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ESTUDOS DO GEMF
N.º 5 2008

PUBLICAÇÃO CO-FINANCIADA PELA
FUNDAÇÃO PARA A CIÊNCIA E TECNOLOGIA

Impresso na Secção de Textos da FEUC
COIMBRA 2008

The Shadow of Death: Analysing the Pre-Exit Productivity of Portuguese Manufacturing Firms ♣

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May 2009

An edited version of this paper was published in Small Business Economics.
DOI: 10.1007/s11187-009-9221-7

Abstract

In this study, we examine the pre-exiting productivity profile of *mature* firms relatively to survivors. We also evaluate how productivity affects the probability of exit along various dimensions. Our approach is an empirical one, and it is based on an unbalanced panel of Portuguese manufacturing firms covering a period of one decade. Our findings confirm that market selection forces low-productivity firms to exit, but there is also evidence that a sizeable portion of low-productivity firms do not shut down. Conversely, there is a non-negligible fraction of high-productivity firms that do actually close. In line, too, with some key theoretical predictions, exiting firms reveal a falling productivity level over a number of years prior to exit. Finally, our results from the survival model show that both low-productivity and small firms are much more likely to exit the market. Industry and macro environment were also found to have a non-negligible role on the exit of mature firms.

Keywords: *Pre-exit performance; Exit pattern; Productivity; Firm survival; Portugal.*
JEL Classification: *L25, D24, D21, L60.*

♣ We thank two anonymous referees of Small Business Economics for their most helpful comments on the previous version of this paper.

1. Introduction

Although firm death is common (Caves, 1998; Ahn, 2001), the pre-exiting productivity pattern of mature firms has been scarcely examined in the industrial dynamics literature. In contrast, unsuccessful entrants have been extensively studied within the literature on post-entry performance (e.g. the special issues on "The Post-entry Performance of Firms" in the *International Journal of Industrial Organization*, 1995, and "The Survival of Firms in Europe" in *Empirica*, 2008, as well as several papers on new-firm survival in this journal). However, as pointed out by Haltiwanger et al. (2007), from a theoretical point of view, we may expect differences in exit behaviour across new and mature firms. In this vein, Jovanovic (1982), for example, developed the notion that there is greater heterogeneity in productivity across new firms than across mature firms, which means that the determinants of firm failure are expected to be distinct between the two types of firms. The organizational ecology approach, in turn, has emphasized that mature and new firms do not interact with the environment exactly in the same way. From the point of view of the empirical literature, the least one can also say is that the evidence is largely favourable to the hypothesis that exit of young and mature firms is explained by a different set of determinants (e.g. Audretsch, 1994; Bellone et al., 2006).

In this study, we take a very pragmatic route and define a mature firm as one that is at least 10 years old.[1] It is well known that, for entrants, the rate of early mortality is very high in the first few years after entry; then mortality decreases to finally stabilize somewhere between the sixth and the tenth year of life (Geroski, 1995; Caves, 1998). According to Baldwin (1995), in Canada, for example, the exit rate for 1971 entrants was about 10% at the end of the first year – an exit rate twice as high as the one for mature firms – but after ten years the exit rate for both types of firms was roughly the same. For Swedish firms, Box (2008) found that the first six years were more hazardous than the following years, where no distinct pattern over time

[1] Most empirical studies point to firms achieving the mature state somewhere between the sixth and tenth year of life. In our dataset, the results from using an alternative threshold (e.g. eight years) are virtually the same as the ones reported in section 4 below.

was detected, while, for German firms, Strotmann (2007) found that the seventh year after birth seemed to be the critical point. It is also a well-known stylized fact that the growth rate among successful entrants is very high, although it may take more than one decade to achieve the incumbents' average size (Audretsch and Mata, 1995; Geroski, 1995; Mata et al., 1995).

With respect to the characteristics of exiting firms, the industrial organization literature (e.g. the stochastic models of industrial dynamics of Jovanovic, 1982, Ericson and Pakes, 1995, and Hopenhayn, 1992) underscores two key propositions: *a*) exit of mature firms is concentrated among the ones with the lowest productivity level; and *b*) productivity decreases over a number of years prior to exit. In somewhat contrasting position, however, the approaches from the labour economics perspective (e.g. Evans and Jovanovic, 1989; Taylor, 1999) and from the resource-based theory of the firm (e.g. Wernerfelt, 1984; Barney, 1991) have pointed out that firm exit may well be determined by factors other than strict firm performance.

The main purpose of this paper is to examine the productivity performance of mature firms in the pre-exit period by using two alternative measures: total factor productivity (TFP) and labour productivity (LP). We will also evaluate how productivity affects the hazard rate, controlling for other *internal* and *external* dimensions and for unobserved firm heterogeneity. In this study, exit comprises bankruptcy and voluntary closure.[2] To conduct the analysis, we will use an original unbalanced panel of Portuguese manufacturing firms covering the period 1991-2000 (annual observations; see Carreira e Teixeira, 2008). By specifically focusing on the pre-exit analysis of firm-level productivity in a period of one decade, we aim to shed further light on the profile of a typical mature exiting firm. We claim, in particular, that there is evidence in favour of the 'shadow of death' effect (after Griliches and Regev, 1995), according to which exit does not happen by a stroke of misfortune, but rather it is the result of a persistent productivity fall that seems to flag, to some extent, an impeding death. We also found that there

[2] As pointed out by Headd (2003) and van Praag (2003), it would be preferable to distinguish voluntary from involuntary closures, but unfortunately (see section 3.2 below) this distinction is not possible in our

is a sizeable portion of low-productivity firms that do not exit and, conversely, that there is a non-negligible fraction of high-productivity firms that do actually close.

The paper is organized as follows. Section 2 presents a brief theoretical incursion, plus some major empirical findings related to the pattern of exit of mature firms. Section 3 presents the data and discusses the methodology. Section 4 analyses the productivity gap between continuing and exiting firms (in the exiting year and over a given period prior to exit), and how internal and external factors influence the likelihood of a firm exiting the market. Finally, section 5 offers some concluding remarks.

2. Theory and selected empirical findings

The main purpose of our analysis is to understand the extent to which the exit of a mature firm is due to low productivity or rather to other non-productivity-related aspects ('non-economic-forced exit', after Harada, 2007). Our testing hypotheses are thus primarily drawn from Industrial Organization; but we also try to extend the analysis to other strands of literature, namely by incorporating in our study other stylized facts extracted, in particular, from the Resource-based Theory of the Firm, Labour Economics, and Organizational Ecology.

The stochastic models of competitive markets developed by Jovanovic (1982), Ericson and Pakes (1995) and Hopenhayn (1992), *inter al*., provide an interesting theoretical framework in which both heterogeneity across firms *and* entry and exit can be analysed. These models have in common the presumption that firm's decisions (on entry, exit, and investment, for example) seek to maximize the expected present discounted value of profits conditional on the current information set. In the Jovanovic model, for example, firms discover their own pre-determined (but unknown) productive efficiency through a process of Bayesian learning from its post-entry profits. Firms then expand when they realize they are efficient, and shrink (or

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dataset. This limitation is present in virtually all empirical studies in the literature, with a few exceptions (e.g. Harada, 2007).

exit) when they learn they are not. In contrast, Ericson and Pakes (1995), while assuming that firms know their current productive efficiency, allow productivity to change over time either as the stochastic outcome of their (and rivals') investments or as the result of changes in overall market conditions (see also Pakes and Ericson, 1998). Hopenhayn (1992), in turn, allows industry-specific effects to play a key role within a competitive industry in stationary equilibrium (see also Asplund and Nocke, 2003, Cabral, 1995, and Hopenhayn and Rogerson, 1993).

Given the strict connection between productivity and profits, four main predictions can be then derived from this literature: *a*) firms do not survive if their productivity is below certain critical level; *b*) in the pre-exit period, the productivity of exiting firms falls continuously relative to survivors; *c*) smaller and younger firms have a higher likelihood of exit than their larger and older counterparts; and *d*) industry and macro environments do matter to survivability. We next discuss each one of these predictions, mainly from the point of view of the empirical research.

(*a*) *Productivity*. Many empirical studies indicate that the likelihood of exit tends to decline with productivity. For example, Baily et al. (1992) and Doms et al. (1995), using a panel of United States manufacturing plants, report that the negative effect of productivity on the probability of exit is sizeable. In the case of UK and Spanish manufacturing sectors, Disney et al. (2003a) and Esteve-Pérez and Mañez-Castillejo (2008), respectively, found that high-productivity firms have a lower hazard rate. Bellone et al. (2006), in turn, observed that inefficient mature firms are more likely to shut down in the French manufacturing sector. However, in sharp contradiction with the results found by Almus (2004) for new German firms, Bellone et al. did not obtain an identical effect in the case of newly created firms.

However powerful the stochastic model predictions may be, they have not received across-the-board confirmation in the empirical literature. For example, Baily et al. (1992), analysing the productivity performance of United States manufacturing, did not confirm the prediction that there is a critical productivity level below which firms necessarily shut down. Indeed, these authors found that while approximately 50% of exiting plants (in the 1972-1977 period) were from the bottom two (1972) quintiles, roughly 30% of exits were from the top two quintiles. Moreover, although closings were concentrated at the bottom of the productivity distribution, many low-productivity plants did not actually exit in the observed period.

The explanation of this apparent contradiction is often found outside the industrial organization approach. In the labour economics literature, for example, the analysis of exit has been mostly focused on the business owner, in which case the decision to shut down depends not only on firm performance, but also on availability of alternative sources of ownership income, as well as on other arguments of the owner's utility function (Evans and Jovanovic, 1989; Taylor, 1999). For its part, the managerial approach has extended the theorization to encompass the entrepreneur's human capital, and his/her ability to implement a proper firm strategy (Gimeno et.al., 1997), while the resource-based view of the firm has pointed out that the chances of survival ultimately depend on firm's ability to exploit specific capabilities, which in turn are determined by the firm's revealed competence in the use of limited resources (Wernerfelt, 1984; Barney, 1991). Along this line of reasoning, Headd (2003) and Bates (2005), for the USA, and Harada (2007) for Japan, have identified two types of closures: 'successful' closures (i.e. non-economic-forced exits) and 'unsuccessful' closures (failures). In this framework, it is then possible to observe low-productivity survivors and high-productivity exits, which implies that some other key factors are necessarily at stake (see Taylor, 1999; Hamilton, 2000; Morton and Podolny, 2002; Saridakis et al., 2008).

Hypothesis 1: A higher productivity level reduces the probability of exit, all else equal.

Hypothesis 2: Low- (high-) productivity firms with higher (lower) ability to exploit specific capabilities have lower (higher) probability of exit.

(*b*) *The 'Shadow of death' effect*. The empirical literature also suggests that exiting firms do not face a 'sudden death'. On the contrary, firms tend to reveal a steady decrease in their productivity level relative to survivors well before closure. In particular, Griliches and Regev (1995) found that, for the Israeli manufacturing sector, firms appeared to signal their exit by revealing lower productivity several years before failure. This 'shadow of death' phenomenon was also detected by Bellone et al. (2006) for the French manufacturing sector.

The pre-exit performance has also been analyzed by observing changes in firm size (employment). But while Troske (1996), using Wisconsin (USA) data on manufacturing firms older than 5 years, showed that firm relative size declines monotonically over the (8-year) period prior to exit, Wagner (1999), using a panel of manufacturing firms from Lower Saxony (Germany), did not confirm this finding.

Hypothesis 3: Exiting firms reveal a falling productivity level in a number of years prior to exit.

(*c*) *Age and size*. In line with the predictions from industrial organization, the resource-based view of the firm has argued that the probability of exit declines with age and size as older and larger firms often command more resources and have higher managerial experience (tacit knowledge). Several empirical analysis confirm indeed that both larger and older firms are more likely to survive than smaller and younger ones (e.g. Dunne et al., 1989, for US manufacturing plants; Mata and Portugal, 1994, 2002, for Portuguese manufacturing establishments; Disney et al., 2003b, for UK manufacturing establishments; Esteve-Pérez et al., 2004, for Spanish manufacturing firms; Strotmann, 2007, for Germany manufacturing firms; and Box, 2008, for Sweden firms).

Despite this evidence, the empirical research is not entirely conclusive with respect to the effect of firm age on survivability, as seemingly contradictory evidence from non-monotonic and U-shaped hazard rates has been found in the literature (e.g. Esteve-Pérez et al., 2008; Esteve-Pérez and Mañez-Castillejo, 2008). As a way of explanation, authors from Organizational Ecology have claimed that there are several other possible routes between age and exit, and, accordingly, have proposed the concepts of 'liability of newness', 'liability of adolescence' and 'liability of senescence' (Hannan, 2005). According to the latter, for example, older firms tend to be relatively inert and, as a consequence, increasingly ill-suited to deal with quickly changing environments (Baum, 1989; Hannan, 1998). Clearly, in this case, the hazard rate of mature firms will tend to be higher. In turn, Geroski (1995) argued that if the goal is to measure firm capabilities with precision then one should be better off using variables like R&D, advertising and labour quality rather than size and age.

Hypothesis 4: Larger firms have lower probability of exit.

Hypothesis 5: There is no clear causal relationship between the age of a mature firm and the probability of exit.

(*d*) *Industry and macro environment*. Strengthening the claims from industrial organization, the organizational ecology approach stresses the environmental conditions as a key determinant of closure. It is expected, in particular, that relatively favourable market conditions will lead to a higher price-cost-margin and therefore to a lower risk of failure of mature firms. Several empirical studies confirm indeed a positive impact of industry growth and industry size on the survival probability of firms (Audretsch and Mahmood, 1994, 1995; Mata and Portugal, 1994, 2002; Mata et al., 1995; Audretsch, 1995a, 1995b; Bellone et al., 2006; Strotmann, 2007). For its part, less market competition is expected to lead to a higher price-cost-margin and to a higher probability of survival. A higher degree of market concentration, for example, is supposed to result in a lower risk of exit (Geroski et al., 2007 and Strotmann, 2007), although in this situation one cannot exclude the possibility of firms becoming somewhat more complacent which may hurt survivability in the long run (Bellone et al., 2006). High entry rates, in turn, have a negative impact on the survival probability of firms (Mata and

Portugal, 1994, 2002; Mata et al., 1995; Geroski et al., 2007; Strotmann, 2007). Firms in high-tech industries seem to have a lower probability of survival than firms in medium- and low-tech industries (Audretsch, 1995b; Esteve-Pérez et al., 2004), although the evidence found by Strotmann (2007) does not seem to be totally favourable to the latter. Finally, the likelihood of exit tends to be closely related to the economic cycle, with the risk of death being lower in economic booms (Fotopoulos and Louri, 2000; Geroski et al., 2007; Strotmann, 2007; Box, 2008; Esteve-Pérez et al., 2008; Fertala, 2008).

Hypothesis 6: Favourable demand market conditions impact positively the probability of survival, while the intensity of competition decreases the chances of survival.

Hypothesis 7: The probability of exit is inversely related to the economic cycle.

3. Data and methodology

3.1. The dataset

The raw data is drawn from *Inquérito às Empresas Harmonizado* (IEH), an annual business survey conducted by the Portuguese Statistical Office (INE). It contains, in particular, detailed input and output information required to compute productivity at firm level (see Carreira, 2006). Our dataset of manufacturing firms comprises some 1,900 units from the central region (*Região Centro*) of Portugal, observed over a 10-year interval (1991-2000, unbalanced panel). In this sample, firms with more than 100 employees were chosen with certainty, while those with 20 to 99 employees were drawn randomly. The sample is considered representative with respect to sectoral disaggregation (at 3-digit level), both in terms of employment size and output. Small and large firms were then weighted to ensure that the results are representative of the Portuguese population at sector level.[3]

The longitudinal dimension of the panel was constructed using firm's identification number in the IEH dataset. Additional information with respect to birth/death year was drawn from *Ficheiro de Unidades Estatísticas* (FUE), also collected by INE. By combining these two datasets (i.e. IEH and FUE), it was then possible to determine, with no margin of error, the status of any given unit in any given year: continuing, entering or exiting. In particular, an exit from the sample is taken as a closure if and only if the corresponding firm has been coded as 'dead' by the Valued Added Tax authority. Within our observation window, 293 closings were observed, leading to a total of some 6,800 data points (unbalanced panel).[4]

Clearly, our dataset presents advantages and weaknesses. The main advantage is that the raw survey is assembled at firm level rather than at the plant level, the typical relevant unit in terms of the actual decision to exit the market. Another positive aspect is the length of the panel, which allows us to follow firms' performance over a period sufficiently long. The main weakness is perhaps the fact that we only observe firms with at least 20 employees, thus losing track of an important source of exit. In the Portuguese manufacturing industry, very small firms – i.e. those with less than 20 employees – represent about 77% of the population of firms, but only 20% of the total manufacturing employment and 12% of the industrial production (Carreira, 2006).

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[3] The aggregate results for the entire *Portuguese* manufacturing sector were also weighted. We note that *Região Centro* represents approximately 1/7 of the Portuguese GDP and 1/6 of total employment. Either in terms of employment or output, the shares of each one of the 17 sub-sectors in the manufacturing aggregate at national and *Região Centro* level are virtually the same, with the observed differences in 2000, for example, never exceeding 6 percentage points.

[4] We note that the observation of exit is constrained by the characteristics of the IEH survey. Thus, in our dataset exit comprises bankruptcy and voluntary closure, as well as the residual category of mergers/acquisitions, a rare and negligible event which according to Mata and Portugal (2002, 2004) does not exceed 1% of the total number of closures. A change in sector of activity in turn is taken as diversification, not as an exit. All firms younger than 10-years old were dropped from our sample.

3.2. Methodology

We will first analyse the productivity of exiting firms relatively to survivors and the rates of transition over specific time intervals to then estimate the determinants of exit using survival methods.[5] Given the characteristics of our dataset, survival models are more appropriate to study the exit process than the Probit or Logit approach (Mata and Portugal, 1994, Esteve-Pérez et al., 2004). In particular, survival models are well suited to analyse how exit rates evolve over time, conditional on a given set of time-varying covariates and in the presence of right censored data (Esteve-Pérez and Mañez-Castillejo, 2008; Esteve-Pérez et al., 2008).[6]

A key concept in survival analysis is the *hazard rate*, which can be defined as the probability that a firm exits the market at time t given that it has survived until t, conditional on a vector of covariates x_{it}. To estimate the hazard function, we employ the semi-parametric Cox Proportional Hazards (CPH hereafter) model (Cox, 1972), given by

$$h(t|x_{it}) = h_0(t) \cdot \exp(x_{it}'\beta), \qquad (1)$$

where h_0 is the baseline hazard function (whose parametric specification needs not to be specified), and x_{it} is a vector of internal and external determinants assumed to influence the hazard rate. (x_{it} includes both time-invariant and time-varying variables.) This is indeed the most widely used estimation method in firm survival analysis (Manjón-Antolín and Arauzo-Carod, 2008). Compared to parametric proportional hazard models, the advantage of the semi-parametric CPH methodology is that it does not require particularly restrictive assumptions on the baseline hazard function. This is especially important when the parametric form of the underlying baseline hazard function is unknown a priori. The semi-parametric CPH approach also seems to be appropriate as our interest is not much in the estimation of the underlying

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[5] See van den Berg (2001) for a detailed technical description of duration models. See also Manjón-Antolín and Arauzo-Carod (2008) for a survey on firm survival methods and evidence.

[6] Right-censoring in our dataset is due to panel rotation, on the one hand, and to firm's survival (i.e. survival after 2000), on the other. Since all firms in our sample started production some time (at least 10 years) before the beginning of the survey, the dataset is also left-censored. This is not a problem as our focus lies on the conditional probability of exit based on calendar time.

baseline hazard function but rather on the effect of productivity (and other determinants) on firm survival.

The CPH model can be expanded in order to incorporate unobserved individual heterogeneity. In this case, model (1) becomes

$$h(t|x_{it}) = h_0(t) \cdot \exp(x_{it}'\beta) \cdot v_i = h_0(t) \cdot \exp(x_{it}'\beta + u_i), \qquad (2)$$

where v_i is a variable representing an unobserved, time-invariant, individual component (*shared 'frailty'*). v_i is also assumed to follow a gamma distribution with unit mean and finite variance σ^2. As we will see below, we will test the null hypothesis of no unobserved heterogeneity. Non-rejection of the null implies the non-frailty case [i.e. model (1) above].

The CPH model assumes that the hazard function is continuous and hence that the firms can be exactly ordered in calendar time with respect to their time of failure. However, given that our data is annual, we cannot of course observe the exact time (day or month) of closure, which means that we have 'ties' in our grouped-form data (Cox and Oakes, 1984). We solve this problem by implementing the method proposed by Efron (1977) (see also footnote 11 below).

Finally, to study the sensitivity of our findings, we estimate a piece-wise constant hazard model (PWCH hereafter) in which the baseline hazard [i.e. h_0 in model (1)] is assumed to be constant within a certain time interval (e.g. during an economic recession/expansion).[7]

3.3. Measurement issues and data description

Firm-level *total factor productivity* (TFP) and *labour productivity* (LP) are our selected productivity measures. Following Baily et al. (1992), the indexes of productivity (ln*TFP* and ln*LP*, respectively) for firm *i* in year *t* are given by:

$$\ln TFP_{it} = \ln Q_{it} - \alpha_K \ln K_{it} - \alpha_L \ln L_{it} - \alpha_M \ln M_{it}, \qquad (4)$$

$$\ln LP_{it} = \ln VA_{it} - \ln L_{it}, \qquad (5)$$

where Q_{it} and VA_{it} are the real gross output and the value added of the i^{th} firm in year t, respectively; K_{it}, L_{it} and M_{it} are capital, labour and intermediate inputs; and α_j denotes factor elasticities, $j = K, L, M$. The gross output is given by the sum of total revenues from sales, services rendered, self-consumption of own production and the change in inventory of final goods. It is deflated by the producer price index at 3-digit level. The labour input is a 12-month employment average. The labour costs embrace all employment costs, including those related to social security payments, and were deflated by the labour price index in manufacturing. The intermediate input includes the cost of materials, services purchased, and other operating costs; it is deflated by the GDP deflator. Capital stock is given by the book value of total net assets. Capital services are defined as the sum of the depreciation and the real interest on net assets. The real interest rate is given by the difference between the annual average of the long-term interest rate and the annual consumer price index. Finally, factor elasticities α_K, α_L and α_M are given by the corresponding industry average cost shares (3-digit level).

For a given firm, the variable *age* is calculated as the difference between year *t* and the birth year, while *size* is given by the monthly employment average. The *GDP growth* and *unemployment* (annual) series were extracted from the OECD database.[8] To isolate industry-specific shocks from macro shocks, we computed the *industry growth* rate in deviation form from the GDP growth rate (the industry growth rate is calculated from *Estatísticas da Produção Industrial*, INE). The *industry size* variable is computed, for each year, as a percentage of the largest (3-digit) industry output level observed in the sample. Following the OECD methodology (OECD, 2005), the *industry technological regime* variable is proxied by a dummy variable equal to 1 if a firm belongs to an industry with high/medium R&D-intensity and 0 otherwise. The variable *industry concentration* is generated directly from the firm-level output data and corresponds to the C-5 concentration ratio computed at the 3-digit level. The *entry rate*

[7] This model was also implemented by Mata and Portugal (2002).

is defined as the ratio of entering firms to the total number of firms (Carreira, 2006). Finally, the variable *export intensity* is given by the share of exports in total output at industry level (2-digit level), and it is taken from the OECD database.

Table 1 provides a brief summary of the selected variables in different subsamples: *all* and *exiting* firms, on the one hand, and by size groups, on the other. Clearly, exiting firms are on average less productive (and smaller) than the entire set of firms in the sample. No clear pattern though is visible with respect to the role of age on the exit behaviour of mature firms. Table 2 gives the correlation across time-varying covariates, and as can be seen, the coefficients are all very small, except in the case of the pair *industry concentration-industry growth* and *industry concentration-technological regime*.

Table 1. Descriptive statistics of productivity, age, and size variables

	All firms			Exiting firms		
	Small	Large	All	Small	Large	All
TFP	2.19 (0.96)	2.16 (0.58)	2.18 (0.83)	1.89 (0.68)	1.86 (0.73)	1.88 (0.69)
Labour productivity	2.79 (3.54)	2.92 (3.39)	2.84 (3.48)	1.67 (1.59)	1.31 (1.08)	1.55 (1.44)
Age	24.1 (14.2)	27.8 (16.4)	25.56 (15.2)	26.5 (15.5)	24.7 (16.5)	25.4 (16.1)
Size	47.3 (23.7)	244.7 (382.1)	123.6 (256.8)	50.9 (23.7)	183.3 (73.8)	95.4 (78.2)

Notes: Small and large firms are those with 20-100 employees and more than 100 employees, respectively. Standard deviations are given in parenthesis.

[8] At http://stats.oecd.org/wbos/Index.aspx

Table 2. Correlation across covariates

	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]
[1] TFP	1										
[2] Labour productivity	0.21*	1									
[3] Age	-0.09*	-0.03	1								
[4] Size	0.02	0.05*	0.04*	1							
[5] GDP growth	0.08*	0.03*	-0.05*	-0.10*	1						
[6] Unemployment	-0.06*	-0.03*	-0.02	0.00	-0.21*	1					
[7] Industry growth	0.05*	0.18*	-0.04*	0.04*	0.09*	0.03*	1				
[8] Industry size	-0.07*	-0.02	0.03*	-0.01	0.14*	-0.05*	-0.18*	1			
[9] Technological regime	0.14*	0.12*	-0.03*	-0.03*	0.03*	-0.03	0.29*	-0.14*	1		
[10] Industry concentration	0.06*	0.21*	-0.04*	0.01	0.03*	-0.02	0.45*	-0.14*	0.57*	1	
[11] Entry rate	0.10*	0.07*	-0.17*	0.03*	-0.02	0.00	-0.04*	-0.24*	0.01	0.14*	1
[12] Export intensity	0.07*	-0.11*	-0.05*	0.11*	0.00	-0.03	-0.10*	-0.09*	0.20*	0.27*	0.21*

Notes: * denotes statistical significance at the .05 level.

4. Empirical Analysis

4.1. The productivity level of exiting firms

Table 3 shows the productivity level of exiting firms normalized by the average productivity of survivors, either in terms of TFP or labour productivity. (In each year, and by industry, the productivity of the 'control group' of survivors was set to 1.) As can be seen, exiting mature firms are, on average, less productive than surviving firms by a 14 and 40 percentage point margin, in the TFP and labour productivity cases, respectively. The hypothesis that there is no productivity differential between surviving and exiting firms is comfortably rejected by the data (at the 1% significance level).

Table 3. Productivity gap between exiting and surviving firms

	TFP	Labour productivity
Annual average	0.857 (-5.010)	0.604 (-7.303)

Notes: In each year (and industry), the productivity of surviving firms is set to 1. Small and large firms are weighted at sector-level; aggregation weighted over 17 two-digit industries by firm's output (TFP case) and employment (LP case), respectively. The *t*-statistic of the null hypothesis of no productivity difference between exiting and continuing firms is given in parenthesis.

While Table 3 shows that the productivity gap between exiting and surviving firms is, on average, sizeable, Table 4 goes a step further and looks at the specific position of exiting firms in the productivity distribution. Thus, as a first step, we ranked the firms in the sample according to their productivity level to then compute the corresponding quintiles in selected years. We want to know, in particular, the percentage of exiting firms, say for example in the period 1992-1994, located in quintile 1 in 1991. The analysis is divided into three exit sub-periods of equal length (1991-1994, 1994-1997, and 1997-2000) in an effort to match as closely as possible with the cycle fluctuations observed in the Portuguese economy in the 1990s.[9] The main result from Table 4 is that most failures in any of the three selected sub-periods come from the lower bottom of the distribution. For instance, taking the exit period 1992-1994 (row 1, TFP measure), 63.2% of the total number of observed exits were, in 1991, in the two lowest quintiles, while only 26.3% were in the two top quintiles. In the case of labour productivity, the corresponding percentages are 50.0 and 35.0. (Similar findings are obtained for 1995-1997 and 1998-2000.)

[9] There was an overall slowdown in 1991-1994, followed by a clear economic recovery which in the last sub-period (1997-2000) seemed to have lost some momentum (Carreira and Teixeira, 2008).

Table 4. Productivity of exiting firms (in percentage)

Exit during:	TFP quintile in the year before the exiting period					
	1 (lowest)	2	3	4	5 (highest)	Total
1992-1994	36.84	26.32	10.53	15.79	10.53	100
1995-1997	40.00	22.90	14.49	10.43	12.17	100
1998-2000	34.38	25.00	10.94	7.81	21.88	100
Exit during:	Labour productivity quintile in the year before the exiting period					
1992-1994	35.00	15.00	15.00	10.00	25.00	100
1995-1997	47.26	16.71	10.95	13.54	11.53	100
1998-2000	54.69	15.63	12.50	7.81	9.38	100

Notes: Quintile 1 is the bottom productivity quintile. The first cell on the top left, for example, means that 36.84 percent of exiting firms in the period 1992-1994 were in the bottom quintile of the 1991 TFP productivity distribution. Aggregation weighted over 17 two-digit industries.

Next, we computed in each quintile the fraction of firms that did not survive until the end of the selected exit period, as well as the corresponding fraction of survivors. These two transition rates are presented in Table 5. Clearly, a substantial fraction of low-productivity firms has a non-negligible degree of resilience: in the TFP case, for example, only 7.9 (4.7%) of the firms that were in the first (second) quintile of the 1991 distribution died in the subsequent 3-year period (7.5 and 3.2%, in the labour productivity case, respectively). Surprisingly enough, a substantial number of high-productivity firms did close: roughly 4.4 and 1.6% of the two top 1991 TFP quintiles (fourth and fifth quintiles, respectively) exit in 1992-1994. It is worthwhile noting though that if we take into account firm's relative size (using either output or employment as a weighting measure), the shares associated with the exit of high-productivity firms (the values in square brackets in the table) become smaller. An obvious implication from this finding is that most high-productivity exiting firms are indeed smaller than survivors.

Table 5. Transition rates (in percentage)

		1994			1997			2000	
		Surviving	Exiting		Surviving	Exiting		Surviving	Exiting
		TFP							
1	Quintiles in 1991	92.13 [95.83]	7.87 [4.17]	Quintiles in 1994	94.25 [92.54]	5.75 [7.46]	Quintiles in 1997	93.04[95.80]	6.96[4.20]
2		95.33 [93.17]	4.67 [6.83]		98.07 [96.71]	1.93 [3.29]		94.64 [97.96]	5.36 [2.04]
3		96.55 [94.10]	3.45 [5.90]		97.14 [96.70]	2.86 [3.30]		98.07 [96.94]	1.93 [3.06]
4		95.65 [95.30]	4.35 [4.70]		98.80 [98.23]	1.20 [1.77]		97.97 [98.02]	2.03 [1.98]
5		98.41 [99.72]	1.59 [0.28]		97.40 [99.28]	2.60 [0.72]		95.53 [98.62]	4.47 [1.38]
		Labour productivity							
1	Quintiles in 1991	92.55 [91.77]	7.45 [8.23]	Quintiles in 1994	92.48 [90.52]	7.52 [9.48]	Quintiles in 1997	89.66 [88.42]	10.34 [11.5]
2		96.81 [97.12]	3.19 [2.88]		98.11 [98.80]	1.89 [1.20]		96.79 [97.19]	3.21 [2.81]
3		95.40 [97.34]	4.60 [2.66]		99.60 [99.97]	0.40 [0.03]		97.45 [96.96]	2.55 [3.04]
4		96.30 [97.64]	3.70 [2.36]		97.18 [95.81]	2.82 [4.19]		98.68 [99.06]	1.32 [0.94]
5		95.38 [95.59]	4.62 [4.41]		98.70 [97.97]	1.30 [2.03]		97.74 [99.12]	2.26 [0.88]

Notes: The first cell on the top left, for example, means that 92.13 percent of firms in the bottom quintile of the 1991 TFP productivity distribution survived up to at least 1994. The rates weighted by output (TFP case) and employment (LP case) are given in square brackets. Aggregation weighted over 17 two-digit industries.

From Tables 4 and 5, there is therefore broad evidence in favour of hypothesis 2, according to which, we recall, the decision to exit the market depends not only on firm productivity performance, but also on firm specific capabilities. In particular, in the high-productivity segment, large firms – the ones that are supposed to command a higher level of resources, according to the resource-based view of the firm – do seem to reveal a lower rate of exit than small firms.[10]

[10] Since our dataset does not contain information on employer's attributes nor other firm characteristics such as liquidity constrains (see Cabral and Mata, 2003; and Oliveira and Fortunato, 2006), we cannot explicitly test the 'non-economic forced exit' hypothesis.

4.2. Pre-exit productivity performance

Having analysed the productivity profile of exiting firms, next we want to know whether exiting firms reveal any pattern of lower than average productivity over the pre-exiting period – the 'shadow of death' effect. Tables 6 and 7 show the time series of the average productivity of 1991 surviving firms, grouped by death year cohort. The 'comparison group' is made up of 2000 surviving firms, that is, firms that were still in operation in year 2000. As expected from the previous discussion, in each death cohort, the productivity level one year before exit (any element of the main diagonal) is always lower than that of survivors (the 1996 death cohort, TFP case, is the sole exception). On average, mature exiting firms are 16 percentage points lower than surviving firms in terms of TFP, and 44 percentage points lower in the labour productivity case.

Table 6. Pre-exit TFP relative to survivors

		Years prior to exit								
		1991	1992	1993	1994	1995	1996	1997	1998	1999
Year of exit	1992	0.934								
	1993	1.044	0.853							
	1994	0.856	0.884	0.751						
	1995	0.904	0.919	0.896	0.899					
	1996	1.067	1.061	1.106	0.992	1.044				
	1997	0.865	0.853	0.785	0.674	0.678	0.681			
	1998	0.847	0.901	0.733	0.564	0.401	0.992	0.831		
	1999	0.824	0.872	0.849	0.751	0.721	0.908	0.910	0.773	
	2000	0.845	0.743	0.757	0.833	0.811	0.799	0.772	0.775	0.763

Notes: The productivity of surviving firms is set to 1. The left cell in the last row, for example, means that in 1991 the productivity of 2000 exiting firms was, on average, at 84.5 percent of the 1991 productivity of survivors. A surviving firm in this context means one that is still in operation in 2000. Aggregation weighted over 17 two-digit industries.

Table 7. Pre-exit labour productivity relative to survivors

		Years prior to exit								
		1991	1992	1993	1994	1995	1996	1997	1998	1999
Year of exit	1992	0.949								
	1993	0.837	0.450							
	1994	0.841	0.241	0.071						
	1995	1.220	1.134	1.058	0.871					
	1996	1.066	0.969	1.442	1.168	0.971				
	1997	0.567	0.621	0.558	0.346	0.275	0.187			
	1998	0.986	0.896	0.384	0.291	0.012	0.329	0.424		
	1999	0.898	0.935	0.817	0.608	0.709	0.899	0.974	0.602	
	2000	0.651	0.348	0.492	0.547	0.608	0.712	0.540	0.532	0.505

Note: See notes to Table 6.

There is also a persistent (and widening) productivity gap between survivors and exiting firms across all death cohorts. Let us take the 2000 death cohort, for instance. In this case, the TFP disadvantage relative to the surviving group is 23.7 percentage points in 1999. This productivity gap was already at 15.5 percentage point mark in 1991. (A stronger pattern is found in the case of the labour productivity measure.) There seems to be therefore a clear productivity disadvantage of exiting firms relatively to survivors not only in the year before exit but also over a good number of years prior to exit.

The CPH model implementation in Table 8 uses as the sole covariate the lagged productivity index, and it confirms quite emphatically the existence of 'shadow of death' effect.[11] Indeed, all lagged productivity terms (up to the fourth term) are statistically significant and negative, a rather clear confirmation of our hypothesis 3, which states that the productivity of exiting firms is persistently lower than that of survivors.

Table 8. The 'Shadow of death' effect

	Lag				
	τ=1	τ=2	τ=3	τ=4	τ=5
$TFP_{t-\tau}$	-1.14*** (0.14)	-1.18*** (0.19)	-1.36*** (0.22)	-1.13*** (0.25)	-0.38 (0. 57)
Log likelihood	-578.77	-509.72	-397.67	-328.34	-249.98
LR test	37.60***	22.75***	22.01***	12.00***	0.41
N	4784	4570	4321	4062	3767
$LP_{t-\tau}$	-0.45*** (0.04)	-0.40*** (0.05)	-0.38*** (0.06)	-0.31*** (0.08)	-0.07 (0.18)
Log likelihood	-562.45	-501.96	-396.93	-329.76	-250.53
LR test	72.10***	39.91***	24.77***	10.22***	0.13
N	4830	4615	4364	4103	3806

Notes: CPH model regressions, with 'ties' handled with the method proposed by Efron (1977). The null hypothesis of no unobserved heterogeneity was not rejected. (The results from the unobserved heterogeneity model are available from the authors upon request.) The (log) TFP and (log) LP were normalized by the average productivity of surviving firms at industry level. Robust standard errors are given in parenthesis. ***, **, and * denote statistical significance at the .01, .05, and .10 levels, respectively.

[11] Estimation was performed using *stcox* command with *efron* and *shared* options of StataSE 9.2. The *strata(industry)* option was not implemented given that the productivity level of exiting firms was normalized by the average productivity of survivors at industry level. The null hypothesis of no unobserved heterogeneity was not rejected.

4.3. The determinants of the hazard rate

The analysis in Sections 4.1 and 4.2 reveals that most deaths tend to be drawn from the lower tail of the productivity distribution. To test explicitly whether exit is more likely among low productivity firms, controlling for other variables, we estimate the hazard rate conditional on a wide set of covariates. As discussed in Section 2, the determinants of firm failure can be summarized into two broad categories. In the first place, we have the so-called *internal factors* to the firm, namely, productivity, size, and age; *external factors* comprise the second set of determinants and include the industry and macro environment variables, proxied in our case by, respectively, industry growth, industry size, technological regime, concentration, entry rate and export intensity, and GDP growth and unemployment. Since all *internal* determinants are expressed in logarithms, the estimated coefficients can be interpreted as elasticity parameters. Given the low (contemporaneous) correlation between the GDP growth rate and unemployment (see Table 2), we kept both variables in the regression.[12]

The results of the Cox proportional hazard model [model (1)] are presented in Table 9. Column (1) takes the TFP as the productivity measure, while in column (2) we have the labour productivity case. We also ran the CPH model with unobserved individual heterogeneity explicitly modelled. Since we cannot reject the null hypothesis that the frailty variance component is equal to zero at the 1% significance level (likelihood-ratio test), Table 9 only presents the coefficient estimates under the hypothesis of no unobserved heterogeneity. (The results from the unobserved heterogeneity model are available from the authors upon request.) In both columns (1) and (2), the null that all parameters are not statistically different from zero

[12] Two possible explanations for the low (negative) correlation between GDP growth and unemployment are in line: the first one is connected to a wide lag between job creation and the economic cycle observed in the Portuguese economy (e.g. Baptista and Thurik, 2007); the second is related to the intense restructuring wave observed in the middle of the 1990s in the Portuguese manufacturing sector (Carreira and Teixeira, 2008).

is rejected at the 0.01 (the Wald test at the bottom of the table). Given that our dependent variable is the hazard rate, a negative (positive) coefficient implies that the corresponding variable reduces (increases) the instantaneous probability of exit, thus increasing (decreasing) the chance of survival.

Table 9. Regression results from the Cox proportional hazard model

Variables	(1)	(2)
Firm-level:		
TFP	-1.115*** (0.155)	
Labour productivity		-0.394*** (0.037)
Age	-0.061 (0.193)	-0.021 (0.186)
Size	-0.238** (0.119)	-0.167 (0.122)
Macro-level:		
GDP growth	-5.923** (2.551)	-6.299*** (2.335)
Unemployment	0.952*** (0.263)	0.907*** (0.264)
Industry-level:		
Growth	-5.568** (2.538)	-5.880*** (2.324)
Size	-5.363* (2.991)	-4.052 (3.049)
Technological regime	-2.240** (1.058)	-2.171** (0.989)
Concentration	0.777** (0.356)	0.762** (0.336)
Entry rate	-0.155 (0.110)	-0.115 (0.105)
Export intensity	-0.007 (0.019)	-0.003 (0.017)
Industry dummies	Yes	Yes
Log likelihood	-628.454	-616.400
Wald test	114.15***	219.40***
N	4546	4546

Notes: CPH model regressions, with 'ties' handled with the method proposed by Efron (1977). The null hypothesis of no unobserved heterogeneity was not rejected. (The results from the unobserved heterogeneity model are available from the authors upon request.) Robust standard errors are given in parenthesis. ***, **, and * denote statistical significance at the .01, .05, and .10 levels, respectively.

We now turn to the impact of productivity level on failures. We found that productivity – either TFP or labour productivity – is negatively signed, a confirmation that a higher productivity level reduces the hazard rate. The magnitude of the productivity effect is nevertheless quite distinct across the two productivity measures. If the TFP increases by 1%, then the hazard of exiting decreases by 0.67% [= (1-exp(-1.12))*1% = (1-0.33)*1% = 0.67%], *ceteris paribus*. In the case of labour productivity, the corresponding reduction in the hazard rate is 0.33% [=1-exp(-0.39) = 1-0.67 = 0.33]. In both cases, the evidence in favour of *hypothesis 1* is quite clear.

The negative sign of the firm size variable also indicates that large firms are less likely to shut down than smaller firms, a result consistent with *hypothesis 4*. For the FTP case, if the variable size increases by 1%, then the hazard of exiting decreases by 0.21% [= 1-exp(-0.24) = (1-0.79) = 0.21]. But the evidence seems to be less strong than the one found for the productivity variable: in column (1), the size coefficient is significant at 0.05, while in column (2) it does not seem to be statistically significant at conventional levels.

For its part, the variable *age* does not have any statistically significant impact on the risk of exit, which seems to contradict most industrial organization predictions. Here we might refer again to Geroski (1995) who pointed out that other firms characteristics may well be capturing the impact of knowledge accumulation. In particular, in our case this impact is likely to have been captured by the productivity and size variables. This possibility is contained in our *hypothesis 5*.

The coefficient of the industry growth variable is negative and statistically significant in specifications (1) and (2) of the table. Thus, industry growth increases survivability, which is consistent with the view that faster growing industries provide better survival opportunities for all units in operation. The risk of exit seems also to be lower when industry size is higher, although the corresponding coefficient is not statistically significant in column (2). For its part, there is evidence that the risk of exit is higher in highly concentrated industries, a result that seems to be more favourable to the organizational ecology approach than to the industrial organization predictions. In turn, the variables entry rate and export intensity do not seem to have any statistically significant impact on the likelihood of exit. The negative sign of the technological regime variable indicates that in high- and medium-tech industries firms are less likely to shut down than otherwise. On the whole, the results seem to confirm that favourable demand market conditions (measured by industry growth and size) have a positive impact on the probability of survival, our *hypothesis 6*, although we do not obtain confirmation that more competition (measured by the C-5, the entry rate and export intensity) induces exit. Finally, the unemployment rate is clearly negatively associated with survival, while the effect of a growing GDP is highly favourable to survival, as postulated by our *hypothesis 7*.[13]

5. Conclusion

In this study we provide an analysis of the exiting profile of mature firms in the Portuguese manufacturing sector over a period of one decade. In the first place, the evidence we found on the existence of a productivity gap between exiting and surviving firms is consistent with the industrial organization prediction that market selection is grounded on efficiency reasons. But low-productivity firms do not necessarily exit nor firms with an above-average productivity are immune to failure. The analysis of the productivity distribution, on the one hand, and the transition rates in different quintiles, on the other, show indeed that both low- and high-productivity firms exit. This result does not exactly fit standard industrial organization predictions; but it confirms that complementary explanations are required to a full description of firm exit as suggested by other strands of literature. Our evidence also shows that exit is not properly a 'sudden death' phenomenon, as exiting firms reveal a steady productivity decline over a period of several years prior to exit. Finally, hazard rate regressions substantiate the

[13] The robustness of the results reported in Table 9 was analysed in the context of the PWCH model. The results from this model (available from the authors upon request) are virtually the same.

finding that a low productivity level increases the probability of exit, with industry- and macro-environment covariates having a non-negligible role on exit of mature firms.

We believe one quick recommendation can be drawn from our findings: since firms in economic trouble are likely to be inefficient, economic policy should in principle facilitate exit rather than protect inefficiency. But given the impact of massive layoffs on aggregate unemployment figures, policy makers tend instead to focus on broader policies of one-size-fits-all type, without giving a proper incentive to firm's own selection of the critical competitiveness factors. In absence of a well-built restructuring strategy that gives priority to efficiency gains, government relief programs are doomed to vanish rather quickly without any enduring impact on economic growth. The confirmation of a shadow of death effect should also give an extra incentive to policy makers to focus on helping individual business to implement early warning systems that anticipate as much as possible key market disruptions. Managers, in turn, should be more effective on distinguishing cyclical from long-term competitiveness policies, focusing their attention predominantly on the latter.

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