Does Competition Prevent or Promote Zombie Firm Formation? International Evidence

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Using plausibly exogenous variation from competition-law reforms across 52 countries, we examine whether and how competition affects zombie firm formation. We find that more stringent competition laws significantly reduce new zombie formation. This decline does not reflect improvements in firms' financial conditions. To the contrary, pro-competitive reforms increase firms' likelihood of financial distress, but reduce the probability that distressed firms subsequently become zombies. These findings suggest that competition curbs zombification by disciplining creditor forbearance and weakening incentives to evergreen distressed borrowers, rather than by shrinking the pool of potential zombie candidates. Consistent with this creditor channel, the effect is stronger in countries with weaker banking sectors, where evergreening incentives are likely to be more pronounced. Overall, our evidence suggests that competition policy disciplines banks rather than firms: it does not prevent firms from falling into distress, but it prevents distress from turning into zombification. Our findings provide new insights into how formal institutions influence zombie firm formation by shaping creditors' incentives and the allocation of credit.