Fund What You Trust?
Social Capital and Moral Hazard in Crowdfunding

by Tse-Chun Lin and Vesa Pursiainen

Discussant: Tamara Nefedova

Interest

- Thought-provoking and topical!

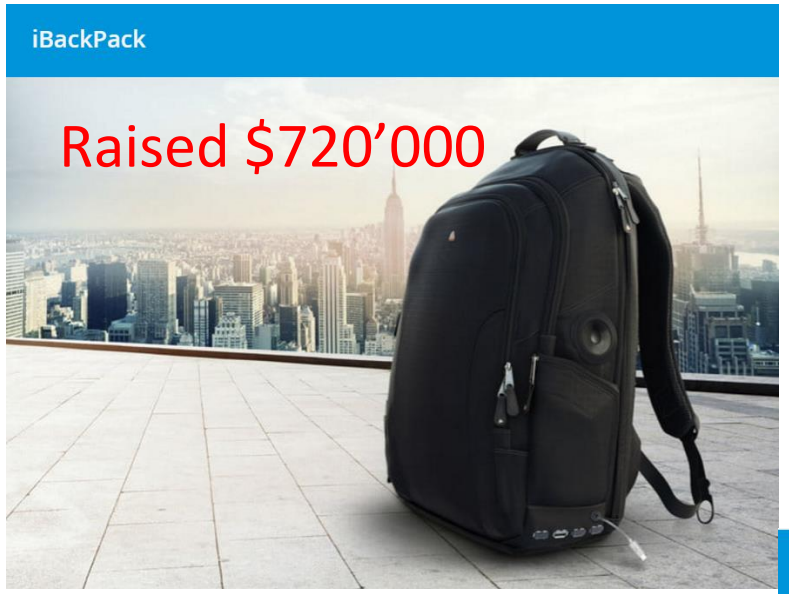
Reward-based crowdfunding has its **PROS**:

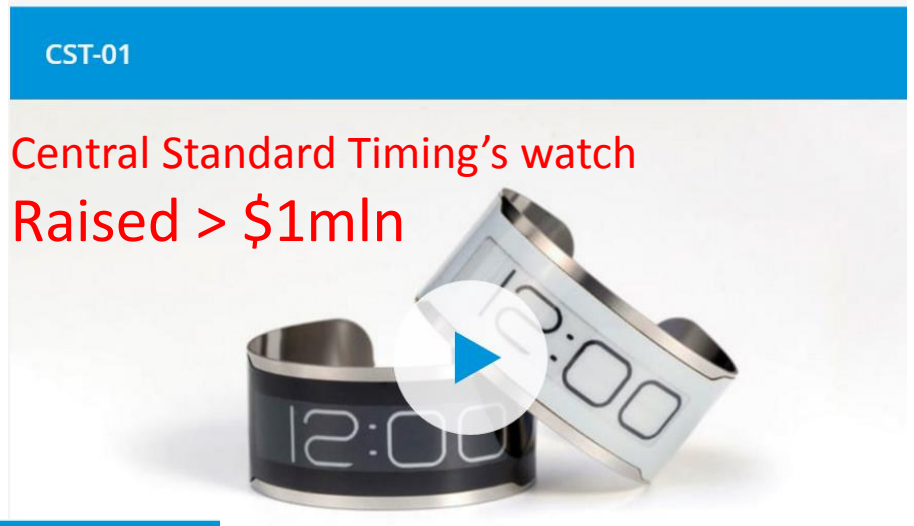
- Allows entrepreneurs to learn about demand
- Provides equal access to financing (female/male entrepreneurs)
- May open complementary sources of financing

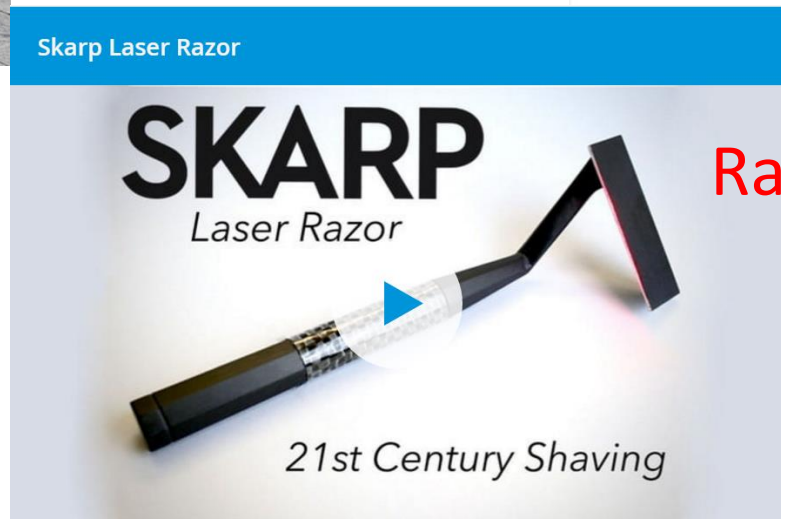
… and **CON(S)**:

Moral hazard

Some crowdfunding “scams”







Raised > $4mln

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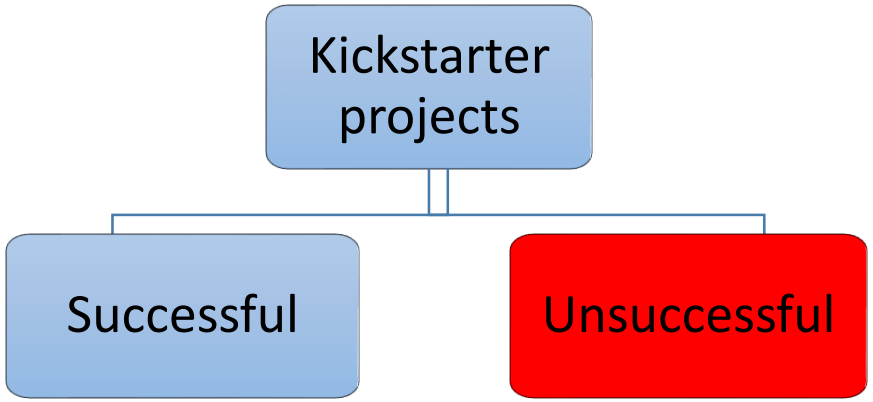
Moral hazard in reward-based crowd-funding

- Mollick (2014) finds little evidence of potential fraud in reward-based crowd-funding (products not delivered **3.6%** and **0.05% in $)**
- Strausz (2017), Chemla and Tinn (2018),Chang (2015) – crowdfunding overcomes moral hazard

Measuring moral hazard

- Your implicit assumption: unsuccessful project has more chances to be fraudulent



But:

✓ Many of unsuccessful projects manage to continue and even get alternative financing, others simply lack crowd interest

✓ Projects can fail to deliver after a successful campaign:

- underestimated funding need
- overfunded but failed to scale up
- Technical manufacturing issues

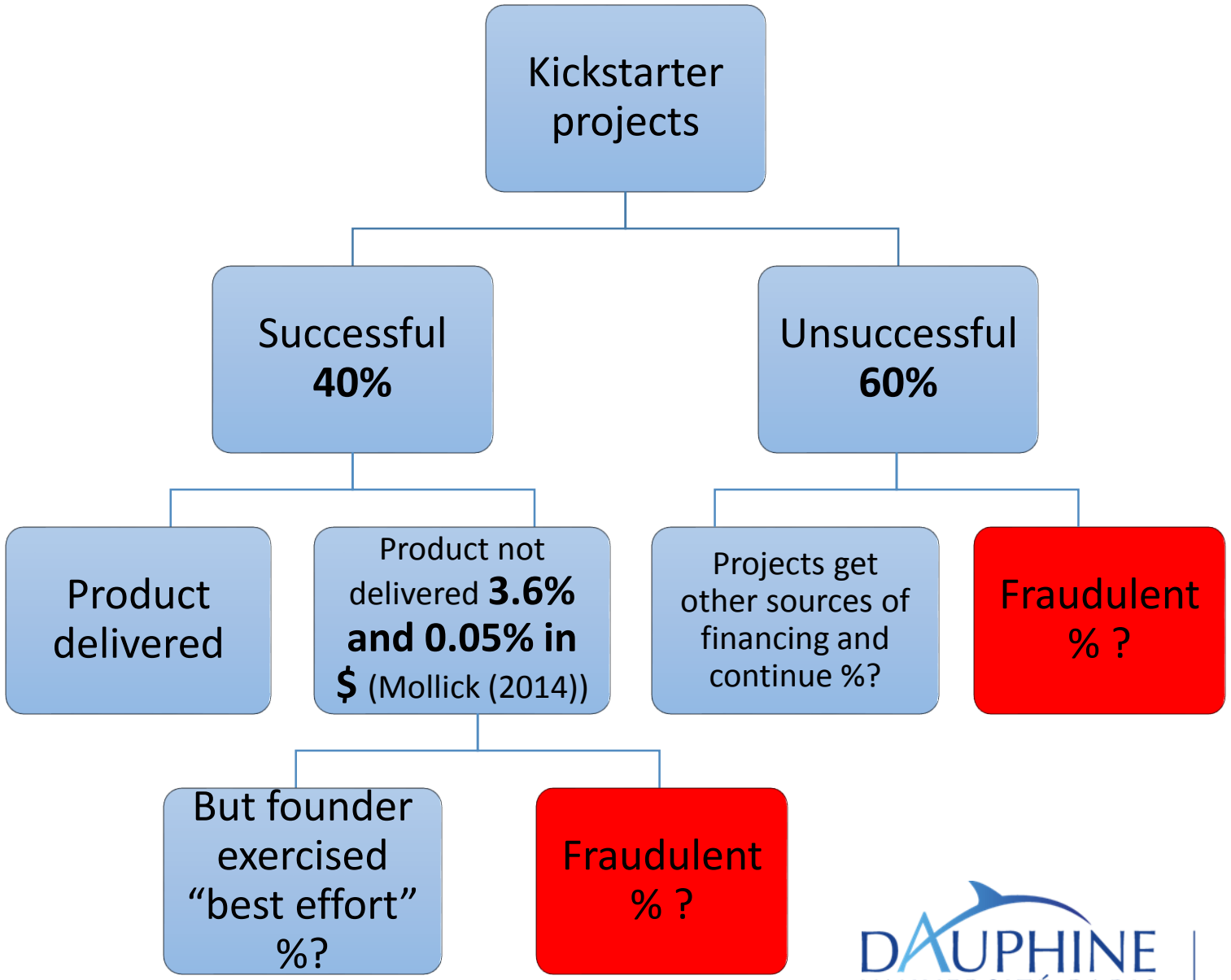
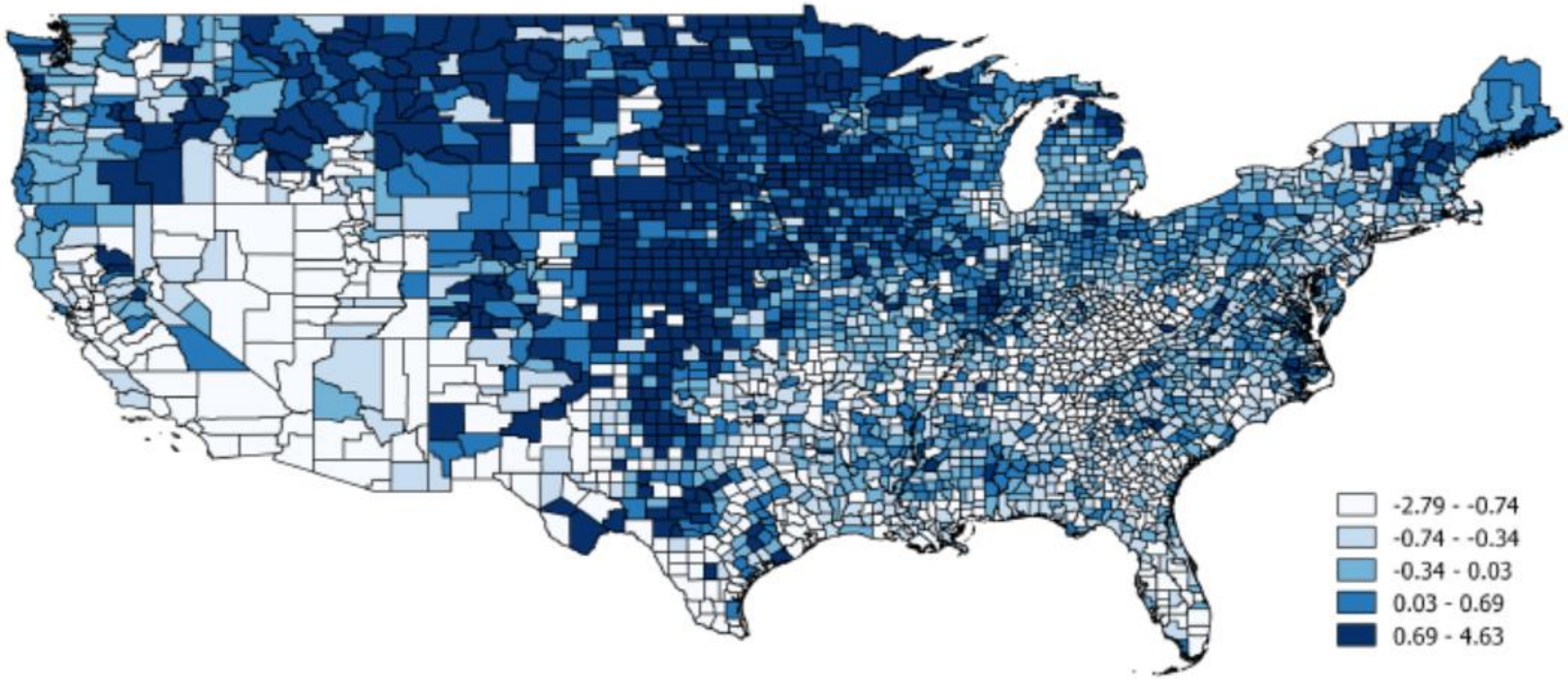

Kickstarter projects
Successful **40%**
Unsuccessful **60%**
Product delivered
Product not delivered **3.6% and 0.05% in $** (Mollick (2014))
Projects get other sources of financing and continue %?
Fraudulent % ?
But founder exercised "best effort" %?
Fraudulent % ?

Figure A.1: Social capital index by county in 2014



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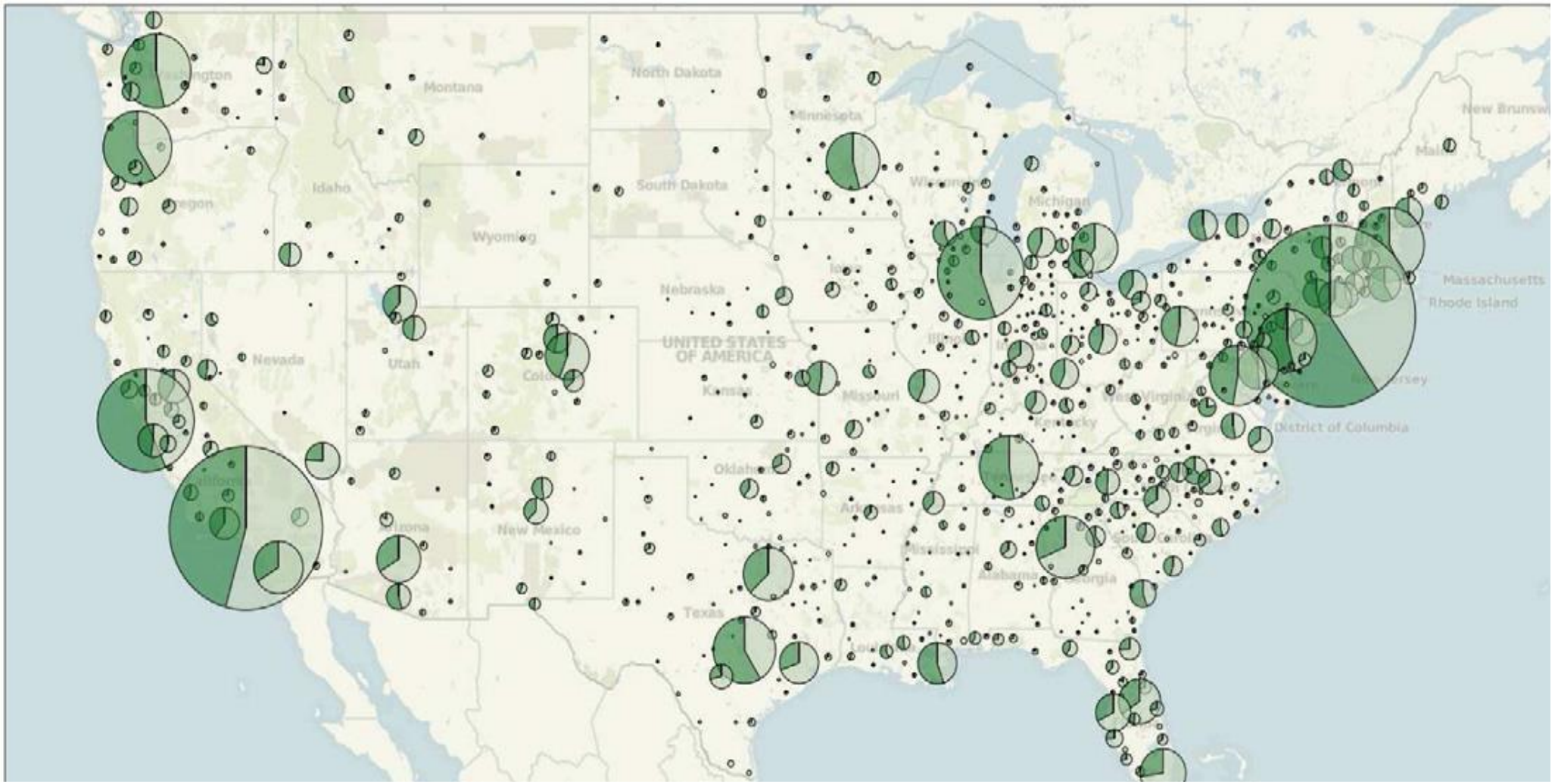
Relative amounts pledged and success



On geographical concentration

- Distribution of started projects and their success are uneven across the country (see Mollick (2014))
- Also each category of projects has its concentration pattern
- What % of funding comes from “high social capital” vs “low social capital” counties?
- It seems like low social capital counties provide a major part of overall funding despite their lack of trust…

Local demand/geographically dispersed demand

In the same spirit as my previous comment:

- Campaigns in high social index counties may rely on local demand

➔ Local backers provide most of the initial funding + other investors herd

“Keep-it-All” (KIA) versus “All-or-Nothing” (AON) model

Cumming, Leboeuf, and Schwienbacher (2015) suggest that entrepreneurs self-select into AOM model to signal they go for the project only if enough funds are raised

- ✓ AON projects transfer the risk to the entrepreneur (Kickstarter)
- ✓ KIA campaigns put most of the risk on the funders (Indiegogo have both options AON and KIA)
- ✓ AON projects have both higher success and completion rates
- ✓ Furthermore, Chemla and Tinn (2018) provide a theoretical prediction that AON model with a sufficiently high target gives incentives to entrepreneurs not to divert funds compared to KIA model (explanation: real option value of learning through campaign helps entrepreneurs to overcome moral hazard problem)

Suggestion:

Hence, KIA should be more prone to moral hazard ➔ use this to analyze social capital and moral hazard (KIA undelivered products should more likely be fraudulent)

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How project types are distributed bw high/low social capital counties?

Rupasingha et al. (2006) find that urban counties have lower level of social capital, than suburban/rural areas (also believed by Putnam (1995))

- Any evidence that some types of projects are more prevalent in rural areas (with presumably high social capital index)? Imagine residents of rural areas mainly start *art, entertainment* and *food* projects and residents of urban areas start mainly risky *technological* projects with high fixed costs: they do not have the same success rate!
- At least some descriptive stats to show what is going on

Kickstarter rule change

- ❑ Did the risk profile of Kickstarter campaigns change?
- ❑ Founders are risk averse ➔ more uncertain projects (e.g., technological) moved to other platforms ➔ coupled with the previous comment on the relation of rural/urban counties and high/low social capital index this may lead to the result you document: SK is less important

New on Kickstarter: “Hardware studio” badges 2018

- The badge means that the project has been accepted into **Hardware Studio Connection** (hardware accelerator/manufacturing mentorship program)
- The aim: to prevent projects from flopping after they meet their funding goal

➔***This initiative may increase the success rate of projects through two channels:***

1) By providing early feedback to the entrepreneurs, the initiative help them to address the development/manufacturing issues early
2) Early screening of projects by the initiative potentially allows to exclude both unfeasible and fraudulent projects (How to disentangle the two?!)

- Check if the participation in the initiative is automatic or entrepreneurs may choose not to participate (self-selecting not to participate may be a proxy for potential fraud)

“Skin in the Game”

- No info on founder’s financial participation in the project,

But:

- Proxy it by “reputational” stake:
  - ✓ Founder’s information availability (LinkedIn, Facebook accounts) and verifiability vs anonymous projects
  - ✓ Anonymous creators conditional on project’s failure may be not perfect, but somewhat better proxy of moral hazard