, (2) crowdequity, (3) reward-based crowdfunding and (4) donation-based crowdfunding. A practical implication of this work is that the ease with which entrepreneurs and other types of fundraisers can raise money via crowdfunding platforms to fund a project depends upon the nature of formal and informal institutions in the economy. A theory of crowdfunding is proposed that explains these developing relationships.

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## 1. Introduction

The use of crowd-based online technology (CBOT) for raising funds from a large number of people is viewed as a disruptive innovation in entrepreneurial financing as well as other forms of fundraising activities. Crowdfunding (CF), the most popular fundraising application of CBOT, is considered to be a truly global movement with significant financial and economic benefits. Some compare CF investors with angel investors and suggest that CF would create 60 million new angel investors in the U.S. alone (Kitchens and Torrence, 2012). According to an estimate of the World Bank, the global CF market will reach US\$93 billion by 2025 (Swart, 2013). It also has a potential to bring significant changes in social practices and political processes. It is thus important and timely for regulators, investors, entrepreneurs and other stakeholders to observe this rapidly evolving phenomenon and share insights, reflections and observations with each other. It is also important for these stakeholders to recognize the forces that are shaping the CF phenomenon. This paper attempts to address both of these pragmatic needs.

Regarding global diffusion of CF, the CF platform (CFP), Grow VC claimed that its members were in over 190 countries, who funded more than 4000 startups by October 2012. As of 2013, there were about 1000 CFPs worldwide, which operated on every continent except Antarctica. As of 2013, entrepreneurs in at least 27 countries had used CFPs to raise debt or equity financing for businesses (Swart, 2013).

Despite all the hype surrounding the CF, however, in reality, it has been a U.S.-centric phenomenon or West-centric at best. For instance, as of August 2012, the U.S. had 191 CFPs, the U.K. had 44 and with the rest of the Europe having 100. Massolution's estimates suggested that in 2013, the U.S. accounted for 72% of the global CF industry estimated at US\$5.1 billion whereas the shares of Europe

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and the rest of the world were 26% and 2% respectively (Say, 2013). Likewise, in 2012, CF campaigns worldwide raised US\$2.7 billion: US\$1.6 billion in North America, US\$945 million in Europe and US\$110 million in the rest of the world (infoDev, 2013). These figures translate to per capita CF investment of about US\$3 in North America, US\$1.30 in Europe and US\$0.02 in the rest of the world.

Despite Asia's economic and technological leadership, CF has been slow to take off in the region. For instance, CF in Japan is in infancy. In 2013, per capita CF investment in Japan was about 15 times as high as in the U.K. (Table 1). In China and India, CF has met with a lukewarm response. In Vietnam, the first CFP was launched in March 2013. CF projects in these economies have encountered barriers related to institutional environments.

First, CF is a form of crowdsourcing. While crowdsourcing has been widely studied, and considerable interest has focused on its impacts on numerous sectors of the economy such as open source software (OSS) development (Stewart et al., 2006), healthcare (Howe, 2006) and labor markets (Horton and Chilton, 2010); and organizational functions such as marketing (Whitla, 2009) and business process outsourcing (La Vecchia and Cisternino, 2010), its use in fundraising activities is a relatively new phenomenon. This research gap is particularly striking in light of the fact that CF differs from other forms of crowdsourcing in an important way: it involves money. Prior research has suggested that people behave differently in situations involving money. For instance, in an experiment, Ellingsen and Johannesson (2009) found that about a third of the participants demanded no compensation for their investments of time, whereas almost all demanded compensation for equally costly monetary investments.

A related point is that while a rich body of literature has focused on the underlying economic aspects of the Internet's two-sided markets (e.g., e-auctions), such markets have been an under-researched area from the standpoint of fundraising activities, especially from an institutional perspective. Huber (1990) suggested that when new uses of a technology are developed and made available (e.g., through purposefully engineered modification) or when organizations make a better use of the capability of the technology, it is important to reassess and evaluate the effects of the technology.

Prior researchers have also found that while the online CFPs tend to eliminate most of the distance-related economic frictions such as monitoring progress, providing input, and gathering information, they do not eliminate social frictions (Agrawal et al., 2011). It is important to have clearly defined rules to encourage entrepreneurship and protect investors and enforce these rules firmly. Such conditions reduce the uncertainty that entrepreneurs and investors face in the CF environment. This demonstrates the effect of formal institutions such as laws and regulations and informal institutions such as social networks and interpersonal trust on the success of a

**Table 1**

The development of the CF industry and related institutions: a comparison of Japan and the U.K.

	Japan	U.K.
CF market size (2013)	US\$80 million (Warnock and Mochizuki, 2014).	US\$578 million (donation based: US\$496 million, equity-based: US\$45 million, reward-based: US\$33 million, debt-based: US\$4 million) (Alois, 2013b).
GDP per capita, nominal (current US\$) (worldbank.org., 2015a)	38,634	41,788
GDP per capita, PPP (current international \$) (worldbank.org., 2015b)	36,449	38,452
Per capita CF investment (US\$)	0.63	9.42
CF investment per US\$10,000 of GDP	0.16	2.25
Laws and regulations related to CF	May 2014: Japan passed legislation similar to the U.S. JOBS Act, which allows equity-based CF. When CF emerged, after the 2008 financial crisis, investors mainly engaged in donation-based or reward-based CF in small amounts through CFPs (Warnock & Mochizuki, 2014). Private companies can raise up to US\$1 million through a CFP. A person will be allowed to invest in equity CF up to US\$5000 (crowdvalley.com, 2014).	In 2014, the Financial Conduct Authority (FCA) introduced a "10 per cent" rule, which requires retail investors that are neither "sophisticated" nor "high net worth" to certify that they are not committing more than 10% of their net investable assets in equity-based CF (Sharman, 2014). The "prudential requirements" for loan-based CFPs: Firms will have to put in place a certain amount of "financial resources" to underpin their business depending on the total value of the loaned funds. Loan-based CFPs are not included under the statutory Financial Services Compensation Scheme (FSCS), which can pay compensation if a firm is unable, or likely to be unable, to pay claims against it (out-law.com, 2014).
Some key features of the CF market	Investors' skepticism about promised returns has been a barrier to attract investments (Warnock & Mochizuki, 2014). Many people are making CF investments in businesses in Northern Japan which were affected by the 2011 quake and tsunami. They do so to "sympathize with the companies and their efforts" rather than to make a profit (bloomberg.com, 2015, para 9).	Some fundraisers were found to provide misleading information when selling shares. Some also found to delete negative comments in forums (forbes.com, 2015).
Some well-known CFPs	Readyfor, Campfire, maneo.jp	Crowdcube.com, Seedrs.com, SyndicateRoom.com
The World Bank's ease of doing business ranking 2015 (out of 189 economies, lower number indicates a better rank)	29	8
WGI ranking (CAF, 2014)	90	7

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