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Firm creation and post-entry dynamics of *de novo* entrants[☆]



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ABSTRACT

We show that within the same age cohort, growth rates of young firms are strongly increasing in firm size. This robust empirical pattern is confined to the initial years after entry; in line with previous studies, we find that growth rates become independent of size as a cohort matures. Both the initial pattern and the subsequent convergence are consistent with the framework of the passive learning model if young firms adjust their size only slowly to new information, for example due to financing or hiring frictions. Importantly, we focus our analysis on firms that enter *de novo*, *i.e.* newly registered firms that start new operations and hire their first

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employee. Using two state-of-the-art record linking methods, we distinguish them from pre-existing companies that merely re-register as a new firm, for example following an ID change or merger. The extremely narrow size distribution that we observe for *de novo* entrants provides further support for the passive learning model.

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1. Introduction

New firms entering the economy are generally both numerous and small. Empirical studies have consistently documented that many young firms fail shortly after entry and firms that expand have a higher probability of survival than firms that stay small (Evans 1987a; Dunne et al., 1989; Mata et al., 1995).¹ The passive learning model of Jovanovic (1982) has been widely used to rationalize these post-entry patterns. It assumes that firms enter with an innate productivity they do not know themselves at entry but discover gradually by operating in the market. Firms that learn they are highly efficient grow and survive, while the inefficient exit.

Less consensus exists on the growth patterns prevailing among young firms that are able to survive. Empirical studies typically find that growth rates are very high in the first years after entry and rapidly decrease with age, another regularity in line with the model of Jovanovic (Evans 1987a; Haltiwanger et al., 2013; Mata and Portugal, 2004). But it is unclear whether within an entry cohort smaller firms grow faster and to some extent catch up in size, or whether larger firms have higher growth rates. Knowing the form of this relationship is important, as theoretical models of firm dynamics often assume or imply a specific relation between growth and size.

In the general version of Jovanovic's model, the size–growth relationship is undetermined. The few studies that have examined the relationship between growth and size of young survivors conditional on age, both measured in terms of employment, report contrasting findings. Evans (1987a), Lotti et al. (2003) and Mata (1994) find a negative relationship, but Haltiwanger et al. (2013) conclude that there is no systematic relationship between firm size and growth. When using their preferred methodology, Haltiwanger et al. (2013) even find that the size–growth relationship within a given age cohort is positive, both for young and older firms.²

¹ Note that some studies have used firms as their unit of analysis while others used plants or establishments. In our analysis, we do not make cross-country comparisons, but rather try to uncover general patterns of firm behavior. The unit of analysis most closely related to the theoretical notion of new firm creation is the firm and that is the unit of observation we will work with. As the vast amount of new entrants only have a single plant or establishment, this definition covers a very similar sample of entrants that plant-level studies would identify.

² The general results presented in Haltiwanger et al. (2013) are shown in greater detail for young firms in Decker et al. (2014).

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