Transitory Shocks, Limited Attention, and a Firm's Decision to Exit*

Avi Goldfarb
Rotman School of Management
University of Toronto
105 St. George Street
Toronto, ON M5S 3E6
416-946-9604
agoldfarb@rotman.utoronto.ca

Mo Xiao
Eller College of Management
University of Arizona
1130 E. Helen Street
Tucson, AZ 85721-0108
520-621-2192
mxiao@eller.arizona.edu

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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 transitory shocks in the profitability of their businesses. Combining a 20 year quarterly panel on the alcohol revenues from every restaurant in Texas with weather data, we document that (1) random variations in the weather affect 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 exit from 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 into this model by allowing an owner to pay limited attention to transitory shocks, 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: inattention, bounded rationality, exit, behavioral industrial organization

JEL Classification: D03, L2, L8

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