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

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Abstract

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.

KEYWORDS: biased behavior, information externalities, optimistic overconfidence

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HOW ENTREPRENEURIAL OVERCONFIDENCE AFFECTS PAYOFFS OF AN
ENTREPRENEURIAL POPULATION**

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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.

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