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Firm exits as a determinant of new entry: Is there evidence of local creative destruction?

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Abstract

This study posits that a local process of creative destruction provides an impetus to regional industrial renewal. We argue that exits of older firms release resources that stimulate local entry. New entrants add value to these resources by redeploying them in more productive uses. We test our hypotheses with a unique longitudinal database encompassing the entry and exit of Canadian manufacturing enterprises. We find that exits of old firms increase entry and that on average new entrants are more productive. Persistent high local rates of exit, however, deter entry.

Keywords: Exit; Entry; Agglomeration; Local renewal

1. Executive summary

Research supports the idea that technological and industrial renewal occurs through a dual process where long periods of incremental evolutionary changes in technology and industrial structure are punctuated by radical discontinuous technological innovations that reshape the industrial landscape (Baum, 1996). Schumpeter (1942) argued that a process of creative destruction is the key driver of changes in technology and industrial landscapes in a market economy. In this process, entering entrepreneurs introduce new technologies,

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products or services to markets and force the exit of incumbents whose offerings become obsolete.

We argue that a complementary process of creative destruction operates at the local level. Unlike the Schumpeterian process where a significant part of the value of knowledge and other resources employed by incumbents gets destroyed, this process does not just conserve, but enhances the productivity of these resources. The exit (destruction) of older firms stimulates the entry (creation) of new enterprises that are not constrained by inertial forces as the older incumbents were, and can combine the resources released by exiting firms in new ways so as to increase productivity.

We hypothesize that exits of old incumbents in a location stimulate entry of new, more productive, enterprises to the same location. To test our hypotheses we have estimated Zero-inflated Poisson (ZIP) models of sectoral entry at the census subdivision level. We have also estimated and compared the productivity levels of firms which exited and those of new entrants. We have used a unique database developed by Statistics Canada that accurately identifies all entries and exits of Canadian firms between 1984 and 1998 in five manufacturing sectors and provides information about firm-level performance. Controlling for collocation (agglomeration economies), competition, diversity of the economic environment, economic region, industry and time fixed effects, and accounting for the possibility of endogeneity and cyclical effects, we find that exits of older incumbents from a location and neighboring locations increase entry levels. Exits of younger firms (with fewer resources to release) also contribute to increases in entry, but their impact is significantly lower. Persistently higher exit rates in a location, however, deter entry, while persistently higher exit rates in neighboring locations increase its attractiveness to new entrants. This suggests that information about relative location risk levels helps entrepreneurs calibrate their choice of location within the region, preventing the process of local creative destruction from perpetuating suboptimal location patterns. The effects of local exit levels of old firms upon entry to the location were found to be stronger than the effects of exits in more distant locations. The effects of exits of younger firms upon entry were purely local. The results are consistent with our articulation of a local creative destruction process. We also show that this process is anchored in relatively small geographical areas.

The results of our study have an important policy implication. They suggest that exit and turnover of firms may have some positive economic welfare benefits that could be lost by shoring up failing companies through subsidies and tax concessions.

2. Introduction

> "The market must clean itself out by taking resources away from the losers, so it creatively destroys the losing companies and reallocates resources to new companies".

Former US House of Representatives Majority Leader Dick Armey (March 2002)

The 21st century ushered in a shift from an economy where innovative activities by large established firms were the prime cause of economic development (Schumpeter 1954) to an economy where entrepreneurs play a key role in economic growth and renewal