

Entrepreneurship and Prudence: The Transition Effect and the Size Effect

Abstract

In this paper we rectify a common mistake found in the economic literature on entrepreneurship. In doing so, we provide the correct assumptions needed in order to have a consistent economic theory that explains the development of new ventures. First, we claim that the transition from secure employment to entrepreneurship is based on prudence instead of decreasing absolute risk aversion (DARA), which is something overlooked in the previous literature. Then, we provide the intuition of this result by separating the transition and size effect caused by a change in future risk. We also characterize the condition for self-selection of occupations via preferences on simple binary lotteries and show that, even in the behavioral context with lotteries, the key condition that explains the self-selection decision of occupations is prudence and not DARA.

Keywords: Risk aversion, DARA, prudence; entrepreneurship.

JEL Classification: D81; M2; L26