

## **The Dynamics of Firm Growth in Atlantic Canada and Canada (1989-1995)<sup>1</sup>**

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This paper utilizes unpublished Statistics Canada data to examine the dynamics of firm growth in Atlantic Canada and Canada during the 1989-1995 period. The six-year analysis focuses on business entries and exits and on trends within specific industries and provinces. Comparisons are made between the Atlantic region and the country as a whole. Results confirm the importance of SMEs to the entrepreneurial activity of the region and the country and indicate that Atlantic Canada continues to outperform the nation in the rate of new business start-ups and in the net retention rate of firms.

### **Introduction**

Since the release of the seminal article by David Birch (1981) in the United States, considerable attention has been devoted to research relating to the contribution of small and medium-sized enterprises (SMEs) to the economies of countries around the world (Doyle & Gallagher, 1987; Acs & Audretsch, 1989; Japan Small Business Research Institute, 1995). In Canada, publications at the national (Industry Canada, 1995), regional (Atlantic Canada Opportunities Agency, 1991) and provincial (Ministry of Industry, Trade and Technology, 1990) levels have highlighted the contributions that small firms make to the economy. The resulting data make a strong case for the role that SMEs have played in job creation, among other areas, and have had a significant influence on the development of public policy. As a result, it is important to continue to investigate the contribution of the SME sector to the country and to the Atlantic region.

The present paper compares firm growth in Canada and in Atlantic Canada for the period from 1989 to 1995 by examining data on the distribution of firms by industry sector, business entries and exits, and growth patterns of new and existing firms. The paper provides data and analysis that will be of use to researchers and to private and public sector decision makers.

### **Literature Review**

Recent research in the United States has cast some doubt on the relative contribution of SMEs and large firms in the area of net job creation (Davis, Haltiwanger & Schuh, 1993). The authors conclude that measurement issues, revolving around the problem of regression toward the mean, have resulted in overstating the small firm sector contribution to employment compared to that of large firms. In Canada, more recent work by Picot, Baldwin and Dupuy (1994) utilizes longitudinal data (1978-92) to measure firm growth in an attempt to determine the impact of measurement issues. They conclude that the use of different measurement approaches does have an impact on the magnitude of the differences in growth rates between small and large firms but also confirm that the small firm sector accounts for a disproportionate share of gross employment gains, gross employment losses and

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the resulting net increase in employment. However, controlling for births or new entrants and focusing only on existing firms, they also conclude that employment growth is very similar in the small and large firm sectors.

Research by Arend et. al. (1997) explores what they refer to as the Engine of growth hypothesis. According to this hypothesis, SMEs are considered to be the Engine of growth for three reasons. First, they account for a disproportionate share of net employment growth. Second, SMEs are a breeding ground for large firms. Third, SMEs provide an efficient market for entrepreneurship. Utilizing data from the Statistics Canada Longitudinal Employment Analysis Program (LEAP) for the period from 1984-1994, the authors confirm the findings of Picot, Baldwin and Dupuy (1996) that net employment growth in Canada is largely the result of births or new firm entrants. They further argue that most new firms are in the small firm class, and it is this effect that generates net positive employment growth (Arend et. al., 1997; 17). As for small firms serving as the source of the large firms of the future, the authors indicate that they find little evidence to support this aspect of the hypothesis. Overall, they conclude that SMEs do provide an efficient market for entrepreneurship and are engines of entrepreneurial activity but not employment growth.

### **Data**

This section includes a description of the data used in the study as well as some of the key definitions. Data<sup>2</sup> in this paper were sourced from Employment Dynamics, Business Size and Life Status, Small Business and Special Surveys Division, Statistics Canada and from a special run of Employment Dynamics. The special run was required in order to obtain firm entry and exit data at the provincial level and to permit analysis of firm dynamics using more detailed employment size categories. There was a structural change in the Statistics Canada data base in 1989 and data prior to 1989 are no longer comparable with data after 1989. The structural change consists of a change from the 1970 SIC system to the 1980 system as well as a change from the Business Register Division system of business identification to the current CFDB system (Central Frame Data Base).

For the purpose of this analysis, a small firm is defined as one with fewer than 100 employees, a medium-sized firm is one with 100-499 employees and a large firm is one with 500 or more employees. The sectors included in the study are: goods-producing which is comprised of the primary sectors (agriculture, fishing and trapping, logging and forestry, and mining), manufacturing and construction; trade which consists of wholesale and retail; market services which includes transportation, communications and utilities, finance, insurance and real estate, and personal and business services; and funded which consists of community services (education, health and welfare) and government services.

### **Findings and Discussion**

The findings and related discussion will be presented in the following three areas: distribution of firms by industry sector; business entries and exits; and growth patterns of new and existing firms.

#### **Distribution of Firms by Industry Sector**

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<sup>2</sup> Readers are cautioned that refinements of the 1990-1993 data by Statistics Canada have resulted in differences in the data presented for that period in this paper to that presented in the 1996 edition of *The State of Small Business and Entrepreneurship in Atlantic Canada*.

Table 1 provides data on the distribution of firms by industry sector in Atlantic Canada for 1989 and for 1995, including the changes that occurred over the six-year period. Similar information for Canada is provided in Table 2. A number of observations are noteworthy with respect to the data for the Atlantic region. First, Atlantic Canada experienced increases in the number of firms in all sectors, except the goods-producing sector, for an overall increase of 5.0%. As Table 1 indicates, the largest increase in the region was in the market services sector, which increased by 2,891 firms or 8.3%. The funded sector followed with an increase of 2,205 firms, representing a 35.3% increase. Second, the region's goods-producing sector decreased by 1,440 firms for a 5.2% decline. Third, the percentage share of the total number of firms in 1995 for the trade and the market services sectors changed only slightly from 1989, while the funded sector increased its share from 7.2% to 9.3% and the goods-producing sector decreased from 31.9% to 28.8%.

**Table 1**  
**Distribution of Firms by Industry Sector**  
**Atlantic Canada**  
**1989-1995**

Industry sector	# of firms 1989	Share of total	# of firms 1995	Share of total	Net change in # of firms	% chg
		%		%		
Goods-producing	27,692	31.9	26,252	28.8	-1,440	-5.2
Trade	18,052	20.8	18,701	20.5	649	3.6
Market Services	34,773	40.1	37,664	41.4	2,891	8.3
Funded	6,248	7.2	8,453	9.3	2,205	35.3
All Industries	86,765	100.00	91,070	100.00	4,305	5.0

Source: Employment Dynamics

Even though Canada experienced a recession during the early 1990s, the number of firms operating in the country increased from 919,275 to 941,738 for a 2.4% increase. As Table 2 indicates, three sectors experienced increases: trade, market services and funded. The market services sector experienced the largest increase in the number of firms, growing by 38,110 firms, for a 10.4% increase. The funded sector also performed extremely well with an increase of 14,510 firms. In fact, the percentage increase for this sector at 20.7% was the largest of all sectors. The goods-producing sector was the only one to experience a decline. A decrease of 33,920 firms or an 11.8% decline in this sector offset most of the gains experienced in each of the other sectors.

**Table 2**  
**Distribution of Firms by Industry Sector**  
**Canada**  
**1989-1995**

Industry sector	# of firms 1989	Share of total	# of firms 1995	Share of total	Net change in # of firms	% chg
		%		%		
Goods-producing	287,626	31.3	253,706	26.9	-33,920	-11.8
Trade	193,596	21.1	197,359	21.0	3,763	1.9
Market Services	367,818	40.0	405,928	43.1	38,110	10.4
Funded Sector	70,235	7.6	84,745	9.0	14,510	20.7
All Industries	919,275	100.00	941,738	100.00	22,463	2.4

Source: Employment Dynamics

The decline in the number of firms in the goods-producing sector also resulted in a significant downward shift in the share of the total number of firms accounted for by this sector from 31.3% to 26.9%. The market services sector increased its share of total by 3% to 43.1% and the funded sector increased by 1.4% to 9.0%. A comparison of Tables 1 and 2 indicates that when the relative size of the region is considered, Atlantic Canada outperformed the national economy, most notably in the funded and goods-producing sectors.

### Business Entries and Exits

According to Baldwin et. al. (1997), business entries and exits are a vital part of the turnover process. In their estimation, firms that are one year old account for between 15% and 20% of the total number of commercial firms in existence at any point in time. However, new firms have extremely high mortality rates and fewer than one in five survive ten years (Baldwin et. al., 1997). A dynamic economy needs a large number of new business start-ups each year for three reasons. First, new firms create jobs that account for the majority of net employment growth (Arend et. al., 1997). Some of these jobs are needed to replace job losses in firms that decrease in size or which exit the economy during a period. Second, the successful entrants, those that survive beyond ten years, provide almost as many jobs as the entire group of entrants—both survivors and exiting firms—did when they first started (Johnson, Baldwin & Hinchley, 1997:8). Third, new firms often introduce new products and services and encourage incumbents to do the same (Geroski, 1995). As a result, it is important to assess the performance of the country and the Atlantic region in terms of business entries and exits.

In the context of this paper, entries are defined as businesses that enter a region's economy during a given year. Exits are defined as firms that have left the economy in a particular period. Entry rates are calculated by dividing the number of new firms by the number of firms that existed at the beginning of the period in question. Exit rates are calculated by dividing the number of exiting firms by the number of firms that existed at the beginning of the same period. Exit statistics do not necessarily measure business failure. In fact, businesses leave the economy for a number of reasons, including mergers, acquisitions and voluntary closures. In some cases a change in legal status, a name change or a change in ownership might appear as an exit in Statistics Canada reports.

Tables 3 and 4 provide a summary of business entry and exit statistics for Canada, Atlantic Canada and each of the individual Atlantic provinces.

**Table 3**  
**Trends in Business Entry Rates**  
**Canada, Atlantic Canada and Provinces**  
**1990-1995**  
**(%)**

<b>Region</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>Average</b>
NF	29.4	25.8	24.5	23.4	20.5	21.0	24.1
PEI	21.2	21.7	17.1	16.7	21.4	20.8	19.8
NS	18.9	18.7	17.7	17.4	17.6	17.4	18.0
NB	19.4	17.1	16.2	15.9	17.0	17.1	17.1
ATL CAN	21.8	20.3	18.9	18.5	18.5	18.5	19.4
CAN	16.7	14.7	14.3	14.2	14.6	14.8	14.9

Source: Special run of Employment Dynamics

Atlantic Canada's average entry rate of 19.4% compares very favourably with the average rate of 14.9% experienced nationally. Not only the region but each of the four Atlantic provinces exceeded the national rate for each of the six years. However, as Table 3 indicates, the entry rate experienced by the region over the period has decreased from 21.8% in 1990 and has levelled at 18.5% for the 1993-1995 period. The pattern of the last three years in Atlantic Canada contrasts with an increase of 0.6% in the national rate over the same period.

Each of the Atlantic provinces experienced a decline in entry rates over the six-year period. However, there was considerable variation among the provinces in the rate of decline. Newfoundland and Labrador experienced the highest entry rate overall, but its decline was also the most pronounced, from 29.4% to 21%. The downward trend in Prince Edward Island was interrupted in 1994, likely reflecting the impact of the construction of the Confederation Bridge, resulting in only a slight decrease of 0.4% in the entry rate. New Brunswick experienced a decline in its entry rate of 2.3% while Nova Scotia was slightly lower at 1.5%. Overall, it would appear that Atlantic Canadians continue to start businesses at rates higher than the national average, however, the margin has narrowed over the last six years.

Table 4 indicates that the Atlantic region experienced an average exit rate of 18.6%, much higher than the national average of 14.5%. The trend over the period also points to a widening in the gap between exit rates in the region and the country, largely reflecting increases in the exit rates for Atlantic Canada. Business exit rates also varied widely within the region. The highest provincial rate in 1995 belonged to Newfoundland and Labrador at 25.3% up from 23.2% in 1990. However, the

largest increase over the period occurred in Prince Edward Island, which experienced a significant increase from 16.0% to 23.2%. It is noteworthy that the bulk of this increase occurred in 1995. Nova Scotia also experienced a slight increase over the period while New Brunswick's exit rate remained virtually unchanged. Although these exit rates might appear somewhat high, it must be pointed out that small firms traditionally experience high exit rates (Arend et. al.,1997) and that this was magnified by the recession which was prevalent in the region during the early 1990s.

**Table 4**  
**Trends in Business Exit Rates**  
**Canada, Atlantic Canada and Provinces**  
**1990-1995**  
**(%)**

Region	1990	1991	1992	1993	1994	1995	Average
NF	23.2	23.0	22.1	23.0	24.2	25.3	23.5
PEI	16.0	16.3	19.2	16.6	17.1	23.2	18.1
NS	16.6	17.4	16.9	17.2	16.8	19.0	17.3
NB	17.5	16.7	15.7	18.0	15.5	17.4	16.8
ATL CAN	18.5	18.5	18.0	17.7	18.3	20.4	18.6
CAN	15.1	15.5	14.0	13.9	13.7	14.6	14.5

Source: Special run of Employment Dynamics

Table 5 provides a comparison of the average entry and exit rates for Canada, Atlantic Canada and each of the Atlantic provinces indicating that the impact on the economy of relatively high entry rates has been largely offset by high exit rates. Atlantic Canada experienced an overall increase in the number of firms operating in the region of 0.8%, exactly double the national rate of 0.4%. Although Newfoundland and Labrador experienced the highest exit rate at 23.5%, the province still managed a net increase in firms of 0.6%, also above the national average. The region's strongest performer was Prince Edward Island, which produced a net increase of 1.7%. The remaining Atlantic provinces, with the exception of New Brunswick, also outperformed the national average.

A comparison of the data presented in Tables 3 and 4 reveals that the percentage of net new firms entering the region's economy has steadily decreased over the 1990-1995 period. In fact, for the first time in ten years, the region experienced a net decrease in the number of firms in 1995 (Atlantic Canada Opportunities Agency, 1998). This situation is extremely serious given the region's dependence on growth in new businesses as an economic stimulant.

**Table 5**  
**Average Entry and Exit Rates for Businesses**  
**Canada, Atlantic Canada and Provinces**  
**1990-1995**

<b>Province</b>	<b>Entry rate (%)</b>	<b>Exit rate (%)</b>	<b>Net gain (%)</b>
NF	24.1	23.5	0.6
PEI	19.8	18.1	1.7
NS	18.0	17.3	0.7
NB	17.1	16.8	0.3
ATL CAN	19.4	18.6	0.8
CAN	14.9	14.5	0.4

Source: Special run of Employment Dynamics

In order to identify areas of strength and weakness within the region, it is useful to examine entries, exits and net retentions within various industry sectors. This information is presented in Table 6.

The comparison of entry and exit rates indicates that a number of sectors performed extremely well over the six-year period. Among the best performers was the funded sector led by education which, with a net increase of 8.8%, reflects the growing number of privately operated educational institutions in the region. The health sector, another major component of the funded category, also performed well with a net gain of 6.7%. Health was followed closely by the business services sector which recorded a net gain of 6.4% leading all other categories in the market services sector. The communications sector was also reasonably strong with an increase of 3.3%. Growth in the goods-producing sector was led by logging and forestry which experienced an entry rate of 22% and an overall increase in the number of firms operating in the region of 3.1%. Particularly encouraging from an employment point of view was the manufacturing sector, which increased by 1.1%.

One of the region=s traditionally strong sectors, agricultural, fishing and trapping, experienced the largest decline at 3.9%. Government services and other services were the only other sectors to experience a decrease over the six years included in the analysis.

**Table 6**  
**Entries and Exits by Industry**  
**Atlantic Canada**  
**1990-1995**

Industry sector	Total entries	Total exits	Entry rate	Exit rate	Net gain
	#		%		
Agriculture, Fishing and Trapping	11,197	13,956	15.75	19.63	-3.9
Logging and Forestry	2,089	1,794	22.04	18.93	3.1
Mining	304	293	18.98	18.29	0.7
Manufacturing	4,550	4,266	17.39	16.30	1.1
Construction	11,545	10,816	19.99	18.73	1.3
Transportation	4,058	3,707	19.46	17.77	1.7
Communications	705	605	23.23	19.93	3.3
Wholesale	4,468	4,015	15.68	14.09	1.6
Retail	13,319	13,123	16.69	16.45	0.2
Finance and Insurance	3,364	3,188	15.31	14.51	0.8
Business Services	6,041	4,510	25.12	18.76	6.4
Government Services	1,519	1,549	28.94	29.51	-0.6
Education	1,201	863	31.33	22.51	8.8
Health	6,158	4,261	21.68	15.01	6.7
Accommodation	7,044	6,188	23.45	20.10	2.9
Other Services	28,048	28,171	25.82	25.93	-0.1
<b>TOTAL</b>	<b>105,610</b>	<b>101,305</b>	<b>20.29</b>	<b>19.46</b>	<b>0.8</b>

Source: Employment Dynamics

### Growth Patterns of New and Existing Firms



This section investigates the growth patterns of firms in existence at the end of 1989, as well as those established after that time. This analysis, based on the data presented in Table 7, examines the growth in number of firms by employment size category.

Several patterns can be identified from a review of Table 7. First, only a small number of firms grew into a larger employment size category over the period. Second, most firms remained stable in size or experienced changes in employment which were not large enough to move them to another category. Third, relatively high numbers of firms of all sizes exited the economy. In order to understand the implications of these patterns, an examination of the movement of firms between employment categories is necessary. Before doing that, however, some clarification of the terminology is necessary. AEntrants $\cong$  are defined as firms which entered the economy during the six-year period under review. AExits $\cong$  are firms which left during that period. AOutflows $\cong$  are firms that existed in 1989 and which moved to a another size category during the six-year period. AInflows $\cong$  are firms moving into a size category from another size category.

**Table 7**  
**The Dynamics of Firms in Atlantic Canada**  
**1990-1995**  
**(000s)**

Status	<5 emp.	5<2 0 emp	20<5 0 emp.	50<100 emp.	100<500 emp.	500 + emp	Tota l firm s
Firms in existence at the end of 1989	64.7	12.8	3.6	1.5	2.3	1.9	86.8
% of all firms	74.5	14.8	4.2	1.7	2.6	2.2	100. 0

**FIRMS COMING INTO THE SIZE CATEGORY**

New entrants	90.3	6.9	3.1	1.7	2.4	1.2	105. 6
Inflows	3.6	2.2	1.0	0.5	0.4	0.1	7.8
Total	93.9	9.1	4.1	2.2	2.8	1.3	113. 4

**FIRMS LEAVING THE SIZE CATEGORY**

Exits of 1989 firms	37.6	3.9	1.2	0.6	0.9	0.5	44.7
Outflows	1.7	4.1	1.1	0.5	0.3	0.1	7.8
Exits of post-							

1989 firms	47.6	4.0	2.0	1.0	1.4	0.6	56.6
Total	86.9	12.0	4.3	2.1	2.6	1.2	109.1

Net Change	7.0	-2.9	-0.2	0.1	0.2	0.1	4.3
Firms in existence at the end of 1995	71.7	9.9	3.4	1.6	2.5	2.0	91.1
% of all firms	78.7	10.8	3.7	1.9	2.7	2.2	100.0
% change	10.8	-22.6	-5.5	6.7	8.7	5.3	5.0

Source: Special run of Employment Dynamics

The most volatile size category was the smallest (<5 employees). This category experienced the highest number of entrants and exits. It also accounted for the largest increase in the number of firms and for almost all of the increase in firms in the region over the six-year period. The medium-sized and large-firm categories also achieved modest increases. In keeping with the findings of Arend et. al. (1997), very few small firms grew to a point where they entered a larger size category. In fact, most small firms remained about the same size. There may be a number of reasons for this. First, small businesses tend to have somewhat restricted access to the financial and human resources needed for expansion. Second, many small firms are constrained by the size of local markets but find it difficult to see beyond local boundaries. Third, during much of the period under review the region experienced tough economic times. Fourth, some small business owners choose to remain small.

## Conclusions and Implications

In conclusion, Atlantic Canada experienced increases in the number of firms in all sectors except the goods-producing sector over the six-year period and continues to lead the nation in the rate of new business startups. The market services sector led the region in firm growth followed by the funded sector. Although experiencing a decline in the number of firms in the goods-producing sector, the decrease in the region was significantly less than the decrease in the country. The market services and funded sectors also performed well at the national level. Unfortunately, the significant decrease in the goods-producing sector in Canada offset most of the gains that were achieved in each of the other sectors. The downward shift in the percentage share of the total number of firms accounted for by the goods-producing sector may be evidence of the sectoral shifts associated with the new economy.

Average entry rates in the Atlantic region clearly surpassed those of the country as a whole, as did the rates experienced by each of the four Atlantic provinces. Unfortunately, a downward trend in entry rates in the region combined with an increase in exit rates resulted in very small net gains over the period. Although the overall retention rate of firms in the region was higher than in the country, the gap in entry rates narrowed while the gap in exit rates increased, both in Canada's favour. One of the most disturbing findings of the study is the fact that Atlantic Canada experienced a net decrease in the number of firms in 1995, the first time in ten years. This situation is extremely serious in light of the importance of new venture creation and growth in new businesses and has implications for the development of mechanisms and support structures to help reduce the rate at which firms exit the economy.

In terms of performance at the sectoral level, the funded sector led all others in percentage net gains in Atlantic Canada. The education and health areas were responsible for all of the growth in the funded sector, while government services experienced a decline. Strong performances were also recorded in the business services sector, the communication sector, the logging and forestry sector and the accommodation sector. The agriculture, fishing and trapping sector experienced the greatest decline over the period at 3.9%, another illustration of the sectoral shift associated with the new economy.

The findings related to the growth patterns of new and existing firms confirm the findings of previous research (Arend et. al, 1997) which indicate that very few small firms grow to the point where they enter a larger size category. Most firms experienced increases or decreases in employment that were not large enough to move them to another size category. In fact, over the six-year period covered in the present study, the percentage of all firms accounted for by firms with fewer than five employees increased from 74.5% to 78.7%. This category was also the most volatile, experiencing the highest number of entrants and exits. However, the very small firms were also the major contributors to growth in the number of firms, experiencing the largest increase in the number of firms and accounting for almost all of the increase in the number of firms in the region over the period. Although there was substantial activity within the small firm category (<100 employees), its share of the total number of firms remained virtually unchanged over the period at a substantial 95%.

The results of this analysis provide support for the findings of Arend et. al. (1997) that SMEs are engines of entrepreneurial activity and clearly reinforce the importance of new small firms to the economy of the region. However, the finding that most small firms remain small also has implications for the development of policies and programs that address potential barriers and constraints to growth. Finally, the most significant limitation of the present study is the lack of employment data and therefore, the inability to provide evidence as to whether or not SMEs are also engines of employment growth.



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