

# SOCIAL ENTERPRISES' STARTUPS: POSSIBILITIES AND BARRIERS

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## **Abstract**

**Purpose** - In capital markets, the primary interest of all parties involved is to build a profitable entity and to earn a high return on investments. Meanwhile, social enterprises' primary goal is to solve topical social and economic issues of society. Thus, the capacity to attract funding is tied to the specific social problem or need that is being addressed. Consequently, social enterprises dispose of fewer channels for accessing unrestricted sources of risk seed capital than traditional ones. The purpose of this paper is *to investigate the possibilities and barriers* with regard to social enterprises becoming startups.

**Design/methodology/approach** – Qualitative research methods including individual semi-structured interviews with experts and desk research were undertaken.

**Findings** – As startups, social enterprises possess the ability to attract investments, especially impact and angel investments.

**Research limitations/implications** – Due to the limited time, validity and generalisation, further research with additional data is needed to verify social enterprises' envisaged possibilities of being startups. Also, continued efforts are required to adjust risk capital markets to some extent, making them more accessible to social entrepreneurs' needs.

**Originality/value** – The article suggests that there are certain expectations to receive social and financial returns on investments and this balance could benefit both investees (social enterprises) and investors, as well as society on the whole.

**Keywords:** *social enterprises, startups, financial mechanisms*

**JEL Classification:** *L31, M13, G21*

**Classification:** *Research paper*

## **1. INTRODUCTION**

Setting up a social enterprise startup can be more complicated than launching a traditional one since the social mission is as important as financial viability, resulting in greater difficulty in accessing capital and funds, which arises from the limited or even absent understanding of social enterprises and of the social value they generate.

The aim of this research paper is to *investigate the possibilities and barriers* for social enterprises with regard to becoming startups. The article bridges the gap in the existing knowledge on how social enterprises might be startups that attract various investors.

In order to fulfil the aim of the paper the following tasks were assigned: to examine possibilities and barriers that social enterprises might encounter as startups approaching potential investors; to clarify areas of business where social enterprise startups might succeed; to determine who social enterprises' potential investors could be and to examine other funding possibilities; to define the proper supporting mechanisms of social enterprise startups.

This article provides an overview of SE startup possibilities and barriers and presents the findings of prominent authors such as Blank, S. and Dorf, B., Ries, E., Mair, J. and Marti, I., Miller, T., Austin, J., Nicholls, H., LePoutre, J. and others on the issues of social enterprises and startups.

Moreover, in this paper the author has outlined an acknowledged need to access seed and growth-stage capital to foster social enterprises' development and their positive impact on society. It is undeniable that social enterprises have far fewer channels for accessing unrestricted sources of capital.

## **2. THEORETICAL FRAMEWORK OF THE RESEARCH**

Social entrepreneurs create social enterprises by identifying a social problem, pursuing opportunities based on it and developing an innovative means of addressing the problem that generates social and economic value (Mair and Marti, 2006). That is, social enterprises are organizations that

address conditions harmful to society using business (i.e. market-based) methods (Miller et al., 2012). Hence, social entrepreneurship has been labelled “caring capitalism” because of the achievement of relevant social goals within a market framework (Hibbert et al., 2005; Herman and Rendina, 2001).

In fact, social enterprises do business by putting society and positive social change at the core of all their activities. As a sector, social entrepreneurship is experiencing explosive growth (Lepoutre et al., 2013) and is attracting growing amounts of entrepreneurial talent, funding and attention (Choi and Majumbar, 2014).

Lepoutre et al. (2013) have found that countries with higher rates of traditional entrepreneurial activity also tend to have higher rates of social entrepreneurial activity. Also, they explored types based on social mission, revenue model, and innovativeness while developing a methodology to measure population-based social entrepreneurship activity prevalence rates using the Global Entrepreneurship Monitor (GEM) methodology of Total Entrepreneurial Activity (TEA).

The Social Business Initiative’s (SBI) definition of a social enterprise incorporates its three key dimensions, which have been developed over the last decade through academic and policy literature:

- an *entrepreneurial* dimension: engagement in continuous economic activity;
- a *social* dimension: a primary and explicit social purpose; and
- a *governance* dimension: the existence of governance mechanisms to ensure prioritisation of the social purpose and which demonstrate sensitivity to different stakeholder interests.

Similarly, the set of core criteria reflecting the obligatory conditions that an organization has to meet to be identified as a social enterprise under the EU definition are as follows:

- the organisation must engage in *economic activity*;
- it must pursue an explicit and *primary social aim* that benefits society;
- it must have *limits on distribution of profits or assets* to prioritise the social aim;
- it must be *independent* from the State or other for-profit organisations;
- it must have *inclusive governance* i.e. characterised by participatory and/or democratic decision-making processes.

Meanwhile, Kerlin (2006) noted that a social enterprise means different things in different national contexts. Thus, there is a sophisticated discourse about both the criteria and definition of a social enterprise and social entrepreneurship as a whole. Haugh (2005) emphasised that a social enterprise is a collective term for a range of organizations that trade for a social purpose adopting one of a *variety of different legal formats* but sharing the principles of pursuing business-led solutions to achieve social aims and the reinvestment of surplus for community benefit. The objectives focus on socially desired, nonfinancial goals and their outcomes are the non-financial measures of the implied demand for and supply of services. Respectively, Mair & Martí (2006) assume that social entrepreneurship brings about social change and should be viewed as *a cross-sectoral domain* where legal structure and sectoral belonging are less important and social change prevails. Analogically, Nicolls (2006) reckons that “social entrepreneurship represents *an umbrella term* for a considerable range of innovative and dynamic international praxis and discourse in the social and environmental sector”.

One critical issue that has yet to receive extensive attention is how social entrepreneurs acquire the resources they need. Like traditional entrepreneurs, social entrepreneurs must assemble financial capital and other resources to launch and grow their organizations (Austin et al., 2006). Specifically, there seems to be widespread agreement among practitioners that social entrepreneurs confront considerable resource acquisition challenges (Kim et al., 2011), as, quite often, social enterprises are not well understood by traditional investors, who usually think in black and white terms regarding charity and business.

Furthermore, a social enterprise represents an organizational form that fosters two different types of logic: social-welfare and economic (Nicholls, 2010). As Philip (2014) notes, combining multiple types of logic means that social entrepreneurs need to balance them, not only in performing activities but also in ensuring well-developed business narratives in communication with investors by emphasizing strong business models.

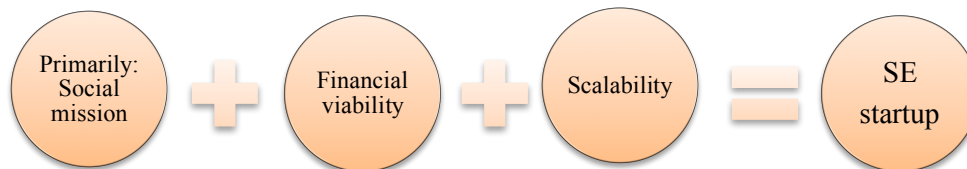
In spite of the fact that social enterprises have gained international prominence and acknowledgement worldwide by putting forward social and environmental goals along with economic values, the *issue of their financial sustainability* is still topical.

To be more precise, *little research* has been conducted to investigate the possibilities and barriers

for social enterprises with regard to becoming startups in the Baltic States. *Few attempts* have been made to identify and analyse the specific possibilities and barriers for social enterprises as startups in the Baltic States.

As to startups' essence, Blank and Dorf (2012) define a startup as "an organization formed to search for a *repeatable* and *scalable* business model", where agile development eliminates wasted time and resources by developing the product iteratively and incrementally. It is undeniable that a typically successful startup has to be highly *profitable*, quickly generating immense return on investments for its investors.

Boschee & McClurg (2003) consider that only *earned income* will ever allow a social enterprise to become a financially sustainable or self-sufficient entity without depending on charitable contributions and public sector subsidies. Profitability is a goal, but it is not the only one, and profits are re-invested in the mission rather than being distributed to shareholders (see Figure 1).



**Figure 1.** Social Enterprise Startups' Goals

*Source: created by the author*

SE startups' goals incorporate social and economic goals in order to solve burning social problems while at the same time being financially sustainable.

Social entrepreneurship involves the recognition, evaluation, and exploitation of opportunities (Austin et al., 2006) and demonstrates "risk-tolerance, innovativeness and pro-activeness", similarly to conventional entrepreneurship, in the social arena (Peredo and McLean, 2006). Specifically, the fundamental premise of social entrepreneurship is to use business knowledge and entrepreneurial principles to solve critical dilemmas facing a society regarding economic, social and environmental problems (Germak and Singh, 2010). Moreover, social entrepreneurs are enterprising individuals "devoted to making a difference and reshaping the way we think about social value creation" (Mair and Marti, 2006). Several scholars and researchers have characterized such enterprises as "hybrids" (Davis, 1997) to reflect their combined interest in creating social value, which is the basis of social entrepreneurship, and generating profit, which is the primary goal of commercial entrepreneurship.

Furthermore, the theory of Lean Startup Methodology (LSM) represents an advanced approach to doing business with the emphasis on *agile* testing and learning from the customer to produce solution-based products. This is an iterative process where problem, product, and customer hypotheses are developed and validated (Ries, 2011).

In accordance with an OECD (2013) report social enterprises may be newly created startups or entities created by the transformation of pre-existing private or government organisations.

As a matter of fact, the proactive approach of *impact investment* might generate a measurable social and financial return. Among the products and strategies that correspond to it as sources of financing for social enterprises, the following could be mentioned: quasi-equity / equity instruments in ethical or social capital markets; solidarity finance; venture philanthropy; individual investment; institutional investment (Mendell and Nogales, 2009); and crowdfunding.

Family offices and high-net-worth individuals constitute approximately 17% of total capital raised by fund managers and are among some of the leading investors in impact investments – a practice forecast was worth \$12.7 billion (€9.4 billion) in 2014, according to the Impact Investor Survey, released by JP Morgan and the Global Impact Investing Network (GIIN).

Alongside this, innovative institutional arrangements between financial organisations and governments might be advocated, for instance through policy measures that co-invest with the private sector and that pursue social returns as well as financial ones. This could be executed by various means, embracing fiscal incentives for investors in social enterprises and/or direct inclusion of public funds into financial mechanisms, fostering cooperation between financial organisations, the third sector and governments (Mendell and Nogales, 2009).

*Social capital markets* are dedicated to the flow of capital towards the social good by addressing society's toughest challenges. As Mendell and Nogales (2009) revealed, in spite of the criticisms and some experience of failure in launching such a system, the conception of a social finance exchange continues to attract social investors, proving that doing good has two bottom lines: social and financial.

*Solidarity finance* is distinguished by the fundamentally principal role of citizens and the variety of socially oriented projects that are supported. The developing sphere of solidarity finance could serve as a meaningful source of capital for social enterprises that meets the criteria required by socially responsible investors (through placements or pro-active investments) expanding this activity to the social investment market (Kritikos, et al., 2007). In Europe there is a network of solidarity finance organisations (FINEUROSOL), which is supported by the European Commission.

*Venture philanthropy* is the utilisation of the venture capital model for a social investment strategy to generate blended returns in the form of financial revenues and social impact. Innovative social investment strategies incorporate finance, business advice and monitoring, allowing social venture philanthropists to introduce new methods by modifying the focus from what were regarded as no-return and maximum-risk charitable funds to the innovative entrepreneurial aspect of initiatives (Cheek, et al., 2015). In Europe the European Venture Philanthropy Association (EVPA) operates quite successfully, representing a variety of venture philanthropists who are engaged in financing social enterprises.

It has been found (OECD, 2013) that *individual investors* are also a source of finance for social enterprises, although their presence is uneven across countries. Two types have been identified: the first refers to socially motivated *high-net-worth investors* (angel investors) whose money is managed by financial advisors, with investments ranging from EUR 100 000 to a few million euro on a long-term basis; the second type is represented by *small-scale investors* (citizen investors), who support local initiatives through local circles of investors with financing from very small amounts to EUR 10 000.

*Institutional investors*, including pension / mutual funds, insurance companies and banks, do not invest in social enterprises directly but through intermediaries as dedicated debt or equity-oriented investment funds since they lack expertise in identifying and selecting social enterprises (Groh and Liechtenstein, 2009). For example, over the last decade in France, the US and Canada, institutional investors have already been targeting the needs of social enterprises, but there are some obstacles in terms of legal issues and adherence to fiduciary responsibility. Also, the European Parliament has approved new regulations on European social entrepreneurship funds and European venture capital funds.

*Crowdfunding* could contribute to the needs of social enterprises in terms of equity being a powerful alternative to traditional investors. Crowdfunding or microcredit platforms such as Kiva, Just Giving and Babyloan have been raising extensive funds dedicated to social projects. According to the Crowdfunding Centre (2014), the highest performing countries based on the number of successful projects (period: 2014 Q2 – April, May & June) were the USA, the UK, Canada, Germany, France, Australia and Italy. Research on crowdfunding in Europe performed by the European Crowdfunding Network (2014) suggests that in order to promote crowdfunding, the European Commission should create a legal framework. Also, Profatilov, Bykova & Olkhovskaya (2015) consider that “crowdfunding gains more and more economic power and requires regulation at the legislative level”.

Regarding Latvian social enterprises, it could be stated that they lack not only a legal framework and recognition in society but also the financial support mechanisms revealed in a study by Lesinska et al. (2012), including financial instruments to attract private investors as well as state and municipal grants and a more developed ecosystem embracing business incubators, accelerators, and hubs dedicated to social enterprises. As Lesinska (2014) noted, most social enterprises in Latvia chose the legal form of the association, that is, non-profit, in looking for donors in order to obtain financing, and only a small part of social enterprises generated some return on economic activities.

A country report (Wilkinson et al., 2014) disclosed that the social investment market did not exist in Latvia. When approaching banks or investors, social enterprises are treated the same as any other enterprise; there are no specialist intermediaries or financial products catering to the specific business models and/or needs of social enterprises. Most social entrepreneurs started their businesses with their own capital, indicating a lack of willingness to take out bank loans due to the perception that external borrowing would decrease their level of independence. Currently, grants are the main form of external finance available to social enterprises.

It has been assumed (EC, DG for Employment, Social Affairs & Inclusion, 2015) that social enterprises in Europe typically adopt a ‘hybrid’ business model, i.e. they derive their revenues from a combination of: market sources, e.g. the sale of goods and services to the public or private sector; and non-market sources, e.g. government subsidies and grants, private donations, non-monetary or in-kind contributions such as voluntary work, etc. Social enterprises thus rely on a mix of revenue streams.

Aside from this, a notable dynamic through which social enterprises are generating earned income is the increasing contracting out of services in healthcare, social care, education, criminal justice, leisure and a host of other areas by public authorities across Europe as a means of securing the best value for money and offering greater choice and personalisation to the users of these services.

The author considers that the variety of potential areas where social enterprises might operate, benefitting society and at the same being profitable, could expand along with changes in society by providing solutions to topical problems, as there are still some gaps which the business and public sectors cannot resolve.

### 3. RESEARCH METHODOLOGY

A triangulation principle has been utilized in this research paper since it is a powerful technique that facilitates validation of data through cross-verification from several sources, both primary and secondary, and by exploiting the following methods: an empirical qualitative research method, in particular semi-structured expert interviews in the fields of social entrepreneurship and startups, and a theoretical qualitative research method – to be precise, desk research.

For data processing, the author has employed qualitative encoding, analysis, interpretation, generalization and elaboration. Theoretical methods, which comprise descriptive, logical and comparative analyses as well as inductive reasoning for the expert interviews and deductive reasoning for assumption testing, have been employed for qualitative data analysis.

The aim was to *investigate the possibilities and barriers* which social enterprises might encounter while searching for investors.

The author conducted six semi-structured expert telephone interviews following a list of questions, but at the same time there was flexibility in how and when the questions were asked, allowing space for the experts to answer on their own terms while sticking to the structure for comparison across the interviewees with a focus on the content and context of the interview.

Among the advantages of the expert interview method, the following could be mentioned: fast access to the field, a quick way of obtaining specific information, less time-consuming than many other methods.

The interview type could be classified as a combination of explorative and theory-generating interviews, which are applied as an orientation in a little investigated field with a focus on subjective aspects of experts’ knowledge, motives, and implicit beliefs to be able to compare and aggregate data.

The interaction type of the expert interviews can be identified as co-expert, conveying a semi-formal dialogue, and the style of questioning was unbiased. The questionnaire was created in February 2016, and the interviewing took place in March and April, 2016, in the Latvian language.

The experts were asked five questions, four of which were open-ended and one of which was semi-open. The questions were structured to clarify whether it is possible for social enterprises to be startups and attract investors as well as to identify the key possibilities and barriers along with the most appropriate ecosystem tools which may benefit social enterprise startups and the funding mechanisms available to them.

According to the Macmillan Dictionary an expert is “someone who has a particular skill or who knows a lot about a particular subject”, that is to say, a person who is very knowledgeable about or skilful in a particular area. The author classifies the respondents as experts since they have specific experience and requisite knowledge in the fields of social entrepreneurship and startups, researching, developing, promoting and working in these areas.

The author selected six experts in the fields of social entrepreneurship and startups. Among them are practitioners and policymakers: an Executive Director of the Social Entrepreneurship Association in Latvia, a freelance non-formal education trainer and fundraising consultant; the Head of the Board at the Latvian Startup Association and the initiator and Director of the Labs of Latvia project; the Head of RISEBA Creative Business Incubator, a lecturer and expert on startup companies and creative industries, the founder and CEO of BIORGANIK Ltd.; a curator at Startup Genome and co-founder at

Tactile Eyesight, also a strategic consultant at Social Media Mapper; the co-founder of the Latvian social enterprise startup LuDE, a CEO at ALINA LLC; the co-founder of the Latvian social enterprise startup Edurio.

According to the Latvian concept of social entrepreneurship as expressed in “The introduction of social entrepreneurship opportunities in Latvia” (2014), social enterprises can be registered in the commercial register as limited liability companies and operate like any other businesses, though it is stated that the majority of them are not sustainable enough in the present business environment. In the future, it is envisaged to give them special status as social enterprises, which will allow them to receive some benefits in state and municipal procurement as well as other financial and non-financial support. Apart from that, the Social Entrepreneurship Association (SEA) was founded in Latvia in 2015 and the pilot project of support activities was launched by the Ministry of Welfare and the financial development institution ALTUM in January 2016 and will continue up to December 2018. Then, based on the project’s results a draft law on a social entrepreneurship framework will be prepared.

A number of steps were taken for the analysis of expert interviews, including: transcription, paraphrasing, headlining, comparison, conceptualization and theoretical generalization.

#### 4. RESEARCH RESULTS

All the experts answered positively to the first crucial question, regarding whether it is possible for a social enterprise whose primary goal is social to be a startup that attracts investors who are interested in potentially highly profitable and fast growing companies. Among the possibilities of how to make it happen, the experts outlined the following preconditions.

Firstly, a social enterprise could be potentially highly profitable and fast growing if it solves a *global* social and/or economic issue while offering products and/or services for a global market.

Secondly, a social enterprise has to adopt a proper business model, for instance, a *hybrid* social enterprise where for-profit and non-profit entities are united and there are three types of integration: embedded (social and economic activities are one and the same), integrated (social and economic activities are synergetic) and external (social and economic activities are linked only through funding). Definitely, a *for-profit* social enterprise model, where *business cannot be separated from the social mission, that is, a product or a service that is sold, triggers social or environmental change*.

Thirdly, the experts acknowledged the specific types of investors that could be attracted, that is, a *new generation of so-called impact investors, who are targeting for-profits and hybrids with social missions, broadening the base of potential clients. Social entrepreneurs have to prove their dual (social and economic) value generation to investors, quantifying not only their financial results but also their social impact. Aside from this, one of the experts, who is a practitioner, noted that the key distinguishing factor in the definition of a social enterprise might be a positive social impact, but not 100% reinvestment of surpluses. Also, angel investors (high-net-worth individuals) were recommended by experts as a possible option for small and medium-sized social enterprise startups, as they typically make decisions on their own and invest in deals earlier than venture capitalists.*

*The second question addressed the areas of business where social enterprise startups might be potentially attractive to investors, in other words, where they see the highest return on investment (ROI), as well as social return on investment (SROI), which is an extra-financial value not reflected in conventional financial accounts but relative to resources invested.* The majority of experts placed the main emphasis here not even on the particular area but on scaling for *global product distribution*. Apart from that, several experts indicated that specifically the *healthcare* industry – for example, preventive rehabilitation services, senior housing and continuing care for retired, assisted living and long-term care services and facilities – could provide global solutions to global markets. Also, IT and technology, ecology, education and logistics, and, specifically, ordering food via the Internet were mentioned by the experts as potentially attractive areas of business for social enterprises as startups. Meanwhile, work integration social enterprises (WISE) were considered by some experts as a bit less attractive due to their low competitiveness, since the work performance and productivity of their employees might be lower than at the average traditional enterprise. However, work integration social enterprises are not sector-dependent and have viable perspectives of growth and development, which was also indicated by the experts. The challenge in this case would be how to organize job coaching and occupational competence training cost-effectively so that it would not become a significant competitive disadvantage.

The next question concerned the barriers that impede social enterprises from being startups and attracting investors. Almost all the experts indicated that in most cases traditional commercial investors simply do not clearly understand the *essence of social entrepreneurship* as well as the value of the social impact added to the financial returns on investments. Moreover, the experts affirmed that it would take longer for social enterprises to become profitable and generate high return on investments.

The questions regarding appropriate funding possibilities for social enterprise startups and the most efficient ecosystem support mechanisms and tools could be united in one block since the experts' responses to them complemented each other. For instance, several experts agreed that *business hubs* oriented toward social enterprises might be powerful ecosystem builders as they could aggregate networking opportunities and relevant expertise along with advice while offering office space and facilities at a low rent in one place. So, they could support newly created social enterprise startups through the tricky early stages. One of the core features of business hubs outlined by the experts was community orientation, as in general they are created to nurture a local network of like-minded and focused entrepreneurs, providing a place where they can work, meet, collaborate, network, learn and even have fun. As to the European experience, some business hubs are privately run for a profit, some are managed by universities, and others are run by local authorities or charities.

Aside from this, some experts suggested that *seed accelerators* would suit the best social enterprise startups, since they might boost intensive business trainings (3-6 months) culminating in a public pitch event or demo day when the startups could be presented to potential investors. Also, there is a highly competitive selection process ensuring that only the most motivated, talented and sustainable startups would participate in the training. However, some of the experts noted that accelerators were too aggressive and assume that an entity will be financially viable in a very short period of time, just 3-6 months, which could be quite challenging for social enterprises as it takes longer for them to become self-sufficient.

Meanwhile, several experts proposed *business incubators* as a helpful tool for long-term ecosystem creation (up to 2 years) for social enterprises, through which they could enjoy tailored well-structured pro bono services, mentoring addressed specifically to their needs, and premises for a rental price that could be substantially lower than the average one on the market. However, there were experts who considered business incubators quite counterproductive since they might introduce the opposite of a startup environment, which could be classified as a comfort zone with a glass house effect.

As to other funding possibilities for social enterprise startups, the experts suggested *state and municipality support mechanisms* in the forms of public procurement, grants, premises, pro bono services, as well as *EU funds*, since the social impact factor is highly valued in any EU project. At the same time, the experts warned that while applying for the abovementioned funding possibilities, these supporting mechanisms could appear quite inflexible and bureaucratic, consuming a lot of time and unable to adjust quickly to anything new.

Finally, *crowdfunding* was recommended by the experts as a potential source for seed and growth capital. However, raising the necessary amount of money was believed by the experts to be a quite complicated process and not generally a successful one, taking into consideration the experience of our Latvian startups, as they were not able to collect the necessary sums for their entities. Nevertheless, crowdfunding platforms were considered by the experts as a useful mechanism for analysing the results, even negative results, as they show if there is any demand for a product or service.

## 5. CONCLUSIONS AND RECOMMENDATIONS

Taking everything above into consideration, the author may conclude that social enterprises have the potential to be startups with the ability to attract various types of investors, especially *impact* and *angel* investors. Moreover, global social and economic solutions targeting global markets while operating in various areas of business, such as healthcare, social care, education, the environment, IT and technology, could potentially ensure the success and financial viability of social enterprise startups.

Apart from this, *for-profit* and *hybrid* business models of social enterprises could fulfil investors' expectations of receiving financial as well as social returns on investments, benefiting both the investees (social enterprises) and the investors as well as society on the whole. Meanwhile, *hubs, accelerators, and business incubators* oriented toward social enterprises might provide the necessary support, promoting their development.

Furthermore, to stimulate the emergence of social enterprise startups, there should be a clear

*understanding* of social enterprises' essence among investors and within the traditional finance sector. Aside from this, crowdfunding together with EU, *state, and municipal financial support mechanisms* could serve as *additional funding possibilities*, critical for seed and growth capital in the early phases of social enterprise startups.

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