

Debt or Equity: Does it Matter for Firm Size Dynamics?*

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Abstract

Recent theoretical work such as Cooley and Quadrini (2001) highlight the role of financial frictions in models of firm dynamics. This paper investigates empirically the implications of the Cooley and Quadrini (2001) model for the determinants of firm size dynamics with special emphasis on financial frictions. To consider the role of financial frictions a measure of the firm's debt-to-asset ratio is included into the firm size dynamic regressions. The T2LEAP database, a unique panel dataset, is employed. T2LEAP is an administrative tax database which contains balance sheet and employment information on the universe of all incorporated manufacturing firms in Canada for the period 1985-1997. Care is taken to control for the firm unobservables to get consistent estimates of the model. Another issue is the possibility of endogeneity between firm size and the debt-to-asset ratio. This paper employs dynamic panel data methodology discussed in Arellano (2002) to estimate these relationships. Preliminary findings show that accounting for firm unobservables is important and financial friction do matter to some firm size dynamics relationships.

Key Words: Firm Dynamics, Leverage, Dynamic Panel Data

JEL Classification: D21, G3, C23

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