When to Exit: Limited Rationality in Firm Decisions

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ABSTRACT

This paper investigates bounded rationality in a high-stake business setting: a restaurant owner’s decision to exit. We examine the degree to which owners consider the role of random variation in the profitability of their businesses. Combining a 16 year monthly panel on the alcohol revenues from every restaurant in Texas with weather data, we document that (1) weather affects revenue, (2) the magnitude of this effect is similar across inexperienced and experienced owners, (3) given the same revenue record, experienced owners are more likely to go out of business after good weather (and stay in business after bad weather) than inexperienced ones. This descriptive evidence motivates a structural model of belief formation and exit decisions. We inject a modicum of bounded rationality in this model by allowing the owner to underestimate or ignore the impact of random or non-random factors, thus misinterpreting revenue signals. We provide the magnitude and scope of this bounded rationality problem through estimating this structural model and conducting counterfactual experiments.

Keywords: behavioral industrial organization, exit, restaurants, rational inattention

JEL Classification: D03, L2, L8

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