



Learning about the unknown: How fast do entrepreneurs adjust their beliefs?[☆]

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Abstract

This paper seeks to measure the extent to which entrepreneurs adjust their beliefs in the light of new information, instead of relying on past experience to guide their decision making. We build a model in which entrepreneurs continually receive valuable but noisy market signals about the true but unobserved productivity of their effort, and use this information to update their expectations of unobserved productivity. The model is estimated using a sample of over 700 self-employed Britons interviewed in 1999 and 2000. It is found that on average, these individuals adjust their expectations of unobserved productivity in the light of new information by only 16%. This suggests that while entrepreneurs do exploit new information, they give much greater weight to their prior beliefs when forming their expectations. Also, there are no significant differences in terms of expectation formation between males and females, employers and non-employers, and experienced and less experienced entrepreneurs. However, younger entrepreneurs respond significantly more sensitively to new information than older entrepreneurs do, with adjustment rates of 21% compared with 14%, respectively. We go on to discuss some policy implications of these findings, and briefly discuss several features of entrepreneurship

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education programs that might help entrepreneurs improve this aspect of their business performance.

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1. Executive summary

To what extent do entrepreneurs rely on past experience when making decisions about their business ventures? And to what extent do they utilise new information about their venture's performance to learn about their true (but unknown) abilities and trading environment? These are empirical questions that we seek to address in the present paper. We do so by building a model in which entrepreneurs continually receive valuable noisy market signals, which they use to update their expectations as new information comes in. We embed a dynamic iterative formulation of this process into a model of optimal effort. This is analysed econometrically to estimate the extent to which entrepreneurs adjust their beliefs in the light of new information.

Knowing the extent to which entrepreneurs adjust their beliefs and so engage actively in learning is desirable for several reasons. First, such knowledge might help us to gauge how 'alert' entrepreneurs are, in the sense of Kirzner's (1979) conception of an entrepreneur who observes the market and reacts alertly to opportunities he/she perceives. The approach that we propose generates evidence that sheds light directly on this question.

Second, if entrepreneurs ignore or respond sluggishly to new information, that might hinder venture performance and ultimately the vitality of the economy as a whole. Some recent research findings suggest that this can be a serious problem in practice (Berry, 1996; Lybaert, 1998).

Third, a belief that entrepreneurs are unresponsive to market signals might encourage governments to devise policy interventions such as entrepreneur education and awareness programs (Sexton et al., 1997). But, the suitability of such programmes presumably depends on the extent to which entrepreneurs actually do adjust their beliefs in practice—a parameter that therefore needs to be measured. A related question is what form such programs should take. Answers depend not only on the speed of adjustment of entrepreneurs' beliefs, but also on what those beliefs relate to, and programs' delivery mechanisms. We will discuss this issue in the light of our empirical results.

Fourth, academies, practitioners and policy-makers might be interested in finding out whether particular entrepreneurial groups are more responsive to new information than others are. That might be valuable for targeting support programs more effectively. We obtain evidence about the similarities and differences between various entrepreneurial groups in this respect.

Fifth, empirical findings about expectations adjustment might also improve our understanding of how rational entrepreneurs are. That might indicate the usefulness for entrepreneurship of models of 'non-algorithmic' decision making (Bygrave, 1993), over-optimism (De Meza and Southey, 1996), and bounded rationality—and so contribute to theory development in entrepreneurship too.

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