# Why Crowdfund?

## Motivations for Kickstarter Funding

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## Abstract

This paper attempts to answer the question, "What makes entrepreneurs utilize crowdfunding?" To answer this question we analyze the level of Kickstarter funding per capita in each state as a function of various macroeconomic variables. We find that states with higher income, states with higher income inequality, states with a lower concentration of small firms, states with lower unemployment and high social media usage are more likely to have higher levels of Kickstarter funding. These results indicate that Kickstarter and other crowdfunding websites are utilized in more affluent and technologically savvy parts of the country, with high levels of business activity.

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# Introduction

With increasing popularity of social media and mass communication, there are new and innovative ways for businesses to get their start. One of these ways is crowdfunding, where people can post plans for projects on the Internet to be funded by the general public. Due to the newness of crowdfunding, not much has been written on the subject, even though it has been becoming increasingly popular over the past few years. Big-budget movies, video games and inventions are becoming a reality that otherwise would not have, thanks to crowdfunding. Notable successful projects include the Pebble Smartwatch[1], Zach Braff's film *Wish I Was Here*[2] and Tim Schaffer's adventure game, *Broken Age*[3]. Crowdfunding presents an interesting addition from an economic standpoint, as it enables a greater amount of funds to be used for business ventures.

Crowdfunding is not without controversy however. Some have criticizedlarge firms and celebraties for monopolizing crowdfunding sites and using their social capital to get funding. An article posted by Kickstarter claims that successful projects attract more funding overall to the site[4]. They cite a chart that shows how funding for all film-related projects on Kickstarter increased with the press associated with Zach Braff's film and the same occurred for funding of Video Game projects with Tim Schaffer's project. While this may be true, people still criticize large firms who go to Kickstarter for funding. Critics claim celebrity-led projects are exploiting their social capital, and crowding out funding for smaller projects. There have also been criticisms of projects that have been fully funded but have been unsuccessful, even though

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[1] Link to Pebble Watch Kickstarter Page: https://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android

[2] Link to *Wish I Was Here* Kickstarter Page: https://www.kickstarter.com/projects/1869987317/wish-i-was-here-1?ref=nav_search

[3] Link to *Double Fine Adventure* (Released as *Broken Age*) Kickstarter Page: https://www.kickstarter.com/projects/doublefine/double-fine-adventure?ref=nav_search

[4] Link to article on Blockbuster Effects: https://www.kickstarter.com/blog/blockbuster-effects

money was awarded to fund the project. Just recently, Peter Moleneyux, creator of the *Black and White* and the *Fable* series of video games, announced that production of his Kickstarter-funded game *Godus* was stopped[5]. What made people especially upset was that the Kickstarter page earned £520,000 British, £100,000 over the amount they requested, and they still signed with a publisher to seek more funding.

This paper asks which economic environment pushes inventors to go to crowdfunding to fund their projects. Do a lack of income, or little availability of funding from conventional sources push creators to search for funds though crowdfunding? Or is Kickstarter a tool for prosperous regions to propagate income growth further? This study will explore the impact of economic indicators on the amount of funding per capita on Kickstarter, by far the Internet's largest crowdfunding website, with the largest projects.

# Literature Review

## How Kickstarter Works

Kickstarter is mainly intended for creative projects: inventions, music, movies, games, and art projects. Other crowdfunding websites serve different purposes. Gofundme.com is mainly for fundraising, while Patreon.com is mainly for subscriptions to audio and video podcasts. Kickstarter is by far the largest and has the most data associated with it[6]. The way Kickstarter works is that a backer pledges any dollar amount (at least one dollar) to a project. To motivate people to contribute, entrepreneurs can offer rewards at various amounts, including a pre-order of the product, a thank you message on a message board or a spoon full of potato

[5] An interview with Peter Molyneux on Godus can be found here: http://www.rockpapershotgun.com/2015/02/13/peter-molyneux-interview-godus-reputation-kickstarter/
[6] Kickstarter had over $1 billion in funding for projects in 2014: http://www.forbes.com/sites/chancebarnett/2014/08/29/crowdfunding-sites-in-2014/

salad[7]. Entrepreneurs who put up their projects provide plans on their site of what they intend to make – including videos, pictures and text descriptions. Creators also must write in their plans about any potential risks they may anticipate. The entrepreneur sets a goal for the amount they want to raise, and deadline for the funding period. If they do not reach their goal by the deadline the entrepreneur receives nothing. If they receive more than the goal amount, they receive it all. Kickstarter then receives between 3 and 5 percent of all successfully-funded project funds. If the funding goal is reached, and the project is not completed, there is no feasible mechanism for money to be refunded, an aspect of crowdfunding that has received much criticism. [8]

## Economic Literature on Crowdfunding

Crowdfunding is seen in the literature as a new mechanism to raise venture capital. Lenders bear risk contingent upon the success of the project. Lenders are also never promised that their money will be returned, even if the project is successful. Backers gain utility from backing projects through "community benefits" (Belleflamme et al. 2013). These benefits include access to interactions with creators, and exclusive updates on the project through the project's Kickstarter page. If larger amounts of money are given, backers can be awarded exclusive items, like t-shirts, or signed copies of the final product. Because many backers each give so little money, they are more content with not receiving any of the profits. With larger contributions, however, investors are more likely to demand profit-sharing. Crowdfunding also bears a close resemblance to angel investing, although the market for angel investing is considerably smaller (Shane et al. 2008).

[7] Link to "Potato Salad" project: https://www.kickstarter.com/projects/324283889/potato-salad
[8] Spence, E. (2012, December 20). The 5% Fee That Makes Kickstarter Refunds A Tricky Proposition. Retrieved January 20, 2015, from http://www.forbes.com/sites/ewanspence/2012/12/20/the-5-fee-that-makes-kickstarter-refunds-a-tricky-proposition/

An article by Schwienbacher et al. (2010) identifies various reasons why businesses may go to crowdfunding to fund their projects. First is lack of pre-existing resources, such as the tools necessary to secure venture capital or loans. Some entrepreneurs may not have the social connections to gain venture capital, and venture and bank capital may be limited in less populated regions of the country. Venture capital is more desirable to entrepreneurs compared to debt as venture capital often comes with a support system. However, venture capitalists demand more control of the business and higher interest rates. An advantage of crowdfunding over venture capital is that no equity or legal control needs to be given to backers. By using the variables Bank Capital and Venture Capital, we will be able to explore the possibility that shortfalls in these alternative funding streams may spur the use of crowdfunding. One disadvantage of crowdfunding is that the production process of the product must be made public in order to keep backers content.

The amount of money requested by the entrepreneur is also an important factor in deciding whether or not to crowdfund. The stock market and venture capitalists require a minimum threshold that may be unrealistic for small businesses; most projects are often too small.

Ward et al. (2010) observe that entrepreneurs see value in the ability for the crowd to vote on projects with their dollars. Confirming market support by having potential customers donate to the project before it is produced is advantageous to entrepreneurs. Others also see the advantage of empowering the community to participate in the creation of a product (Mollick 2014). Instead of large firms controlling what does and does not get produced, more than ever consumers can now vote with their dollars on which projects they would like to see come to light (Ordanini et al. 2011). If a project is funded there is a greater certainty that the project will be a success

before the product goes to market. Tim Schaffer, head of Double Fine Studios – whose video game Broken Age was very successfully funded on the site stated, "Why should a company be able to choose what movies you watch, what music you listen to, what games you play? [With crowdfunding] you can choose" [9]. Products with niche markets are able to satisfy the demand for their products. In the case of Double Fine Adventure, there was demand for a point-and-click adventure game, but no publisher was willing to publish one due to their historic lack of commercial success. Crowdfunding allowed the market to fund the production of the product.

The literature also finds some additional peculiarities that entrepreneurs should keep in mind when turning to crowdfunding. Kuppuswamy et al. (2013) find that funding of projects creates momentum. Projects that reach 60% to 70% of their funding goal amount on Kickstarter have a disproportionately higher probability of being fully funded, in part because projects heading toward success are given more visibility and press. They also find that smaller projects are more successful in generating crowdfunding. The large-scale projects covered in the news are in fact crowdfunding outliers.

Belleflamme et al. 2013 find that while crowdfunding adds value through market research, there are still additional caveats to take into account. The entrepreneur needs to build a network of consumers who are willing to prepay for a product or service. Many successful projects are ones based on the existence of a ready market for their project.

Agrawal et al. 2011 finds that while distance-related restrictions to finding money are eliminated by crowdfunding, social connections now play a larger role. Word of mouth is an important aspect of crowdfunding success, as most money comes from local sources; therefore population density should also an important variable. Higher population means the population is more centralized, and people are more likely to interact. Entrepreneurs with more social capital,

[9] Link to video containing quote: http://www.doublefine.com/dfapay/

and who are close to sources of funding, e.g., other people with disposable income, are more likely to find greater success, celebrities such as Zach Braff and Tim Schaffer for example.

Critics of crowdfunding say celebrities can use their power and influence to promote their projects, which take potential funds away from other projects. In response to this, Kickstarter has posted data showing that popular projects often attract new members to the site who otherwise would not have known about it, thus attracting revenue to similar projects.

Berger et al. (1998) identify a key difference between small and large firms. Small firms have informational opacity, allowing their capital structure to remain hidden. Also, macroeconomic variables affect small businesses to a greater degree than larger businesses, as larger institutional lenders are less likely to invest in smaller institutions if the economic outlook is poor. Crowdfunding provides another source of capital for small businesses, opening opportunities for new and risky products to be created by them.

This paper will attempt to identify the underlying causes of entrepreneurs going to crowdfunding to finance their projects, and of the growth of crowdfunding. Is crowdfunding taking the place of other sources of funding, or is crowdfunding an additional source of funds for pre-established businesses? As stated above, crowdfunding allows products that consumers want to be produced without large corporations backing them. It creates a way for consumers to directly influence the production decision.

## Basis of Research and Design

The study and model being testing is based on a paper that used a similar test concerning small business start-ups (Bartik 1989). This paper looked at both supply and demand variables, such as tax rates, population characteristics, venture capital, labor costs, and public spending, and compared the variables to the success of start-up companies across the fifty states. The study

found that panel data produced more meaningful results, and that success for start-ups depends on entrepreneurial opportunities, where market demand is high relative to industry supply. Therefore this analysis will also use panel data for 50 states from 2010 – 2012. Random effects generalized least squares will be used, because the variation between states is more important than the variation over time. I have identified ten potential factors that may explain differences in funding in each state. Descriptions and sources for each variable can be found in Table 1.

## Variable Selection

Typically firms draw upon debt or equity to finance their business plans. Debt financing comes from banks, while equity finance comes from homes or venture capital. Therefore, bank capital and venture capital will be utilized to see how the availability and use of business funding will impact Kickstarter use. Does more bank capital or venture capital lead to more Kickstarter funding due to increased business activity, or does a lack of bank or venture capital motivate entrepreneurs to seek funding on Kickstarter?

Disposable income is also an important resource in starting a business. For Kickstarter projects, local disposable income may be available from friends and family to fund an entrepreneur's project. As stated in Agrawal et al. 2011, most early funding comes from the local area. Therefore areas with high disposable income should lead to increased funding of projects.

Another resource for financing businesses is government subsidies. Because many projects on Kickstarter are related to art, the most relevant variable available would be public funding of the arts. These financial variables represent potential sources of financing for new businesses, allowing the model to see how the relative presence or absence of each element affects Kickstarter funding.

Variables that indicate social structure were also included in the model. Inequality has been known to increase one's desire to achieve. The expectation is that greater inequality will drive people to seek Kickstarter funding. The study by Bartik (1989) did not include variables for inequality or unemployment. Hearthcote et al. (2010) found that inequality decreases the availability of financial assets. Not much research has been done on crowdfunding and inequality, but a greater amount of inequality could motivate more funding to be sought after.

Unemployment indicates a mismatch between the supply of and demand for labor. If the parameter estimate is positive, it could mean that the unemployed are seeking funding from Kickstarter as a means to gain income. If it is negative, then it will show that those with some employment and therefore economic resources, not the unemployed, are those who use Kickstarter. The U-4 unemployment was used in this study to include discouraged workers who may be looking to Kickstarter as a substitute for work.

Another variable that was included was Facebook usage. Forbes said one of the top priorities for a crowdfunding campaign is the promotion of the campaign and interaction with backers through social media[10]. Social media is one of the best ways to stay in contact with a large group. Therefore a variable was included to take into account the level of social media interaction in each state.

Finally, two variables were included to account for business size. This will reveal the sizes of firms who use Kickstarter. The proportion and the level of activity of small firms was included for this reason. Berger et al. (1998) identified that small businesses are less likely to be invested in during a macroeconomic downturn. Inclusion of these variables will allow the model to show if firm size affects crowdfunding.

[10] Forbes article on crowdfunding advice: http://www.forbes.com/sites/amadoudiallo/2014/01/24/crowdfunding-secrets-7-tips-for-kickstarter-success/

# Data and Methods

The main question we hope to answer is which economic environment creates the greatest demand for crowdfunding. As indicated in the previous section, with this data we will be able to draw inferences in regard to financial resources, firm size and social structure.

## Description of Data

The data for my dependent variable is a file that contains information about 34,000 Kickstarter projects located in the United States. The data given for each project are project name, category, state, status (funded or not funded), goal amount, amount pledged, date, number of backers, number of updates posted, number of comments posted, and number of campaign days. The data was retrieved from a study on the website Apps Blogger (Pi 2013). There are three years of data; therefore pooled cross-section time-series analysis was used over the three years (2010 – 2012).

To calculate the dependent variable, observations were separated by year and aggregated, giving funding within each state within a particular year. Data was available on all states in all years (2010 – 2012). Then aggregate funding per state was divided by the population of the state in order to control for state size. The data was then adjusted for inflation using the regional CPI provided by the Bureau of Labor Statistics. We will compare aggregate funding data per state to the state's financial resources, firm size and social structure. Data on each state's environment was taken from the Bureau of Economic Analysis, US Census Bureau, the Federal Reserve and other sources. The exact sources of each set of data are listed in **Table 1**.

### Method and Controls

First the data had to be controlled for population. Each dollar-denominated variable was divided by the total population of the state in order to control for the size of each state. Natural logarithms were also used on each dollar-denominated variable, so the parameter estimates will express percent changes in the variables. Next the data had to be adjusted for inflation, because three different years of data were used, and to control for differences in purchasing power between regions of the country. Each variable denominated in dollars was adjusted for inflation based on the Regional CPI provided by the Bureau of Labor Statistics (2010 - 2012). All dollar denominated variables are given in 2010 dollars.

To estimate the regression, random-effects generalized-least-squares regression was used. Panel data were used as in the study by Bartik et al. (1989). Also to control for heteroscedasticity, robust estimators were used.

## Results and Interpretation

### Full Model

With these ten explanatory variables, the multiple-regression model to be tested can be written as follows and full results for this regression are provided in **Table 2**:

$$\text{lnkickfund} = \beta_0 + \beta_1\text{lnDispInc} + \beta_2\text{lnVentK} + \beta_3\text{lnBankK} + \beta_4\text{lnArtFund} + \beta_5\text{PopDense} + \beta_6\text{Gini} + \beta_7\text{lnSmallPay} + \beta_8\text{SmallFirms} + \beta_9\text{U4} + \beta_{10}\text{Facebook} + \varepsilon$$

where I expect: $\beta_2, \beta_3, \beta_4 < 0$ and $\beta_1, \beta_5, \beta_6, \beta_7, \beta_8, \beta_9, \beta_{10} > 0$.

For a three-year random-effects model we find that, of our variables, venture capital, bank capital, art funding and population density are insignificant (see table 2). The insignificance of venture capital is puzzling, as research has shown that venture capital should behave similarly to Kickstarter funding. For bank capital, it is possible that the variable chosen is not a good proxy for what was trying to be measured – the strength of the banking system. For further research, including different countries in the study may yield more variation in the data, which will better illustrate a relationship.

(table 2 goes about here)

In addition, the variable for art funding could also suffer from being a bad proxy, as there are many projects on Kickstarter which are unrelated to art. Further research should include more sources of public funding, including scientific research and public education spending.

Population density was another insignificant variable. This could have been because population was something that was already controlled for in all the variables. All other variables were, however significant. The only real surprise is the sign of the unemployment rate, which will be discussed later in the paper. For the reasons above, we remove the variables venture capital, bank capital, art funding, and population density to get a simplified model.

## Simplified Model

For the simplified model, the insignificant variables were removed and the signs of the simplified model are still consistent with those of the Full Model (see results in **Table 2**). Going from the full to simplified model, the $R^2$ value does not decrease and the Wald statistic is still significant at the 1% level. These results do not support the hypothesis that Kickstarter is a way for small businesses that do not have the means to seek funds from conventional sources.

The model finds that areas with high levels of disposable income yield higher levels of funding per capita. In Argrawal et al. (2011), it was found that most early funding comes from friends and family, within a close geographic region. If a project is located in a high-income state, the project will have a greater pool of income to draw from. Our results are consistent with these findings.

Higher income inequality also appears to leads to more Kickstarter funding. A possible explanation could be that areas high in income tend to have greater income inequality, but the correlation between disposable income and Gini coefficients is only 27%. A few articles have pointed out that Kickstarter could potentially reduce gender inequality specifically, because it enables women to begin projects, and participate in providing funding (Marom et al. 2014). It was found that women lead 35% of projects on Kickstarter, and 44% of women are providing funding to projects.

Our results also find that states with high unemployment have lower levels of Kickstarter funding. People working at companies start a majority of largely successful projects. This tells us that Kickstarter is utilized more as a tool for businesses as opposed to a way for the unemployed to start a new business. It is possible that Kickstarter can be used by someone who works during the day and is transitioning into another career. However, many sources online say that a Kickstarter project can be a very large time commitment, and difficult to balance with full time work (although not impossible).[11] As for business size, states with more small firms receive less Kickstarter funding. This could potentially be because larger firms with more social capital are more likely to succeed with Kickstarter projects.

[11]An article from Forbes states, "The top tip is to remember that committing to Kickstarter means committing your life for the time leading up to and for the duration of the campaign. It ends up being a full-time job–a major time suck in the best possible way." (http://www.forbes.com/sites/work-in-progress/2014/08/06/catching-fire-on-kickstarter-eight-insider-tips-for-crowd-funding-success/2/)

Kickstarter is a new form of social media. Therefore it makes sense that states with higher Facebook usage are more likely to use Kickstarter successfully (another form of social media). Many studies have shown that a mastery of Web 2.0 (applications built to be used online like Facebook or Gmail) is necessary for Kickstarter success, and our results confirm these findings.

## Conclusion

All results point to Kickstarter not being a tool for those of lesser means, but more a tool for those with higher income to propagate ideas which others may not expect to be successful. As Tim Schaffer mentioned, Kickstarter is a place for projects to come into existence that would not have otherwise. However, many of these projects require substantial capital and are plagued with delays. Tim Schaffer's *Broken Age* had to be split in two parts, and the second part has not even been released yet. There are other examples of projects that were funded, but failed spectacularly, like Peter Molyneux's *Godus.* People are still making sense of crowdfunding, as it is a relatively new phenomenon. However, while projects can be unsuccessful, this is not something new in the finance world. Financial investors have also been disappointed by failed projects. Criticism for an investment not being able to deliver is part of the risk of investing.

Our findings show that crowdfunding is used more by higher-income states with greater amounts of business activity. This leads us to believe that Kickstarter is not a service for primarily small businesses, but more a way for pre-established businesses to gain capital for projects they could not otherwise receive. However, crowdfunding has led to the creation of viable business projects, including the Pebble watch, and countless films and games, which

would not have been created that, the public has been able to enjoy. As Tim Schaffer said, why should large firms and financers dictate what projects and inventions come to market?

## Suggestions for Future Research

An obvious extension would be to utilize more data. Because Crowdfunding is becoming increasingly popular, more and more projects are being added and funded each day. One of the main problems with this data is that there was so much year-to-year variation in levels of Kickstarter funding. As growth of total funding begins to mature, more reliable and clean data will be available.

If more reliable data were available on the strength and flexibility of each state's banking system, that would allow us to pinpoint more reliably if there is a relationship between a state's banking system and Kickstarter funding. Also, this study only looked at domestic data. Comparing levels of funding to variables in other countries will permit inclusion of more varied environments. Including developing nations will lead to more reliable predictions about the effects of crowdfunding on the extreme poor, which might alter our conclusions.

# Tables

**Table 1: Variable Definitions, Summary Statistics and Data Sources**

| Variable | Definition [Mean; Standard Deviation] | Source |
|---|---|---|
| **lnKick** | Dollar amount of funding per state per 1000 [4.21, 1.32] | Pi, J. (2013). |
| **lnDispInc** | Disposable Income per capita by state [10.49, .13] | US Census Bureau (2010-2012) |
| **lnVentureK** | Total Venture Capital per capita by state [2.66, 1.60] | Price Waterhouse Cooper Money Tree Report (2015) |
| **Gini** | State Gini Coefficients [0.61, 0.37] | US Census Bureau **(**2010-2012) |
| **BankK** | Total assets of all banks insured by FDIC by state in billions [10.06, 1.23] | US Census Bureau (2010-2012**)** |
| **lnArtFund** | Public funding of the arts by state [-.406, .841] | National Assembly of State Art Agencies (2011-2013) |
| **PopDense** | Population Density by State [196.26, 259.63] | US Census Bureau (2010-2012) |
| **lnSmallPay** | Payroll of small businesses (firms with less than 50 employees) [2.76, .21] | US Bureau of Labor Statistics (2011-2013) |
| **SmallFirms** | Percentage of total businesses with less than 50 employees, [.017, .0036] | US Bureau of Labor Statistics (2011-2013) |
| **U4** | Unemployment rate by state [8.69, 1.94] | US Bureau of Labor Statistics (2011-2013) |
| **Facebook** | Facebook users as a percentage of total population [.38, .068] | US Census Bureau (2010-2012) |

**Table 2 - Summary of Random Effects Generalized Least Squares Regression Predicting Kickstarter Funding Per Capita (N=150)**

| | FULL MODEL | | | SIMPLIFIED MODEL | | |
|---|---|---|---|---|---|---|
| **Variable** | **Coef.** | **SE Robust** | **Z** | **Coef.** | **SE Robust** | **Z** |
| **lnDispInc** | 5.021 | (2.12) | 2.37** | 5.579 | (2.49) | 2.24** |
| **lnVentK** | 0.037 | (0.09) | 0.40 | | | |
| **Gini** | 13.351 | (4.40) | 3.04*** | 16.852 | (4.48) | 3.76*** |
| **lnBankK** | -0.056 | (0.09) | -0.65 | | | |
| **lnArtFund** | -0.293 | (0.22) | -1.36 | | | |
| **PopDense** | -0.00035 | (0.00083) | -0.43 | | | |
| **lnSmallPay** | -1.821 | (1.35) | -1.35 | -2.577 | (1.36) | -1.9* |
| **SmallFirms** | -113.701 | (59.46) | -1.91* | -163.193 | (62.67) | -2.6*** |
| **U4** | -0.099 | (0.04) | -2.57*** | -0.117 | (0.04) | -3.24*** |
| **Facebook** | 6.374 | (1.98) | 3.21*** | 7.580 | (1.88) | 4.03*** |
| **Constant** | -50.835 | (20.03) | -2.54** | -56.631 | (23.40) | -2.42*** |
| **$R^2$** | **within** | | 0.38 | **within** | | 0.38 |
| | **between** | | 0.17 | **between** | | 0.13 |
| | **overall** | | 0.19 | **overall** | | 0.15 |
| **Wald** | **$Chi^2(10)$** | | 171.79*** | **$Chi^2(10)$** | | 118.31*** |

*Statistically significant at: 1% (***), 5% (**), 10%(*) levels*

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