ADVANTAGES OF CROWDFUNDING AS AN ALTERNATIVE SOURCE OF FINANCING OF SMALL AND MEDIUM-SIZED ENTERPRISES

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Summary: The lack of funding, and limited access to it are the basic problems faced by small and medium-sized enterprises (SMEs). Given the great role and importance of SMEs in every national economy, any progress in solving these problems in terms of creating and finding alternative sources of funding should attract great attention in both professional and scientific and the wider socio-political communities.

Crowdfunding is an innovative and relatively new concept that connects entrepreneurs and investors through the Internet. This method allows the entrepreneurs to collect funds through the Internet by "open invitation" to finance their projects/ventures and thus raise the necessary funds by relatively small contributions of a relatively large number of investors. As such, crowdfunding is a fast-growing model increasingly debated of in academic circles and the European institutions.

This paper will consider crowdfunding as an alternative means of financing SMEs and try to give different aspects of crowdfunding - and explain how it works, what are the advantages of using it for SMEs and thus expand the knowledge on the topic.

Key words: crowdfunding, small and medium enterprises, financing, Internet.

JEL Classification: G32, L21, L26, M13, M21

1. INTRODUCTION

Difficult access to funding is one of the most important constraints to the growth and development of SMEs. Recent developments - the global economic and financial crisis has further worsened the situation in the area and increased the pressure to find alternative sources of funding. Therefore, the search for alternative sources of funding has become increasingly common in recent years.
Widespread access to the Internet and the emergence of social networks along with the growing emancipation of the masses (groups), offer interesting possibilities. Using these phenomena in the method called crowdfunding can allow entrepreneurs to raise funds for their project/venture. Otherwise speaking, the entrepreneur finds alternative in crowdfunding, and instead of relying on the small number of highly sophisticated investors and bank managers, he uses the benefits of the Internet and motivates and uses a large audience (a large number of individuals), of which each member gives a modest/small contribution, but they all together reach the common goal. Crowdfunding is thus used as a much needed and necessary alternative source of SMEs financing.

Academic circles have very little knowledge about the dynamics of a successful crowdfunding, its frequency and precise way of using crowdfunding mechanisms, and since we are of the opinion that this may be an important alternative source of financing for SMEs, we find that, as such, it deserves more serious attention. The aim of this paper is to make the first few steps towards analytical understanding of crowdfunding, the way it works and the benefits it provides.

In short, the paper intends to demonstrate the wide array of options that crowdfunding provides, which could be of benefit not only to the wider academic and socio-political community, but also to potential crowdfunding users - SMEs. Therefore, the paper is structured as follows: Section 2 deals with the problem of financing SMEs, and in sub-section it discusses the relationship of banks to this problem. Section 3 gives the definition of crowdfunding and a schematic overview of its operation. In addition, this section identifies the participants, agents and explains crowdfunding operation step-by-step. The multiple benefits of using crowdfunding are described in Section 4. Concluding remarks are given in Section 5 which is also the last part of the paper.

2. PROBLEM OF FINANCING OF SMALL AND MEDIUM-SIZED ENTERPRISES

Small and medium enterprises (SMEs) play an important role and are a key source of growth in the national economy. According to Djerić (2009, 30), it is considered that there is a kind of a market economy if at least 40% of the gross domestic product (GDP) is generated by small business. The same author states that 99% of European businesses today are concentrated in SMEs (usually up to 250 employees) and 90% of those companies perform micro-business defined by employment of ten or fewer employees, whereas the European Union (EU) now has 40 SMEs per 1000 inhabitants (and among member states, the Czech Republic has the most with 86 SMEs per 1000 inhabitants). According to the European Commission, SMEs in particular are the most important source of new employment: every year in Europe, they create more than 4 million new jobs (European Commission 2013, 4). In the crisis, they generate the greatest number of new jobs (in the EU, more than 66% of all employees work in SMEs, and in developing countries this percentage is much higher). Nowadays, they are often the only ones who still create new jobs, being a way to prevent the migration of people from passive geographical area, thus having a strong impact on economic development at the national, regional and local level.

New ventures and projects require the resources to succeed, and one of the main problems is to find sources of funding, which are not family, friends or own savings. According to Schwienbacher and Larralde (2010, 3), the problem faced by entrepreneurs at the very beginning of their entrepreneurial initiatives (that require smaller amounts of initial capital), is how to secure external sources of funding given the lack of collaterals, insufficient cash flows and the presence of greater information asymmetry with investors. As Belleflamme, Lambert and Schwienbacher (2013, 4) argue, many entrepreneurial ventures remain unfunded, be it through bank loans or equity capital, partly because of a lack of sufficient value that can be pledged to investors and partly because of unsuccessful attempts to convince investors in the success of the project/venture.

The SMEs have suffered the biggest impact of the global financial crisis from 2008. The consequences are still felt today. While the strategy for economic recovery was focused on fiscal policy and the banking system, the focus of the financial burden was laid on SMEs and so they were left without the necessary resources for their business, without bank loans and access to credit lines from financial services industry (De Buysere al. 2012, 8).

The European Commission states its goal to support the business environment for SMEs and promotion of successful entrepreneurship. Their view is that without adequate funding and without liquidity, no business can operate, invest and grow, and indeed, access to finance is one of the levers
of growth for SMEs (European Commission 2013, 8). At the same time, access to finance constitutes one of the major constraints on the growth of entrepreneurship in Europe.

Given the fact that SMEs are predominantly relying on bank loans as a source of funding, this paper will further on consider the motives, constraints and business practices of the banking sector as the main and often the only source of external funding for this important business segment.

2.1. Banks and their relation to the problem

The systematic study of this issue is found in the part of the doctoral dissertation by Sinković Dean (Sinković 2011, 170-73). By analyzing a number of relevant articles in this field, the author notes that the previous considerations point to the fact that the banking sector, especially big banks are not motivated enough to finance SMEs, which can be a limiting factor for long-term economic development. The author highlights the following from the analyzed papers (Sinković 2011, 170-71).

- In some economies, banks perceive SMEs as high-profit organizations and, as such, involve them in bank credit portfolios. However, macroeconomic instability occurs as the main limiting factor for the financing of these enterprises in developing countries.
- In order to better provide services to the SME sector, banks develop their regional affiliates and thus decentralize the sale of financial services. However, the functions and decisions relating to the granting of credit and risk management remain strictly centralized, as usual.
- The share of SME loans in total bank portfolios is much lower compared to large companies. In addition, SMEs suffer from higher interest rates and fees on loans and have a larger share of non-performing loans.
- It has been observed that foreign-owned banks rely more on collaterals in the form of real estate and pay greater attention to the processing of information.
- There are characteristic differences in SME financing between banks in developed countries and banks in developing countries. It has been observed that banks in developing countries have a lower share of investment loans, and higher interest rates and fees.

All this leads to a conclusion that the banks are not providing enough funding under sufficiently good/acceptable terms to finance SMEs in developing countries, and that they are not very fond to finance SMEs in developing countries. Why is this so? Possible reasons are as follows (Sinković 2011, 172-73):

- It is noticeable that the majority of SMEs in developing countries have above-average profitability and below-average productivity.
- A key reason for the reduced lending to SMEs in developing countries is their above-average risk, based on the lack of capital and reliance on short-term debt, which makes them particularly sensitive to fluctuations in the business cycle. Thesis on the vulnerability of SMEs was further confirmed by the economic crisis which was reflected in their share in the bank NPLs.
- One of the economic characteristics of SMEs in developing countries, compared to large enterprises, is the low level of productivity as a result of an unstable demand for their products and services, and the use of outdated technologies. On the other hand, SMEs have a high share of total corporate profits because the interest of their owners is profit payment. Profit payment and a low rate of reinvestment of capital of SMEs in the end result in a low ratio of capital and liabilities (less than 30%). For this reason, banks, as lenders, categorise SMEs as a high-risk sector.

Lack of financial resources and limited access to them are identified as one of the key problems in the operations of SMEs (Rakićević et al. 2013, 33). In this regard, it is reasonable to ask whether the policies to stimulate SMEs rely on direct intervention in financial markets (with the given risks) or finding alternative sources of SMEs financing. The answer is the latter one, because it is undisputed that without accessible and affordable financial arrangements many companies will not be able to develop their own projects (innovation) and ventures and generate new jobs. That is why we think that alternative sources of funding should be found and explored, and the crowdfunding is one of them.
3. CROWDFUNDING: WHAT IT IS AND HOW IT WORKS

Crowdfunding is a relatively new phenomenon and as such has not been sufficiently explored. However, more frequent use of crowdfunding in the areas of entrepreneurial finance attracts interest of wider academic and socio-political community. As argued by Giudici et al. (2012, 2-3), a crowdfunding research is in its infancy and has two main characteristics: first, it is its interdisciplinary nature, because it is a blend of finance, economics and management, sociology and information systems; the second, it is being discussed both inside and outside of the traditional academic discussions and debates about the crowdfunding can be found in scientific and professional articles, popular books, newspaper articles, and Web portals.

This part of the paper gives a theoretical discussion of the concept of crowdfunding. The first sub-section relates to the definition of crowdfunding, whereas the second describes its functioning.

3.1. Definition of crowdfunding

By studying the relevant literature in this area, we came to the conclusion that there is no a universally accepted and comprehensive definition of crowdfunding. Therefore, in this paper we give a review of the definitions of crowdfunding.

According to De Buyser et al. (2012, 9), crowdfunding can be defined as a joint effort of several individuals who are part of the network and pool their resources to support projects/ventures initiated by other people or organizations. This activity is usually done through or with the help of the Internet. Thus, certain projects and ventures are financed by small contributions from a large number of individuals, allowing innovators, entrepreneurs and business owners to use their social networks to raise capital.

Slightly different definition is offered by Belleflamme, Lambert and Schwienbacher (2013, 8), and according to them, "Crowdfunding involves an open call, mostly through the Internet, for the provision of financial resources either in form of donation or in exchange for the future product or some form of reward to support initiatives for specific purposes."

Ahlers et al. (2012, 4-5) give a similar definition, and quoting Hemer, they define crowdfunding as "open call, essentially through the Internet, for the provision of financial resources either in form of donations (without rewards) or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes."

An interesting opinion can be found in the work Valanciene and Jegeleviciute (2013, 40-1), who think that crowdfunding is based on close cooperation between investors, intermediaries and entrepreneurs, and thus the complete definition of crowdfunding should highlight not only the most important significance of this method but also the relationship between these three types of participants. They argue that the increase in capital and new investment opportunities arise from the successful connections and the result can not be achieved if one party does not cooperate. In this sense, they describe crowdfunding as a way of establishing a link between entrepreneurs who raise capital and new investors who are a source of capital and are willing to invest small amounts of money through Internet intermediaries.

Finally, Mollick (2013, 2), suggests in his paper that the broad definition of crowdfunding is elusive because it is currently applied, and will probably continue to be applied in the future, in many areas. Instead, the author argues that it is advisable that the academic community dealing with the study of alternative sources of financing and entrepreneurial financing in which crowdfunding tends to occupy a special place, takes the narrower definition of this term. According to him, the definition which is specific to the entrepreneurial concept of crowdfunding, while leaving room for further development and upgrading of the concept, is as follows: "Crowdfunding refers to the efforts by entrepreneurial individuals and groups - cultural, social, and for-profit - to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries."

Finally, it can be concluded that crowdfunding is a kind of innovation that is an outgrowth of social media, and is respected by all three participating parties - entrepreneurs, investors and intermediaries. European institutions also discuss carefully about crowdfunding as an alternative source of financing of SMEs, particularly in the context of the Entrepreneurship Action Plan 2020.
Advantages of Crowdfunding as an Alternative Source of Financing of Small and Medium-Sized Enterprises (European Commission 2013), and as such it attracts more attention of the governments of European countries who see it as a way to create new jobs and ensure macroeconomic stability.

3.2. How does crowdfunding work?

Based on the author's own research and experience (participation in donor crowdfunding), and studied literature (besides the above, see also Lehner, 2012), here is a simplified scheme of functioning of crowdfunding (Figure 1) which identifies the actors and their motives, intermediaries and explain how crowdfunding functions, step by step.

**Figure 1: Functioning of crowdfunding**

Crowdfunding actors are the entrepreneurs on one side, and financiers/crowdfunders on the other side. Between them there is an intermediary – Internet, through which they communicate. Crowdfunding is a system that requires close cooperation between three types of participants, as each of them has a mission that leads them together along the desired goal, because individually they do not mean anything.

SMEs, individuals, non-governmental organizations (NGOs) and others usually appear in the role of the entrepreneur. Entrepreneurs are trying to raise funds for their projects/ventures through crowdfunding as an alternative source of financing. They do not only seek to provide capital through crowdfunding, but also test their business ideas. If a large group of individuals is willing to invest,
there is a high probability that the idea is good and will be accepted (Valanciene and Jegeleviciute, 2013, 41).

On the other hand, investors are a large group of ordinary people who recognize the potential of the project or consider certain ideas promising and have an inner urge to participate in the implementation and therefore invest smaller financial resources. In this way, crowdfunding enables ordinary people, who do not possess the competence of professional investors to decide which business ideas will be implemented, and which will not. According to De Buyser et al. (2012, 12), the motives for their involvement in crowdfunding can be: social return, material (in the form of products and/or services), financial return and refund.

Between actors of crowdfunding there is an intermediary – Internet through which all communications and fundraising take place. Actors can communicate directly and indirectly. In the case of direct communication between entrepreneurs and investors, the intermediaries used can be Twitter, Facebook, LinkedIn, Myspace, blogs, their own web sites and entrepreneurs’ resumes (CV), and other methods. In the case of indirect communication, the usual intermediaries are crowdfunding platforms - specialized crowdfunding websites that present different business models of crowdfunding, and allow investors to invest. According to Valanciene and Jegeleviciute (2013, 41), crowdfunding platforms can be divided into two groups depending on the way they behave with the collected money. The first group of crowdfunding platforms holds the funds in an escrow account and if the required amount has not been collected, the money is paid back to investors, whereas other types of crowdfunding platforms allow entrepreneurs to keep all the proceeds.

A simplified description of the crowdfunding platforms functioning is given in the work of De Buyser et al. (2012, 14) and Ahlers et al. (2012, 5), and we believe that we will best explain it with the example of SellaBand.com. SellaBand is an online platform launched in August 2006 with headquarters in Amsterdam and acts as an intermediary between the new music bands and their supporters (fans). It helps musicians to raise money for the issuance of their first professional album. At the beginning of its work it functioned as follows. Musicians can post demo songs on the platform, and in that way visitors to the site can listen to music free and choose the performers that they want to invest in. Artists/musicians try to collect the amount of $ 50,000 with $ 10 in-payments. While the fundraising is ongoing, the paid money is in an escrow account until they collect the amount of $ 50,000. When this amount is reached it is used to finance the recording of the artist's project. Finally, investors are rewarded with an even share of 10% of album sales (SellaBand 2013). SellaBand was the first website of this kind and its followers are MyMajorCompany in France, Akamusic in Belgium and ArtistShare in the United States.

Under the proposed scheme, crowdfunding involves the following activities and it functions as described below (see related numbers in Figure 1):

**Step 1: The entrepreneur identifies an opportunity to raise funds for the financing of projects/ventures through a crowdfunding**

When entrepreneurs have interesting and promising projects, business ideas, innovations, and no possibility of financing them from conventional sources they recognize the opportunity in crowdfunding and send an open call over the Internet for fundraising. At this stage they present economic information, provide information about their projects/ventures and do everything over the Internet that appears to be an effective agent that saves both time and money which are so very important for entrepreneurs.

**Step 2: Crowd/crowdfunder recognizes the opportunity to invest through a crowdfunding**

Investors/crowdfunders are willing to support new ideas and search for interesting projects/ventures in which they can participate and be useful. At this stage they usually use Internet as a vehicle to collect information on projects/ventures, expand their knowledge and skills in order to be ready to provide support. Exchange of opinions and experiences with earlier crowdfunders has the major role in this phase.
Step 3: Making decisions on funding/investment

After the crowd/crowdfunders recognize investment opportunities through crowdfunding, find the project/venture with which they identify and recognize the change and innovation that the project could bring, they decide to help to ensure social confirmation of the project/venture, or make a decision on funding.

Step 4: Implementation of the project/venture

When the initiator of the project/venture raises sufficient funds through a crowdfunding he/she moves into its implementation. Once the project/venture has been realized the next step is taken - reward/rewarding.

Step 5: Reward/Rewarding

Rewards under the crowdfunding can be monetary or non-monetary, and may be absent in the case of a grant. Lamber and Schwienbacher (2010, 9) make difference in their study between donor, active and passive crowdfunding, according to the type of reward received by crowdfunders. There are no material rewards with the grant, as mentioned earlier, given the fact that donors are primarily driven by altruistic motives, and they have a sense of personal satisfaction in supporting a specific project or venture. In addition to rewards, the active crowdfunding provides investors direct involvement in the decision-making process, and in some cases, participation in the distribution of income. Unlike the previous, the passive crowdfunding involves reward, but without direct involvement in the decision-making or spending time and providing expert advice in relation to the project/venture.

In the paper of Kappel (2009, 375) the division is made between the “ex post facto crowdfunding” where funding is provided in exchange for the finished/complete product and "ex ante crowdfunding” where the funds are provided at the beginning in order to achieve mutually desired outcomes (eg, this type can be found in financing political campaigns).

Finally, De Buyser et al. (2012, 10-11) and Gajda and Walton (2013, 7-11), argue that there are basically four types of crowdfunding such as: crowdfunding based on donations, rewards, capital (equity crowdfunding) and credit-debt crowdfunding. In their work, these authors give an overview of potential crowdfunding - modalities which are derivatives or a combination of some of these four types. According to their opinion, the rewards can be as follows, depending on the type of crowdfunding:

- Crowdfunding based on donations: without the right to reward;
- Crowdfunding based on rewards: a contract for a product or service;
- Crowdfunding based on equity: shares, income from the project/venture;
- Credit-debt crowdfunding: loan agreement, repayment plus interest.

4. THE ADVANTAGE OF USING CROWDFUNDING FOR SMALL AND MEDIUM-SIZED ENTERPRISES

Financing of SMEs is disproportionate and largely affected by macroeconomic conditions, be they good or adverse, and under the major impact of market forecasts, stock health, the overall economy, monetary policy (Schwienbacher and Larralde 2010, 11). Since many of these companies are not able to provide the necessary and sufficient funding for their projects/ventures from traditional investors they are forced to seek and use alternative sources of funding, and crowdfunding is certainly one of them.

Provision of financial resources is the main, but not the only advantage of using a crowdfunding. Therefore, the following section of the paper will point out the benefits provided to SMEs through crowdfunding as an alternative source of funding. Of course, in addition to a number of advantages, this method has several disadvantages, but they are not discussed in this paper, and might be discussed in the coming ones.
In their paper, De Buyser et al. (2012, 9) argue that SMEs use crowdfunding for market research, financing and marketing. We basically agree with this statement, but we believe that the advantages of using crowdfunding are more numerous and we distinguish the following ones:

1. The "wisdom of the crowd" argument

Entrepreneurs may require external assistance and support to start their business, or to assess the social potential of their products. Crowdfunders, as opposed to business angels or venture capital funds, do not need to have special knowledge about the industry. The argument of "the wisdom of the crowd," explains that the group/audience can sometimes be more effective in solving problems in a company than individuals or teams, and this eventually means that crowdfunders will be more effective than several individual investors (Schwienbacher and Larralde 2010, 12).

From another point of view, the risk overtaken by crowdfunders can be much lower, and not just because of the smaller amount of money they invest individually, but due to the fact that they can become consumers. The moment the product is launched in the market they have the drive to promote the product, especially if they participate in the distribution of income. In contrast, when the project/venture is financed by several large investors, the product promotion would require significant advertising campaign (Schwienbacher and Larralde 2010, 12).

2. Retaining management control over the company

Funding modalities such as business angels and venture capital funds allow investors the significant control over company decision. Unlike them, crowdfunding need not give investors such rights. Therefore, when a company has raised capital through crowdfunding, the entrepreneurs do not lose their right to make their own business decisions (Valanciene and Jegeleviciute 2013, 43).

3. Removing geographic barriers to investment

The great advantage of crowdfunding, compared to other forms of financing, is the removal of geographic barriers to investment, which means that the geographical distance between the entrepreneur and the investor does not play any role. Confirmation of this can be found in the work of Belleflamme et al. (2013, 11), citing Agrawal, Catalini and Golfarb (2011), who investigated the geographical origin of the consumers who invest in SellaBand platform (which we discussed in the previous section) and noticed that the average distance between the artist - entrepreneurs and investors was almost 5,000 km, suggesting a reduced role of spatial proximity in terms of crowdfunding.

On the other hand, crowdfunding allows people to invest in their communities and thus contribute to sustainable economic development. Most businesses will concentrate on the project within their geographical area, but will try fund-raising globally (Valanciene and Jegeleviciute 2013, 43). Finally, it means that crowdfunding advantage is reflected in the fact that it enables local projects to attract global investors.

4. Market research – marketability

Crowdfunding can provide the entrepreneur valuable signals about the market potential of the product/project that they want to run (Schwienbacher and Larralde 2010, 7). Specifically, it is indicated that demand for the product will be good if it is demonstrated that there is great interest in investing in the presented project/venture, and if it is assumed that investors are at the same time the potential consumers/customers.

5. Marketing purposes – product promotion

Crowdfunding is also used for marketing purposes, it provokes interest in new projects in the early stages of their development and it helps to achieve competitive advantage even before the projects see the light of day (Mollick 2013, 3).

According to Gajda and Walton (2013, 2), the main advantage of crowdfunding is reflected in the fact that financiers are also potential customers and ambassadors of the project and will assist in its promotion through their own networks. The financier is usually identified with the project, being open to change and willing to help to ensure the social confirmation of the concept.
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6. Cost reduction

According to Schwienbacher and Larralde (2010, 6), one of the reasons why companies use crowd is cost reduction. By participating in the creation of a product and improving its design, the crowdfunding can contribute to creating value for the company/entrepreneur. Moreover, it allows the company to reduce the length of the development of new products, as well as their costs, and to have better accepted product in the market.

Finally, we can conclude that, without additional costs, no other form of investment but the crowdfunding can facilitate the sale of the product in advance, market research and mouth-to-mouth promotion.

It can be said that crowdfunding is now one of the most promising tools to facilitate innovation, facilitate the generation of jobs and ensure economic growth. De Buyser et al. (2012, 8), believe that crowdfunding is one of the most attractive ways to fund new ideas, small business and job generation throughout Europe. According to them, it is a very democratic tool that will enable the creation of value on many levels, not only in the domain of the finance.

5. CONCLUSION

In this paper, the crowdfunding is seen as an alternative way to fill the gap in the absence of capital for SMEs marginalized by traditional funding sources. The study carried out in this paper is an attempt to clarify various aspects of crowdfunding and the benefits of its use for SMEs and thus gain more knowledge on this fast-growing phenomenon.

In any case, each SME will have to balance the advantages and disadvantages of various alternative forms of financing, but it is highly likely that crowdfunding will be the cheapest source of funding for most projects/ventures (Lambert and Schwienbacher 2010, 12). According to Lambert and Schwienbacher (2010, 12), the crowdfunding can be seen as a broader concept whose sole aim is not only to raise funds, but it is also a way to develop corporate activities through the process of raising funds.

The potential and significance of crowdfunding is recognized around the world. The USA President Obama signed the JOBS Act (Jumpstart Our Business Startups) on 5 April 2012. This Act legalized the equity crowdfunding (a model that gives ownership shares) in the initial projects/ventures by the so-called "non-accredited" investors and it has been in force since the beginning of 2013. That is why the U.S. magazine Forbes declared 2013 as the "year of the evolution of crowdfunding" (Caldbeck 2012, Forbes 2013). European Crowdfunding Framework (De Buyser et al. 2012) also emphasizes the importance of this alternative form of financing and brings the political debate in Europe on this issue.

In accordance with the Action Plan of the European Commission Entrepreneurship 2020 (European Commission 2013), the crowdfunding as an alternative for funding of SMEs is discussed seriously within European institutions. The group of their experts claims that crowdfunding can actually have the potential to become an important source of financing for SMEs concerned with the lack of funds, and in conclusion, they state that it is necessary to stimulate crowdfunding in Europe without over-regulation, but with adequate protection of investors and entrepreneurs.

Finally, it can be concluded that crowdfunding as an alternative source of financing of SMEs makes capital more accessible and efficient, and in the end, creates more jobs and increases GDP. Therefore, European, national and local legislators and policy makers need to recognize in it a chance and join forces to establish legislation that will be supportive of the development and expansion of a crowdfunding in Europe.
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