

# **A comparative analysis of US and EU regulatory frameworks of crowdfunding for the cultural and creative industries**

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## *Abstract*

In the face of the dramatic shrinking of public and private funding, the arts, culture and creative industries are increasingly relying on crowdfunding (CCCF). Furthermore, crowdfunding is relevant for its informative, promotional, co-creative and democratizing features. Yet CCCF is still a fragmented and below-potential market. Main reasons for this untapped potential include a lack of transparency and trust affected by national regulatory frameworks. We first assess the series of benefits and barriers of CCCF, and we propose and estimate a simple model of startup firms raising capital, pointing to the importance of how CCCF is regulated. We then critically analyze and compare the regulatory frameworks that may enhance CCCF benefits and limit its barriers and risks in both the United States and the European Union. We finally suggest some policy recommendations and future research in this field.

*Keywords:* Funding for the arts and culture; Reward-based and donation-based crowdfunding; Comparative analysis of regulation policy; United States; European Union.

## **1 Introduction**

Since launching in 2009, the famous US platform Kickstarter has hosted over 450,000 projects that have raised in excess of \$4.7 billion (Kickstarter 2019). To put this in context, it only took a few years before arts projects on Kickstarter raised more funds annually than the US National Endowment for the Arts' entire appropriation (Franzen 2012). In the face of shrinking public and private funding in the cultural and creative sector globally, crowdfunding has recently emerged as a valid alternative or complementary mode of funding the arts and culture. In addition to reasons for public support of institutions advancing public-goods aspects of research and development, strong rationales for

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subsidizing the cultural and creative sector frequently find support in theory and in practice (Throsby 1994). Whether it is Baumol and Bowen's (1965) cost disease arguments or public-goods aspects of many cultural resources, powerful normative arguments support subsidizing the cultural and creative sector – and crowdfunded ventures are no exception.

Crowdfunding in the cultural and creative sector (CCCF) is mainly oriented toward the financing of projects, rather than structural finance. CCCF usually takes the form of donation or reward crowdfunding, where only in the latter case the backer expects a reward, either symbolic or in-kind (e.g., limited editions, tours, networking sessions, prototypes), more rarely monetary. Developed initially and especially in the USA, but also in the UK and continental Europe, CCCF represents a market in significant expansion and evolution. CCCF is becoming increasingly important to finance cultural and creative projects and ventures, tapping entrepreneurial potential (Lazzaro 2017). Furthermore, it favors community involvement, market research and audience development, the sharing of information and promotion, besides the development of professional skills (European Commission 2017). Arguably, CCCF's core advantages arise for its ability to lower the transaction costs for expanding market size or for fundraising to cover fixed cost of product development (which often has zero marginal production cost in creative sector). Yet, it is not free of barriers and risks.

If we look at CCCF markets, they look fragmented in terms of platforms' business models, geographical distribution/concentration, relevance of CCI sectors covered, available information, implied skills to operate and access the market, and, in particular, regulation, with distinct features of donation and reward crowdfunding compared to investment or equity- and lending-based crowdfunding. In such a rapidly evolving marketplace, it becomes then crucial to look at the two main areas interested by CCCF, namely the US and Europe, and to critically analyze and compare their respective regulatory frameworks. In this sense, the major contribution of this paper is to highlight current regulation aspects of CCCF from an economic perspective and through a comparative way of its two major markets, in order to offer policy recommendations to main stakeholders.

The plan of the paper goes as follows. We first analyze some fundamental features of CCCF and the associated benefits and barriers, and we propose and estimate a simple model of startup firms raising capital. The basic model keys on transaction costs and the size of the market relative to costs of launching a project – both factors that regulation can affect. This conceptual description of the emerging CCCF market points to the importance of how it is regulated (Section 2). We then turn to an assessment of the regulatory frameworks that may enhance CCCF benefits and limit CCCF barriers and risks in both the United States (Section 3) and the European Union and its member states (Section 4). The review of the literature and industry reports for the US and the EU highlights different priorities and approaches. In general, “the success of local platforms largely depends on the characteristics of the national market and competition from international platforms” (Torkanovskiy 2016, 115). Although CCCF regulation is fairly limited in the United States, regulatory systems in the European Union that have been described as “heavily limit[ing] mechanisms to promote offers and campaigns to a wide range of potential investors... [and] hinder[ing] the emergence of an ecosystem with platforms that can offer the infrastructure for internet-based campaigns” (Hooghiemstra and de Buysere 2016, 135). We finally provide a critical comparison of these regulatory frameworks in Section 5. This

comparative lens leads to policy recommendations and suggestions for future research.

## **2 Benefits and barriers to CCCF expansion**

### ***2.1 Benefits***

The rapid emergence of donation and reward crowdfunding, especially for cultural and creative projects and ventures, points to many benefits and barriers. Appreciating those benefits and barriers is central to regulating crowdfunding's operations and growth (Lazzaro and Noonan 2019). At its core, crowdfunding's key distinctive innovation owes to its dramatically lower transaction costs for fundraising associated with its online platform and associated technologies. By lowering the transaction costs, the creator can now market her project to a much larger audience ('the crowd') at far lower costs for communication and payment and, in many cases, delivery of goods and services.

The growth in crowdfunding as a preferred fundraising technology comes as some creators are better able to reach their market. The lower transaction costs can affect the intensive margins by lowering fundraising costs among existing contributors, which helps the viability of previously marginal projects as well as giving creators better 'market research' data from crowdfunding campaigns' performances. Perhaps most dramatically, crowdfunding's reduced transaction costs affect the extensive margin, enabling some artists and creators the opportunity to market their projects where previously they lacked a sufficient audience or identifiable market. Along the extensive margin, crowdfunding has launched new artists' careers, made costly hobbies and professional projects more affordable, and financed innovative experiments that might never have seen the light of day by, essentially, drawing in a larger market to help fund the venture. As lower transaction costs have expanded the size of the crowd, more interested contributors can be identified and previously unviable ('niche') projects can receive a "green light".

The advantages of the crowdfunding platform and approach have been touted at length elsewhere. Broader geographic distribution of financing for entrepreneurial projects often leads the list of crowdfunding's benefits (Sorenson et al. 2016). How crowdfunding platforms fit with a "world is flat" perspective on the global economy continues to receive scholarly attention (e.g. Agrawal et al. 2015, Fleming and Sorenson 2016, Mendes-Da-Silva et al. 2016, Giudici et al. 2018), with a preliminary conclusion that new venture financing is far less geographically concentrated under crowdfunding (Yu et al. 2017). Yet location continues to matter a great deal, especially at the extensive margin, as crowdfunding has enabled more geographic spread of projects as ventures in smaller markets become viable. This geographic 'flattening' effect reaches not just where projects are located, but also where the creators and the backers need to locate – as increasingly the producers and consumers need not collocate (Breznitz and Noonan 2020).

Other major benefits related to crowdfunding's lower transaction costs include improved information in these online fundraising markets. Project creators can better convey the qualities of their ideas, products, services, etc. in a rich, multimedia environment. Prospective buyers, for instance, can sample some of the new songs before deciding to commit, rather than taking a gamble on dropping money in a hat. Crowdfunding research routinely shows that projects with better information describing

their venture are more likely to reach their fundraising goals (Mollick 2014, Courtney et al. 2017). Allowing creators to share more information can reduce uncertainty in the market, but does little to address information asymmetries. Yet these crowdfunding ecosystems take cues from other online sales platforms to create and maintain information about creator reputation. In some cases, they also foster more interaction between the creator and prospective backers, allowing for even richer exchanges of information.

Lastly, allowing creators to collect better market research data through a crowdfunding campaign can yield great value to creators, including enhancing their odds of later receiving more traditional venture capital (Butticè and Noonan 2016, Xu 2017). In essence, testing prototypes in a crowdfunding marketplace with real stakes (money) marks a substantial improvement in market research over running focus groups and expert opinion.

Indirect benefits of crowdfunding also warrant attention, as these often grab the limelight. Advocates often point to crowdfunding's ability to "democratize funding" (Mollick and Robb 2016) and "levelling the playing field" (De Buysere et al. 2012, Bruton et al. 2015, Breznitz and Noonan 2020). In a sense, these refer to the promise of crowdfunding to expand the margins of viable projects and allow new entrants. Insofar as there are severe barriers to entry for funding – for venture capital, for government funding, for charitable donations, etc. – then crowdfunding may indeed offer a platform that bypasses those monopolized funding markets. In this sense, crowdfunding closely resembles other platform-based disruptive markets, such as ridesharing and AirBnB, whose benefits partly derive from overcoming barriers to entry. It even helps reduce barriers to entry into more conventional financing. A correlation exists between "Kickstarter projects in a region" and "increased angel investing activity, even after instrumenting with projects that should not be of interest to investors" (Yu et al. 2017).

Bringing creators more directly in contact with their audience or crowd may generate positive spillovers beyond improved market research. It might improve experiences for backers, give stakeholders more influence over production, and even identify more 'wisdom of the masses' (Mollick and Nanda 2015). Diversifying the pool of funders, and thus diversifying the projects that ultimately receive funding, may hold some of the largest benefits from a broader, social perspective. Fears of "mob rule" and "tyranny of the majority" aside, crowdfunding as a mechanism to mitigate elitism in new cultural and creative ventures may yet hold benefits for society. Each of these indirect benefits, however, greatly depends on barriers that crowdfunding faces, which may disenfranchise certain groups from participating in crowdfunding.

## ***2.2 Barriers***

Despite the rapid rise of CCCF, it faces significant barriers and poses some serious risks. The most immediate issue, mentioned above, concerns information asymmetry and the lack of transparency. Although information asymmetry in fundraising is not exclusive to crowdfunding, merely shifting the marketplace to an online forum hardly resolves the matter. Adverse selection, whereby good projects would fail because observably identical bad projects are the only projects that sustain on the crowdfunding platform, remains a concern in theory at least. Although the growth of crowdfunding platforms suggests that either this concern is overstated or that there are many 'lemons' (Akerlof 1970) waiting for

the crowdfunding opportunity, the fundamental challenge of better enabling transparency remains. Again, this is true for all fundraising campaigns for new ventures.

Perhaps a bigger concern for crowdfunding is the moral hazard problem (Strausz 2017), or the possibility that creators fail to adequately deliver to their backers. Once funded, projects may face suboptimal pressure to deliver on their promises. Though reputational effects may be severe, one-off creators who simply scam the market before disappearing into anonymity pose a threat. Subtler, and potentially more threatening, are the biases that crowdfunding might support. Although it might promise to ‘democratize’ funding, its theoretical promise might be replaced by a reality of discrimination (Rhue and Clark 2016, Youkin and Kuppuswamy 2017) and other biases (Greenberg and Mollick 2017, Johnson et al. 2018).

Agrawal et al. (2014) find that crowdfunding is not geographically constrained and tends to support ‘market-for-superstar’-style distributions with fundraising highly skewed to a few creators. Crowdfunding capital may substitute for other traditional sources of financing, although this research continues to evolve (see, e.g., Roma et al. 2017, Yu et al. 2017). In addition, Agrawal et al. (2014) observe a prominent role of friends and family in early stages of fundraising. Clearly social networks matter, especially for certain types of more local projects than for wide-reaching digital projects (Breznitz and Noonan 2020). Crowdfunding platforms play a key role in reaching contributors – whether they are members of a local community making a donation to cover fixed costs or they are consumers effectively using crowdfunding as a presale platform.

### ***2.3 A simple model of crowdfunding platforms and minimum efficient scale***

Consider a simple model of startup firms that face fixed costs (FC) associated with raising capital to develop and market their product. In some small markets, relative to the fixed startup costs, the demand does not support production by even one firm. This situation can be seen in panel A of Figure 1, where local demand cannot reach even the minimum efficient scale. The advent of crowdfunding can be seen to reduce the fixed costs associated with raising capital. Lowering the transaction costs of fundraising shifts the average cost (AC) curve downward to AC'. This draws new firms to enter this market using the crowdfunding platform. With traditional venture capital (and finance for arts and cultural projects) concentrating geographically, technologies that reduce fundraising costs may have uneven effects across different markets. If the FC associated with fundraising is negatively correlated with local market size or density, then crowdfunding technologies may lead to disproportionately more entry in smaller markets than in larger one. These smaller markets might be for local goods and services in less populous communities (e.g. small-town theaters, local festivals) or for niche goods for rare tastes (e.g. highly specialized film or music genres).

An alternative conception of crowdfunding platforms models them as essentially online pre-sale markets, reducing transaction costs for reaching a broader market rather than reducing transaction costs for capital fundraising. This alternative model is illustrated in Panel B of Figure 1. Here, the cost curve is unchanged and the demand curve shifts outward to D' as the online platform allows the firm to reach more consumers.

[Figure 1 here]

The difference between the two models stems from different models of crowdfunding. Equity-based models, where backers are investors rather than consumers, correspond more to Panel A and a crowdfunding technology that reduces transaction costs in fundraising. Reward-based models, where the backers are consumers making advance purchases, correspond more to Panel B and a crowdfunding technology that expands the size of the market. Both approaches show how crowdfunding can reduce the *relative* minimum efficient scale (MES) in these markets to enable new entry. As crowdfunding lowers the transaction costs of reaching the crowd of investors or of consumers, these crowds enable new producers to succeed in new markets. The lower MES may disproportionately favor entry in small markets, as demand in larger markets may already exceed MES.

The relationship between crowdfunding platforms and MES points to the technology’s potential to spur entrepreneurship in the creative and cultural sector, especially in smaller markets. If the fixed costs of new entry are largely the same for a given project, regardless of the size of the market, then crowdfunding’s role in reducing costs and thus MES should mean it has bigger impacts in smaller markets. This can be seen in the results from Breznitz and Noonan (2020), who show that non-digital crowdfunding projects tend to disperse into smaller markets, rather than concentrate in larger cities. Data from one of the world’s largest reward-based crowdfunding platforms, Kickstarter, can illustrate the empirical relationship between domestic market size and crowdfunding activity. This US-based platform holds a dominant position in the US, and it also attracts many projects from around the world.<sup>1</sup> Creators who use Kickstarter can tap into a larger ‘crowd’ of backers and buyers. Although it is just one platform, and a country’s Kickstarter activity may not be proportionate<sup>2</sup> to its total crowdfunding activity, we hypothesize that this tool to expand crowd size will disproportionately impact smaller domestic markets. To test this, we use data from Kickstarter.com, with descriptive statistics in Table 1.<sup>3</sup>

[Table 1 here]

For 162 non-US countries, we estimate an OLS regression of the (logged) total funds raised via Kickstarter per capita on wealth (logged GDP per capita), (logged) population, and indicators for OECD countries and whether a majority of its population is English-speaking. The results robustly show very strong relationships with wealth and population:

$$FUNDRAISED_{pc} = 3.63 + 0.50 GDP_{pc} - 0.35 POP + 1.89 OECD + 0.92 ENGLISH$$

The regression explains much of the variation in fundraising ( $R^2 = 0.64$ ), and the

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<sup>1</sup> Recent Kickstarter data (obtained from webscraping via <https://webrobots.io/kickstarter-datasets> and accessed on 24 April 2020) indicate that the share of non-US projects on the platform has grown from 0% to 44% over the past nine years.

<sup>2</sup> The extent to which domestic platforms are dominant and substitute or, instead, complement (multihoming) to Kickstarter can differ systematically from country to country, and how its net effect covaries with domestic market size is theoretically ambiguous.

<sup>3</sup> Kickstarter data are obtained from the CrowdBerkeley dataset in 2017 and include all funds raised on that platform, by country, through 2016. All values are measured as 2016 USD.

strong, positive roles of wealth, OECD membership, and English language are as expected. The inelastic relationship between population and fundraising, with the coefficient for population less than unity ( $\beta = -0.35$ , robust standard error = 0.06), reveals that – although total Kickstarter activity grows with population – the Kickstarter funds raised per capita is greater in less populous countries.<sup>4</sup> Smaller domestic markets are able to take more advantage of the crowdfunding platform. This is to be expected if platforms like Kickstarter help new entrants reach larger crowds that might not have been available in their domestic or regional market. The practice of multihoming, where entrepreneurs can use a global platform like Kickstarter concurrently with their domestic platform, would amplify the effect of crowdfunding in encouraging new, previously unprofitable ventures in smaller markets. Historical limitations on use of platforms based on nationality and substantial learning costs to launch projects on new additional, different platforms act as barriers to crowdfunding. Removing trade barriers and expanding markets can also complement crowdfunding’s technological advances in reducing the MES.

## **2.4 Regulation**

Ultimately, crowdfunding’s ability to achieve its potentials and overcome its barriers depends directly on how it is regulated. As an emerging marketplace, the regulatory framework for raising funds through the crowdfunding platforms is reactionary and still evolving. Lacking a regulatory system in place at the outset, the crowdfunding approach enjoyed some rapid growth without (legal) barriers and associated compliance fixed costs (Calcagno and Sobel 2014). But unregulated growth can pose some risks, especially if participants in the crowdfunding marketplace are victims of fraud, predation or bias, or if inherent risks on the platform deters optimal investments.

The absence of clear standards and stable regulation in these markets can dissuade creators and backers from participating, and it can lead to distortions in the marketplace as some projects, or even some platforms, are favored through market design, taxation, or technological limitations. This may be especially true in Europe, where variation in national regulatory frameworks limit growth of what is essentially a global marketplace. The lack of harmonization between national systems stands as a major barrier. Compounding this lack of harmonization in regulatory systems are important differences in fiscal regimes, financial incentives, payment systems, intellectual property rights, data protection, professional standards, languages, and more. Crossing borders or switching among crowdfunding platforms can require significant adjustment costs. Market fragmentation in crowdfunding, especially in a post-Brexit world, remains a serious barrier to its continued expansion.

## **3 CCCF regulatory framework in the USA**

The fiscal regulatory framework governing CCCF ventures within the United States is still emerging. Though more limited than the European legal and regulatory framework(s) for

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<sup>4</sup> We also estimate this regression model with (raw) per-capita funds raised as the dependent variable. The results ( $FUNDSRAISED_{pc} = 0.41 + 0.03 GDP_{pc} - 0.02 POP + 0.45 OECD + 0.24 ENGLISH$ ) indicate a very similar story: per-capita funds raised in Kickstarter are greater in smaller domestic markets.

maintenance of crowdfunding, the existing laws and regulatory climate in the US provide opportunities and challenges for regulators and those engaging in CCCF. Prior reviews of crowdfunding regulation explicitly focus solely on laws such as the JOBS Act of 2013 that only apply to equity-based crowdfunding. In short, the JOBS Act exempted crowdfunding from federal securities laws to allow small businesses to raise capital from a variety of sources that included using crowdfunding to sell securities to the general public (Securities and Exchange Commission 2018). Over \$1.5 billion has since been raised through these mechanisms (Barnett 2016). Although the law does not apply to reward or donation crowdfunding, it has inspired a number of state-specific exemptions to increase local investment in small business both related to and separate from the arts. Unlike equity-based crowdfunding and its strict oversight by the Securities and Exchange Commission and the Financial Industry Regulatory Authority, the attention paid to regulation of US CCCF is more diffuse and indirect.

US federal and state laws do touch on crowdfunding in a limited way. Federal law governing crowdfunding is contained within the Code of Federal Regulations, specifically within Title 17, Chapter 2, Part 227. This federal code provides guidelines and requirements for issuers, intermediaries and funding portals of financial securities.<sup>5</sup> Several other miscellaneous provisions in this section of the CFR are tied to the Securities Act (1933) and to regulating of equity-based crowdfunding. State laws regarding crowdfunding, on the other hand, generally aim to encourage local investment. Thus, they tend to include more provisions related to reward-based crowdfunding. The crowdfunding laws of most states have only been written on or after 2014 as a direct response to federal passage of the JOBS Act and the increasing importance of online commerce. States such as California, New York and Ohio have no intrastate crowdfunding exemption on the books for equity-based crowdfunding, although 36 currently do (Zeoli 2017). States vary in policy areas such as the maximum income that can be received from equity-based crowdfunding ventures and the necessary ratio of investors pledging money from within the state itself. Explicit references to reward or donation crowdfunding by state agencies are rare. The Indiana Secretary of State makes passing reference to encouraging investment in local artists within the context of small business,<sup>6</sup> the California Attorney General offers advice for those who may have been victims of an RC scam,<sup>7</sup> and Washington state offers guidance for how crowdfunding donations should be considered for taxation purposes.<sup>8</sup> Relevant state codes apply exclusively to equity-based crowdfunding ventures. State-level regulation of crowdfunding only applies to ventures resulting in small businesses using equity-based crowdfunding; and reward or donation crowdfunding campaigns garner no special regulation.

Taxation of CCCF remains an unclear and evolving situation in the US. Government regulation and taxation of the crowdfunding platforms themselves depends on the company statute. For example, Kickstarter is a public-benefit corporation (which mixes tenets of profit maximization with concern for public benefit), while alternatives such as GoFundMe are for-profit companies. Although the tax treatment of these companies is straightforward, how to tax the crowdfunding ventures themselves – the creators, vendors,

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<sup>5</sup> 17 C.F.R. § 227.100-503.

<sup>6</sup> “Indiana Securities Division”. (2018). Accessed August 28. <https://www.in.gov/sos/securities/4114.htm>

<sup>7</sup> “Online Crowdfunding”. *ibid.*

<sup>8</sup> “Crowdfunding” *ibid.*



and investors – remains more complex. Generally, income accrued by artists and content creators on crowdfunding platforms is treated as taxable income by federal law (Metrejean and McKay 2015).

Though seemingly straightforward, some questions remain over what sorts of expenses are deductible and how (if at all) the Gift Exclusion under Section 102(a) of the federal tax code can be utilized in relation to crowdfunding ventures. The former issue depends on whether the venture is deemed a business or a hobby. As Metrejean and McKay (2015) note, “If the activity is deemed a trade or business, all otherwise allowable trade or business expenses should be deductible against the income (Sec. 62). If, however, the activity is deemed to be a hobby, only expenses to the extent of the income will be deductible (Sec. 183). Additionally, vendors and artists using Kickstarter and related platforms have an incentive to attempt to classify the proceeds raised from their reward-based crowdfunding venture as non-taxable gifts instead of traditional income. This exemption was intended for smaller transactions between family and friends, which certainly apply in many reward-based crowdfunding ventures. Yet some creators may attempt to classify donations made by strangers for an artistic venture as gift-giving. US tax law is somewhat vague in this regard, especially as content creators reconcile the general lack of deference shown to the definition of “gifts” in American courts, with Kickstarter itself urging users to attempt to utilize the gift loophole (Dietz 2014). Such exemptions would likely apply for the typical smaller project: research has indicated that the majority of backers of most artistic crowdfunding ventures are close family and friends (English 2013, Borst et al. 2018). Regardless, income accrued from crowdfunding ventures is generally treated as taxable income gained as the result of a business transaction at the federal level and, presumably, at the state level as well (no guidance appears to be provided in this regard). When declaring income from crowdfunding ventures, no clear consensus exists for the timing of reporting. There is no guidance given at the federal level. Although Washington state requires the income to be reported when the project is fully funded, other states could be more aggressive and treat contributions as similar to sales – thus requiring the income to be reported at the time of contribution (and allowing for a later credit if the funding ultimately does not vest (Gruba et al. 2015).

A related taxation issue involves how crowdfunding platforms apply sales tax. Given the significant competitive advantage for online marketplaces derived from their avoiding sales tax (Goolsbee 2000), treating reward-based crowdfunding pledges as essentially taxable pre-sales could affect the attractiveness of these platforms. Broadly, how sales tax applies to donations made to crowdfunding ventures with expectation of rewards primarily depends on the type of reward being offered. Selling tangible personal property, electronically delivered digital products, or certain services is subject to traditional retail sales tax, and crowdfunding platforms might seem to offer no exemption. Other rewards (e.g., listing backers’ names online), however, may not qualify for retail tax and thus be considered donations (Gruba et al. 2015). Moreover, inter-state shipping of rewards complicates the calculation of sales tax. The legal landscape for taxing interstate online retail sales continues to evolve, and states offer no explicit crowdfunding-specific guidance.

Other regulatory concerns about crowdfunding platforms focus on issues of intellectual property (IP), patent law, and intentional acts of fraud perpetrated via crowdfunding platforms. Sharing early-stage ideas without proper protection of original

ideas raises the risk of copyright infringement and other IP protection issues. Roberts and Nowotarski (2013) observe that the nature of “crowdfunding compounds the general difficulties faced with any product launch in a crowded IP landscape with unprecedented exposure of projects at the very earliest stages.”

Fraud in reward-based crowdfunding captures considerable public attention in the United States. This includes acts of fraud (intentional or otherwise) and failing to deliver the rewards or perks promised by the crowdfunding project. According to Mollick (2015), only around 9% of projects fail to deliver promised rewards, with most of those failures being from smaller projects and no noticeable links between failure rates and demographics such as education, gender and family status. Limited options exist for jilted investors to ensure reception of deliverables or a refund of their donation. Crowdfunding platforms generally refuse to refund money directly to investors when projects fail. Kickstarter maintains that while creators are required to “fulfill all rewards of their project or refund any backer whose reward they do not or cannot fulfill” (Strickler et al. 2012), the platform itself is not responsible for funds changing hands at any point in the transaction process. To Kickstarter, “The fact that Kickstarter allows creators to take risks and attempt to create something ambitious [despite not being guaranteed] is a feature, not a bug” (Strickler et al. 2012). Though frustrated backers of larger fundraising efforts occasionally undertake legal action (Gunatra 2016), such cases are rare. The lack of case law may be due to the high legal costs relative to the small donation amounts typically made to artists and vendors (Moores 2015). The office of the California Attorney General does offer a brief guide to help potential investors avoid fraudulent reward-based crowdfunding ventures through practical steps, such as researching creators and crowdfunding platforms, doing reverse Google image searches, asking direct questions and more, as well as providing contact information to both common crowdfunding platforms and watchdog agencies such as the FTC and Better Business Bureau.<sup>9</sup> Regulatory frameworks for rewards-based crowdfunding in the US do not oversee the platforms themselves, but they do include general regulatory mechanisms for fraud (intentional or otherwise), such as consumer protections offered by the FTC and state attorneys general.

To conclude, the regulatory framework governing crowdfunding platforms in the United States is much looser for reward-based ventures than the stricter SEC laws governing equity-based investment in crowdfunded securities. The CFR contains no regulations strictly related to reward-based crowdfunding, and laws passed at the state level also fail to provide notable structure or guidelines for vendors and artists hoping to fundraise by using reward-based incentives. Some scholarly literature does address relevant issues such as gift exemption, IP theft, and fraud. But, by far, the regulation and its scholarly analysis are more plentiful for crowdfunding artists and platforms within the European Union.

#### **4 CCCF regulatory framework in the EU**

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<sup>9</sup> “Online Crowdfunding.” *ibid.*

In Europe the cultural and creative sector is defined by the European-Union regulation.<sup>10</sup> It is thus not surprising that CCCF as such has been increasingly part of the policy agendas of the European Union as well as of its member countries. Policies are mainly aimed at (indirectly) improving the CCCF regulatory framework, besides its awareness and hence its adoption by users (European Commission 2017).

Overall crowdfunding regulation is mainly competence of member states, a number of which have developed specific legislations in the last couple of years. A harmonization at the EU level is in fact not the rule, and so far there is no European crowdfunding legislation or ad hoc EU authority in charge of crowdfunding regulation, resulting in a EU fragmented market (Patti and Polyák 2017). A major consequence of that is the hindering of cross-border crowdfunding (ECN 2017). The EU is even less likely interested to play a harmonization role in the regulation of reward and donation crowdfunding, as financial return, securities and financial markets stability are not involved (ECN 2017). Such regulation is therefore unrestrictive or unspecific, and requirements simply imply standard trade or business licensing (Patti and Polyák 2017). Contrary to investment crowdfunding, reward and donation crowdfunding is also excluded from the recent Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business,<sup>11</sup> because it does not deal with financial products and related information asymmetries.

At a more global level, the regulation of crowdfunding in general falls within the scope of the International Organization of Securities Commissions (IOSCO), like, in particular, the limitation of cross-border activities, due to different regulatory systems (European Commission 2017). Yet in the last years the EU, together with its member states, has become interested in the potential of the overall growing crowdfunding market, addressing it in a series of economic, financial and innovation policies.<sup>12</sup> For instance, the public consultation on the mid-term review of the Capital Market Union of 2017 by the European Commission<sup>13</sup> (which urges the strengthening and integration of EU capital markets and EU-wide supervision for the development of SMEs and job creation (ECN 2017)) considers the role of Financial Technology (“FinTech”) and crowdfunding as improving market efficiency and competition.

The EU approach toward CCCF regulation remains rather soft, by means of workshops and public consultations, communications, a stakeholders' forum, reviews, reports and commissioned studies. In fact, besides fostering ‘hard’ regulation and fiscal incentives, policy makers can fulfill ‘softer’ roles toward CCCF, such as facilitators of the sharing of information, for instance on best practices, key performance indicators and market analysis, match-funders, funders or owners of platforms, funders of research on crowdfunding and awareness campaigns, etc. (European Commission 2017).

National regulatory frameworks instead differ in whether they treat specifically about crowdfunding or not (Patti and Polyák 2017) and the degree through which they facilitate or, on the contrary, restrain crowdfunding (European Commission 2017). In

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<sup>10</sup> Regulation (EU) No 1295/2013 of the European Parliament and of the Council of 11th December 2013 establishing the Creative Europe Programme (2014 to 2020) and repealing Decisions No 1718/2006/EC, No 1855/2006/EC and No 1041/2009/EC.

<sup>11</sup> COM/2018/0113 final - 2018/048 (COD).

<sup>12</sup> Such as the European Commission for Innovation Union, Capital Markets Union, the Green paper on long-term financing of the European economy and the Entrepreneurship 2020 Action Plan.

<sup>13</sup> COM(2017) 292 final.

Europe, the United Kingdom, where more than 80% of European alternative finance is concentrated, represents the country most supportive of CCCF, followed by France, Germany, the Netherlands and Finland. Furthermore, the UK shows the highest average amount of money raised per campaign (Cambridge University 2016). Main features of UK's most supportive policy include a progressive regulation and tax reliefs (CrowdfundingHub 2016).

CCCF is diversely developed in EU member states (ECN 2017).<sup>14</sup> For instance, Belgium was among the pioneers and nowadays counts many platforms and a flourishing activity, contrary to Austria, Cyprus, Latvia and Lithuania, the latter even lacking any platform. In Ireland CCCF is quite developed, although the market is relatively small, and it is operated by local and Irish versions of international crowdfunding providers. In Italy, the Netherlands, Spain, Poland and Slovakia CCCF is quite developed and there operate many platforms. In the Czech Republic it is also successful and popular, though the platforms are domestic. In Denmark CCCF is quite diffused through domestic and especially main foreign platforms, such as Kickstarter. In Germany crowdfunding is offered also by regionally organized cooperative banks to reach out to rural areas. In Greece crowdfunding platforms have been developed by a wide realm of players, including credit institutions, museums, NGOs, non-profit organizations, as well as other companies. In Malta, where only one national platform operates next to international platforms, crowdfunding campaigns are expanding. In Luxembourg crowdfunding is still in an initial phase: given the small size of the market, there is only one foreign-based platform and other local and international attempts have not persisted. Similarly, in Hungary, Romania and Slovenia CCCF is still recent and to develop. Contrary to most countries, in Croatia crowdfunding is in decline and is operated almost only through international platforms, due to the small market. In Sweden, where investment crowdfunding is most important, CCCF is less diffused.

Since CCCF does not generally imply financial investments and returns, similarly to the EU, national legislations are usually less concerned about it. National regulation measures for CCCF are rather more limited and less impacted by the EU regulation with respect to investment crowdfunding for the reasons mentioned above (ECN 2017). These measures may be general, like mandatory licensing of (usually nationally) platforms, or concerning payment service. In a number of EU countries crowdfunding may be also subject to other related national laws and regulations on anti-money laundering (Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, UK) and anti-terrorism financing (Austria, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Ireland, Italy, Latvia, Lithuania, Malta, Netherlands, Poland, Romania, Slovakia, Slovenia, Spain, Sweden), consumer protection (Austria, Belgium, Estonia, Greece, Hungary, Italy, Latvia, Slovenia, Spain, Sweden), privacy/personal data protection (Belgium, Croatia, Cyprus, Estonia, France, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Netherlands, Romania, Slovakia, Slovenia, Spain, UK), advertising/marketing (Denmark, Estonia, Hungary, Latvia), intellectual property (Greece), fundraising (Denmark) and humanitarian agencies (Slovenia). Similarly, despite the absence of a EU crowdfunding harmonization, recently developing national crowdfunding regulations are often impacted by other, related EU

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<sup>14</sup> However, available data on crowdfunding in the various countries may not be always complete.

regulations, such as those on data protection and consumer protection. As for the protection of backers, in Europe this falls under consumer protection regulation and in particular under Directive 1999/44/EC on the sale of consumer goods and their conforming, Directive 2011/83/EU on consumer rights and withdrawal on distance sales, and Directive 93/13/EC on unfair terms in consumer contracts (Gutiérrez and Sáez 2018). In Sweden, which is among the most liberal countries toward CCCF, the lack of licensing lowers the entry barriers for foreign operators.

Yet various exceptions to missing or reduced specific regulation of CCCF exist in EU countries (ECN 2017). For instance, in the Czech Republic donation-based crowdfunding is subject to public collection requirements and scrutiny by the regional authority,<sup>15</sup> possibly limiting platforms activities. In Denmark reward pledges are taxed similarly to company sales, while platforms require a money collection permit in the case of donations. In Estonia, parallel to platforms regulation, a public-private cluster organization has promoted a non-binding code of best practice together with market participants. In Germany CCCF is not regulated at all, although this could become less the case when it is reward-based, because of some assimilation to investment products. In Hungary CCCF is generally exempted from the regulatory requirements, although payment services and custodial services requirements may apply, depending on the structure used by the platform and service provided by the company, but the application of these requirements is uncertain, contributing to the underdevelopment of the Hungarian crowdfunding market. In 2017 Ireland launched a public consultation on regulation of crowdfunding, which found the crowdfunding industry and stakeholders favorable, since they felt it would favor both the industry and consumers; yet the main concern was that regulation might be overly burdensome or onerous, and hinder the development of the industry, also from an international (in- as well outbound) perspective (Irish Department of Finance 2018). In Lithuania, the would-be CCCF platforms (since there is none so far) would be governed by the civil code, and collected funds would be taxed like taxable income. Also in Poland crowdfunding is basically ruled by the civil code. In the Netherlands, where a legal definition of crowdfunding does not exist, tax rules apply depending on the size and purpose of donations. In Spain and Portugal CCCF is the object of a relatively more articulated regulation, in particular when monetary rewards are implied. Furthermore, Portuguese regulation requires a prior registry at the Portuguese Authority for Consumer's Protection to comply with several information requirements. In Slovakia donations are subject to the civil code and the Public Collections Act, and regulation may intervene with large rewards. In Slovenia, individual taxpayers donating through crowdfunding are bound to regulation on personal income tax. In some other countries like the UK, France, Spain and Belgium, backers can benefit of tax incentives in the case of donation crowdfunding, but not reward, and also these schemes quite differ (Cicchello et al. 2019).<sup>16</sup>

Despite the absence of crowdfunding harmonization in the EU, there are regulation similarities and/or cross-border activities between neighboring countries and in common language areas (e.g., Austria and Germany; Belgium and France or the Netherlands; the Czech Republic and Slovakia; Slovenia and Austria). Larger national crowdfunding

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<sup>15</sup> No specific regulation instead exists for platforms.

<sup>16</sup> Although it has been found that fiscal incentives are not per se significant drivers for contributors in Europe (European Commission 2017).

markets are also the most interested by international (in/outbound) activity.

To conclude, CCCF is not regulated at the EU level and is rather the object of a variety of recent and developing national regulations, although these regulations tend to be general rather than specific about CCCF. The practice of CCCF is also quite varied across countries, as the associated business models of the operating platforms. The lack of regulation harmonization at the EU level favors a fragmentation of the crowdfunding market, leaving the sizes of national markets relatively small, and limiting crowdfunding crossing borders. Moreover, a lack of a clear and comprehensive regulation favors uncertainty, hinders consumers' confidence, and hence the upscaling of the market. Therefore, the majority of EU countries, especially the most experienced ones, are in favor of a regulation of crowdfunding and its EU harmonization, at the same time avoiding too heavy, non-transparent and onerous regulation. On the other hand, a minority of relatively less experienced countries (e.g., Malta, Slovakia, etc.) are in favor of a more liberal framework to facilitate the market expansion.

## **5 A critical comparison and policy recommendations**

The review of regulatory frameworks in the US and the EU, and corresponding recommendations, are summarized in Table 2. Across several dimensions, the similarities and differences in regulatory approaches are apparent. Overall, considerable similarities exist in the body of regulatory law and practice still being developed. However, the US and the EU display very different degrees of harmonization in regulatory frameworks within the continents. In the US, the lack of active state-level regulations (and the limitations on US state governments regulating interstate commerce) leaves the federal government to establish CCCF-specific regulations. The result is a highly harmonized, and largely unregulated, single market for CCCF in the US. By contrast, the lack of an harmonizing effort at the EU level has allowed for diverging regulatory approaches by member European states.

[Table 2 here]

### ***5.1 Self-regulation***

The lack of regulation, perhaps in a lower stakes and more experimental setting, has fostered an environment of openness, creativity, and accessibility. Gutiérrez and Sáez (2018) highlight the innovativeness of reward-based compared to investment-based crowdfunding. In particular, in reward-based crowdfunding non-penalty contracts may foster the discovery of talent by backers.

Crowdfunding platforms may engage in some self-regulation. The terms-of-use of the largest platforms provide some guidance on prohibited offerings and how income (for creators) or contributions (for backers) should be reported for taxation or tax relief. Instances of larger-scale operations intentionally pushing fraudulent but seemingly appealing projects to receive money with no future intent to provide deliverables are rare. Moreover, scams are common enough that an online database (kickscammed.com) exists

for Internet users to search and record acts of crowdfunding fraud, in addition to active discussion boards. A rich ecosystem of third-party information providers has also emerged to provide backers (and creators) with additional information (e.g., kickended, kicktraq, krowdster). In general, the low-cost approach of self-regulation has been consistent with maintaining lower transaction costs between creators and backers, an essential ingredient in unlocking crowdfunding's benefits.

## ***5.2 Harmonization***

Harmonization comes to the fore as the other major issue in CCCF regulation. Disparate regulatory frameworks create extra uncertainty and cost for creators engaging in crowdfunding. Moreover, by fragmenting the markets, the potential for crowdfunding to tap into larger marketplaces – larger crowds – is diminished. Regulatory recommendations put forward for the EU point to the increasing of cross-border crowdfunding and the upscaling of platforms, besides establishing a code of conduct to regulate crowdfunding and hence increase trust (European Commission 2017). Removing misunderstandings about crowdfunding platforms – are they storefronts for existing products or platforms to supporting new creations? – can help reduce frictions surrounding breached contracts when projects unintentionally fail to deliver (Ganatra 2015). Following core economic advantages outlined above, regulation to expand marketplaces to larger crowds (attracting more creators and more backers) stands to grow its benefits.

## ***5.3 Intellectual property rights and fraud***

Concerns about IP protection and fraud remain in the CCCF context. In both the US and the EU, more general laws to protect IP and protect against fraud continue to function and apply to crowdfunding; no special regulation exists. Whether that approach, coupled with self-regulation, will continue to be sufficient remains to be seen. Further, whether there are efficiency gains from alternative regulatory approaches is an open question. Instituting better protections exist to attract innovators to share their ideas may enable further expansion of CCCF. Miao (2015) recommends several reforms to balance the need to protect IP while encouraging innovation in crowdfunding platforms. Ganatra (2015) provides recommendations on future transparency and regulation for the emerging market of CCCF.

## ***5.4 Recommendations***

Firstly, harmonizing CCCF regulatory regimes among the states holds the greatest promise to remove barriers for continued beneficial crowdfunding expansion. Lowering the transaction costs and tapping into bigger crowds lowers the MES and allows for more new, creative entrants. This especially applies to the EU, but also to the US.

Secondly, balance should be struck to encourage entrepreneurship (Stephen et al. 2009). The approach to regulation taken for equity-based crowdfunding, emphasizing disclosure and transparency requirements, could reduce information asymmetries and encourage CCCF (Ganatra 2015); it may also reduce instances of creator failure, though limiting entry to crowdfunding. A risk-free crowdfunding ecosystem likely fails to deliver

on its many advantages of fostering creativity and innovative cultural projects.

The power of crowdfunding platforms reaching larger and more targeted population and eliciting their preferences for various ventures can be used to inform public projects and goals. Moreover, programs such as matching funding, can more directly link public funds to the will of the public (i.e. the crowd).

## 6 Conclusions

Crowdfunding represents an important alternative, or complement, to the financing modes and sources of the cultural and creative sector. Furthermore, crowdfunding is relevant for its informative, promotional, co-creative and democratizing features. Rewards and donations, with their distinctive features, are the prominent models in CCCF. We have assessed the benefits and barriers of CCCF through the lenses of regulatory frameworks, the institutional instruments allowing, or supporting, crowdfunding to achieve its potentials and overcome its barriers. We have critically considered and compared the regulatory frameworks of the two main marketplaces, namely the US and the EU, in terms of involved authorities and respective roles, regulation intensity and specificity and degree of harmonization, together with other aspects of taxation, IPR and fraud.

We have highlighted as CCCF presents a series of benefits, such as: lower transaction costs and potentially wider and better market outreach through applied technologies; financing, and related risk, diversification; new viability of niche markets and creative supply; broader geographical distribution of financing; rich and multimedia information about creative innovation conveyed to the market; more interaction and information reciprocally shared on the market from more upstream phases of the value chain; better collection of market data and reduction of uncertainty – although not necessarily information asymmetries. A focus on these core benefits guides regulatory reform recommendations. Indirect benefits include positive spillovers from subsequent interest generated among investors and democratized funding. Benefits are reinforced by the presence of IPR and social networking, but also depend on existing barriers and risks. Barriers relate to entry and exit of platforms and creative organisations and professionals. Risks deal with information asymmetries and associated adverse selection and moral hazard, although these are not exclusive of crowdfunding.

We have discussed how crowdfunding ability to achieve its potentials and overcome its barriers depends directly on how it is regulated, to reduce fraud, bias, confusion of standards and, ultimately international harmonization in terms of parties' rights protection, professional standards and fiscal regimes. At the same time, over-regulation and excessive costs ought to be avoided. By looking at both the US and the EU, CCCF results an important and emerging practice. Corresponding regulations are not specific and limited, and are evolving especially in the EU. While in the US crowdfunding regulation is a federal matter and is highly harmonized, in the EU regulation is mainly exercised at member-states level, implying a great variety of regulatory frameworks and, correspondingly, of business models. At central level, the EU rather intervenes in a soft way, through consultations, the main reasons being the prevalent non-financial nature of CCCF.

In our critical comparison we have further highlighted how the limited regulation



by public authorities may allow for self-regulation of operators, and hence contribute to openness, creativity, and accessibility in the CCCF marketplace. As for IPR, the practice of CCCF calls for more specific transparent regulation. A lack of harmonization within the EU and internationally may pose considerable challenges to CCCF and its expansion. In fact, while a non-harmonized market may deter new entrants because of perspective profits face to bureaucracy costs, investments and market size, sufficiently liberalized single small markets may favor big international (or global) entrants, with consequent expansion of the market although with possible drawbacks, first of all in terms of diversity.

Recommendations point to a harmonization of CCCF, starting from the EU, and to a supportive, rather than oppressive, regulation, for instance enhancing transparency, stressing measures in favor of entrepreneurs, tolerating some levels of risk, and fostering more forms of public-private partnership.

In this paper we especially opted for an analysis from a policy-maker's perspective, highlighting the various areas of intervention of CCCF regulation. Another perspective was possible – however alternative – in terms of the direct subjects of such regulation, namely creators, backers and platforms, and other stakeholders. Furthermore, as we have shown, CCCF regulation is a quite diverse matter that follows its rapidly evolving market, which implies a constant effort of update, as well as multiple margins of intervention, in particular for policy-design purposes. Regulating multi-sided platform industries poses significant complexity, where network and scale economies, possibility of monopoly power by platforms, and competition among platforms inducing some market fragmentation (Evans 2003).

Because of the distinct features and functioning of CCCF with respect to other crowdfunding models, future research should deserve more separate and focused efforts, also based on available data. Developing datasets that enable comparative analysis, especially across multiple platforms, would be especially helpful. As crowdfunding per se is global, and the creative economy is expanding worldwide, it would be relevant to expand its comparative regulation analysis to other geographical areas of the world. The study of CCCF in particular allows to better disentangle the innovation component typical of creativity, and new collective creative patterns. Therefore, research on CCCF regulation should further disentangle their possible leverages. Spillovers from CCCF to other more traditional forms of financing new ventures and IP protection remain important areas for future research.

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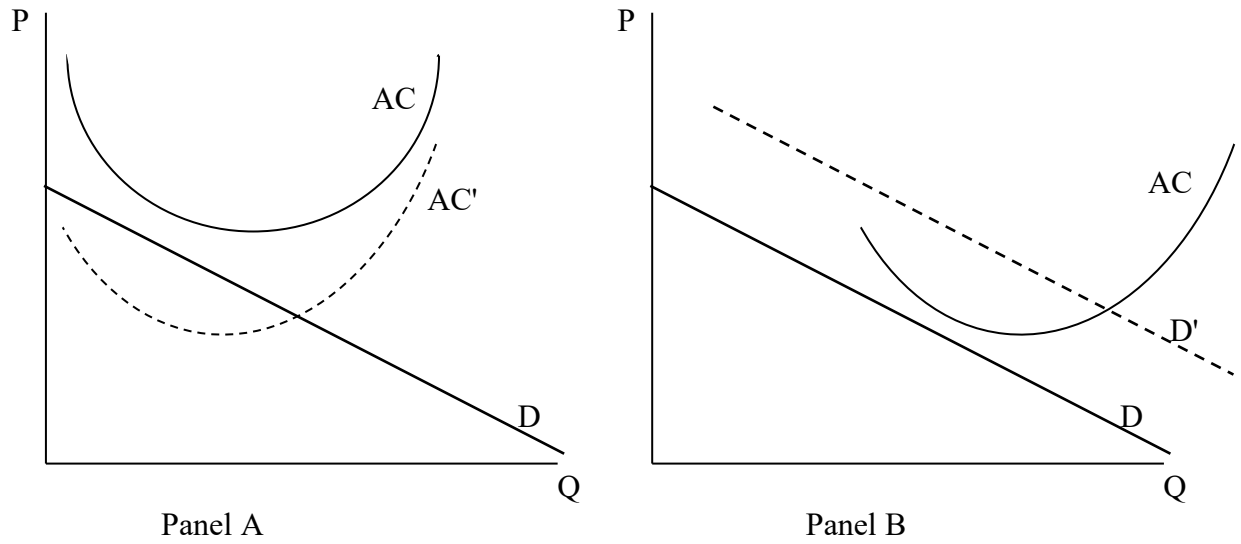
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**Figure 1: Crowdfunding and minimum efficient scale (MES)**



**Table 1: Descriptive statistics for Kickstarter projects, by non-US country**

variable	All (N=162)		OECD only (N=35)		EU (N=28)	
	mean	std. dev.	mean	std. dev.	mean	std. dev.
FUNDSRAISED <sub>pc</sub>	0.183	0.47	0.630	0.82	0.522	0.80
GDP <sub>pc</sub>	0.015	2.16	0.037	0.02	0.032	0.02
POP (millions)	42.940	154.09	27.607	34.62	18.150	23.39
OECD	0.216		1		0.821	
ENGLISH	0.247		0.514		0.536	

Note: OECD and ENGLISH are dummy variables.

**Table 2: Comparison between US and EU regulatory frameworks for CCCF and recommendations**

<b>Dimension</b>	<b>United States</b>	<b>European Union</b>	<b>Recommendations</b>
Regulation of equity-based crowdfunding	JOBS Act (2013) to allow and regulate	Proposed EU regulation for ECSP	Adapt their disclosure and transparency requirements to reduce information asymmetries and creators' risk of failure also in CCCF
Regulation of RC/DC overall	Little or no special attention – just like any sale or donation	Little, but some member states regulate more stringently	Balance, to support creative entrepreneurship and CCCF growth
Role of federal/EU-level regulation	Primary, yet largely silent	Soft, largely consultations	Harmonize, to reduce transaction costs and allow CCCF growth
Role of state/national-level regulation	As taxing authority, offers some guidance	Primary, some fragmented markets and regulation	Use CCCF proactively to support public decision-making and public-private partnerships
Taxation of creators	As income, generally ambiguous	Mixed, sometimes as sales	Support creative entrepreneurs
Tax incentives for backers	Generally none, though possibly used to avoid sales tax	Mixed, limitedly to donations	Reduce tax-incentives transaction costs
IP protection	No special policy	No special policy	Balance regulation to protect IP and encourage innovation
Fraud protection	Like any other transaction; platforms self-regulate	Like any other transaction	Monitor against fraudulent information
Changes over time	Remains largely unregulated	Continues to evolve, especially at state level	Follow up and support CCCF growth