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"I think I can, I think I can": Overconfidence and entrepreneurial behavior

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Abstract

High failure rates and low average returns suggest that too many people may be entering markets as entrepreneurs. Thus, anticipating how one will perform in the market is a fundamental component of the decision to start a business. Using a large sample obtained from population surveys conducted in 18 countries, we study what variables are significantly associated with the decision to start a business. We find strong evidence that subjective, and often biased, perceptions have a crucial impact on new business creation across all countries in our sample. The strongest cross-national covariate of an individual's entrepreneurial propensity is shown to be whether the person believes herself to have the sufficient skills, knowledge and ability to start a business. In addition, we find a significant negative correlation between this reported level of entrepreneurial confidence and the approximate survival chances of nascent entrepreneurs across countries. Our results suggest that some countries exhibit relatively high rates of start-up activity because their inhabitants are more (over)confident than in other countries.

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> "Young men of an adventurous disposition are more attracted by the prospects of a great success than they are deterred by the fear of failure."
> Alfred Marshall (1920, p. 554)

1. Introduction

Many new businesses fail shortly after inception (Baldwin, 1995; Dunne, Roberts, & Samuelson, 1988), and entrepreneurship is a career choice that does not pay on average. Hamilton (2000) has shown that, except for the highest 25% of entrepreneurial incomes, staying in a wage job or moving back to it makes more economic sense than starting a new business. Along similar lines, Moskovitz and Vissing-Jørgensen (2002) have investigated the risk-return profile of investments in private enterprises and found them to be inferior to those in publicly traded assets such as stocks. High business failure rates and low average financial returns to entrepreneurship suggest that, at least with respect to pecuniary interests and individual welfare, too many people may be entering markets as entrepreneurs.

Given the social and economic relevance of creating new businesses, it is important to understand how entry decisions are made, what factors influence individuals who make these decisions, and what kinds of errors these individuals are likely to make. Excess entrepreneurial entry into markets has also been demonstrated in experimental studies and causally linked to overconfidence. Camerer and Lovallo (1999) run a simultaneous market-entry experiment where the payoffs of participants decrease with the number of entrants, i.e. the intensity of competition. Their findings showed that entering subjects thought that the total profit earned by all entrants would be negative but estimated that their own profit would be positive. Camerer and Lovallo (1999) also suggest that the analysis conducted with field data would be a very desirable way to study further the possibility of overconfidence as an explanation for excess entry and an especially compelling complement to experimental evidence. Finding empirical evidence of overconfidence requires measuring entrepreneurial confidence and linking such measure to actual start-up activities. Our paper contributes to this area of inquiry.

Using a large sample obtained from surveys conducted in 18 countries, we use probit analyses to study what variables have a significant impact on an individual's decision to start a business. Data used in our analysis were collected for the 2001 population survey of the Global Entrepreneurship Monitor (GEM) project. GEM is an ongoing large scale academic project designed to study the causes and implications of entrepreneurial behavior across countries. The main purpose of the survey was to create a representative random sample of population in each country and to identify individuals in each sample who, at the time of the survey, owned and managed a business or were in the process of starting one. Our data are original and exceptionally well suited for our purpose since they do not rely on the respondents ex post explanations for their own decisions. In other words, our data do not suffer from "hindsight bias" (Fischhoff, 1975; Thaler, 2000).