

PDF hosted at the Radboud Repository of the Radboud University Nijmegen

The following full text is a publisher's version.

For additional information about this publication click this link.

<http://hdl.handle.net/2066/130115>

Please be advised that this information was generated on 2020-11-28 and may be subject to change.

6-6-2009

A PLEA FOR INDIVIDUALLY 'IRRATIONAL' ENTREPRENEURSHIP: HOW ENTREPRENEURIAL OVERCONFIDENCE AFFECTS PAYOFFS OF AN ENTREPRENEURIAL POPULATION (SUMMARY)

Diemo Urbig

Max Planck Institute of Economics, Germany, urbig@econ.mpg.de

Utz Weitzel

Utrecht University School of Economics, Netherlands

Recommended Citation

Urbig, Diemo and Weitzel, Utz (2009) "A PLEA FOR INDIVIDUALLY 'IRRATIONAL' ENTREPRENEURSHIP: HOW ENTREPRENEURIAL OVERCONFIDENCE AFFECTS PAYOFFS OF AN ENTREPRENEURIAL POPULATION (SUMMARY)," *Frontiers of Entrepreneurship Research*: Vol. 29: Iss. 6, Article 19.

Available at: <http://digitalknowledge.babson.edu/fer/vol29/iss6/19>

This Summary is brought to you for free and open access by the Entrepreneurship at Babson at Digital Knowledge at Babson. It has been accepted for inclusion in Frontiers of Entrepreneurship Research by an authorized administrator of Digital Knowledge at Babson. For more information, please contact digitalknowledge@babson.edu.

**A PLEA FOR INDIVIDUALLY 'IRRATIONAL' ENTREPRENEURSHIP:
HOW ENTREPRENEURIAL OVERCONFIDENCE AFFECTS PAYOFFS OF AN
ENTREPRENEURIAL POPULATION**

*Diemo Urbig, Max Planck Institute of Economics, Germany
Utz Weitzel, Utrecht University School of Economics, Netherlands*

Principal Topic

Although entrepreneurship is generally considered positive, it is unclear if policy should discourage unrealistically overconfident people from becoming entrepreneurs (e.g., Parker, 2007). Despite decreasing actual profits, biased behavior can trigger information externalities relevant to entrepreneurship (Shane and Venkataraman, 2000) and ultimately create advantages for populations with biased rather than unbiased members (Bernardo and Welch, 2001). Existing studies on information externalities focus on overconfidence in privately acquired information, but ignore the effects of being overly optimistic about one's competences and idiosyncratic risks, i.e. optimistic overconfidence. Despite the importance for entrepreneurship policies, analyses on the optimal magnitudes of such biases, their prevalence within populations, and their relations to market size, are largely absent in the literature.

Methods

Building on economic models of social learning focusing on effects of information externalities, this study provides a theory-based analysis using a quantitative model that comprises characteristics central to entrepreneurship. Observable entrepreneurial decisions and outcomes are considered as potential information externalities. An upper limit for the number of successful exploitations reproduces the ambivalent property of late decisions to be more informed, but running the risk of entering a saturated market (Lévesque and Shepherd, 2002). A theoretical analysis, supplemented by numerical analyses, investigates the effects of the model parameters.

Results and Implications

The analysis shows that a balanced combination of overconfidence in privately acquired information and optimistic overconfidence is often better for a population's welfare than unbiased entrepreneurship. Magnitudes of optimal biases depend on market size and idiosyncratic risks, both of which influence the benefits of information externalities. "De-biasing" might make potential entrepreneurs more rational in a narrow sense, but it is likely to reduce a population's expected profit. Implications for entrepreneurship policy are discussed.

David Hart starts his book on entrepreneurship policy (2003) by saying that we should not toss the entrepreneurship baby out with the dot-com bath water. Similarly, we can conclude that we should not toss the entrepreneurship baby out with the water of irrationality. Making potential entrepreneurs more rational should not be the default strategy for dealing with entrepreneurs' cognitive biases within entrepreneurship-oriented policy.

CONTACT: Diemo Urbig; urbig@econ.mpg.de; (T) +49 3641 686 771; (F) +49 3641 686 710; Max Planck Institute of Economics, Kahlaische Str. 10, 07745 Jena, Germany.