ECONOMIC VIEWPOINT

# Small Businesses: Heavyweights in Quebec's Economy

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Small businesses abound in all parts of Quebec. Not only do they make up a large share of the province's GDP and exports, but they also account for many of its employers. If the ongoing worker shortage is holding them back, that's not the only challenge ahead of them. In 2023, small businesses will continue to contend with inflation, elevated interest rates, high energy prices, and limited borrowing capacity. Labour scarcity will continue to be an issue for them over the long term, as will boosting their competitiveness and managing the green transition and supply chain logistics. Quebec's small businesses will have to be proactive, creative, bold and forward-thinking. In this note, we'll briefly discuss the challenges they face in the short, medium and longer term.

## The Role of Small Businesses in Quebec's Economy

Small businesses are defined as enterprises that employ fewer than 100 employees (see box 1 for definitions). In 2021, they accounted for 98% of Quebec businesses, which is in line with what we see in Ontario and nationwide. Furthermore, 88% of Quebec businesses employed fewer than 20 workers, compared to 90% in Canada and Ontario. According to Statistics Canada estimates, small businesses account for more than one-third of Canada's GDP. The most recent data for this estimate is from 2019, and there's no provincial breakdown. Things may be different now since the pandemic, but on average, small businesses made up 38.1% of Canada's GDP from 2015 to 2019, varying between 36.7% and 39.6%. In comparison, medium-sized businesses (those with 100 to 499 employees) and large businesses accounted for 14.3% and 47.6% of GDP, respectively.

### BOX 1
**Small, Medium or Large?**

The size of a business is defined by how many employees it has:

- Small businesses have 1 to 99 employees.
- Medium-sized businesses have between 100 and 499 employees.
- Large companies have 500 or more employees.

Source: Statistics Canada

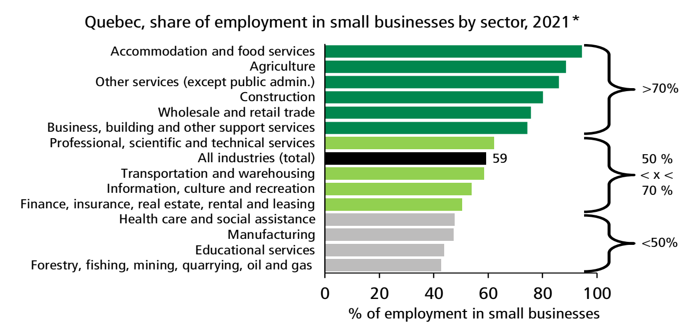
More recent data is available for exports. In 2021, small businesses accounted for 20.2% of Canada's international goods exports by value. That's very similar to pre-pandemic figures for 2017 and 2018.

## Small Businesses, Big Employers

On average in the 2010s, small businesses accounted for 63.9% of jobs in Quebec.[1] That number began edging down gradually in 2017 and has been below 60% since 2021 due to pandemic disruptions. Some sectors have an especially high share of businesses with fewer than 100 employees.

As seen in graph 1, small businesses accounted for 70% or more of jobs in accommodation and food services, agriculture,

**GRAPH 1**
**There is significant variation in small business prevalence by sector**




* Small business: 1 to 99 employees. The denominator excludes the self-employed.
Sources: Statistics Canada and Desjardins Economic Studies

[1] The denominator is composed of total employees. It excludes the self-employed.

other services (hair care, esthetic services, auto repair, etc.), construction, wholesale and retail trade, and business services. These sectors are dominated by small businesses, as defined above.

The figure stands at between 50% and 70% in professional, scientific and technical services; transportation and warehousing; information, culture and recreation; and finance, insurance, real estate, rental and leasing. It's less than 50% in health care and social assistance. That's not surprising, as this category includes hospitals, nursing homes and long-term care facilities. It's also below 50% in manufacturing and in educational services, as well as in forestry, fishing, mining, quarrying, oil and gas.

## Regional Profile

In terms of what percentage of businesses are small businesses, the figure varies little from one administrative region to the next. They accounted for the biggest share in Gaspésie–Îles-de-la-Madeleine (99.1%) and the lowest in Nord-du-Québec (95.9%), likely due to the impact that big mining corporations, Hydro-Québec and logging companies have on the labour market there.

The administrative region of Montreal (the island) was home to a quarter (25.4%) of Quebec's small businesses in 2021. Montérégie accounted for 18.2% and Capitale-Nationale 8.2%, followed by Laurentides at 6.0% and Chaudière-Appalaches at 5.8%. The figure was less than 5.0% in all other regions.

## Short-Term Challenges

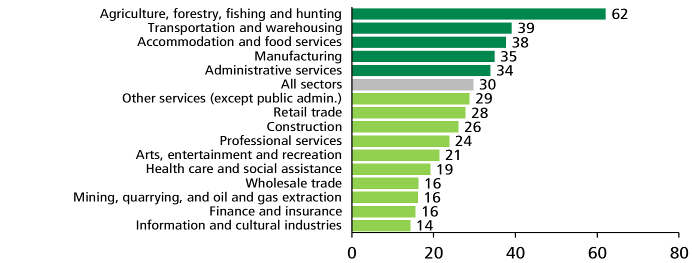
2023 will look a lot like 2022. Small businesses will be contending with higher inflation than what we've become accustomed to in recent decades. From 2017 to 2021, the average inflation rate was 1.9%. It was 3.8% in 2021 and is expected to come in at around 6.5% in 2022. Inflation should come down in 2023, averaging about 3.0%. In the meantime, it's something small businesses will continue to have to contend with, caught in a tricky spot between rising input costs and customers' declining purchasing power.

They'll also be dealing with high interest rates. According to a Statistics Canada survey conducted in the third quarter of 2022, 62% of agriculture, forestry, fishing and hunting businesses said they're feeling the pinch of higher borrowing costs (graph 2). Other sectors particularly concerned, but to a lesser extent, include transportation and warehousing (39%), accommodation and food services (38%), manufacturing (35%) and administrative services (34%). That's above the Quebec average of 30%.

The sectors hardest hit by COVID-19 lockdowns are the ones least able to take on more debt. Other services (hair care and esthetic services, auto repair, etc.), accommodation and food services, transportation and warehousing, and health care are the most stretched. The situation is most worrisome for micro-enterprises, defined as businesses with 1 to 4 employees.

**GRAPH 2**
**Quebec's agriculture and forestry sector is most concerned about the higher cost of borrowing**

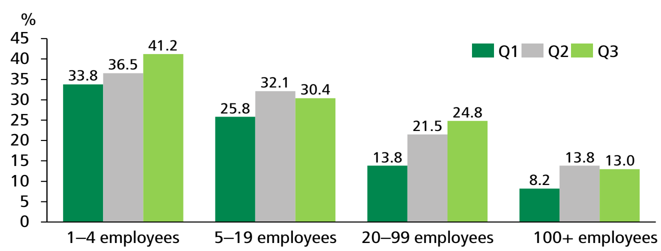
Q3 2022
Rising interest rates and debt costs (% of respondents that named this as an obstacle)




* Real estate sector not illustrated as data too unreliable
Sources: Statistics Canada and Desjardins Economic Studies

**GRAPH 3**
**A larger share of Quebec's small and micro-businesses are experiencing difficulties**

Q1 2022 to Q3 2022
Businesses that say they can't take on more debt (as a % of respondents)



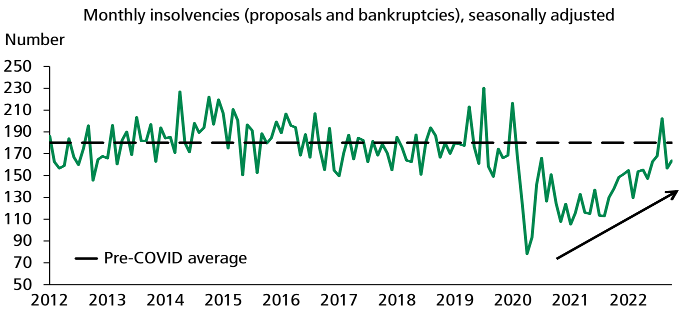

Sources: Statistics Canada and Desjardins Economic Studies

More than 40% of them say they can't take on more debt (graph 3). That number is around 30% for businesses with 5 to 19 employees, and about 25% for those with 20 to 99 employees in Q3 2022.

Between the pandemic, soaring inflation and rising interest rates, businesses are dealing with fatigue. It's been nearly three years now that they've had to continually adapt. So it's no surprise that insolvencies are up, after falling during the pandemic thanks to government assistance. Since the second half of 2021, the number of insolvencies is back to pre-pandemic levels (graph 4 on page 3). In all likelihood, the current economic slowdown and eventual recession will make it more difficult to do business. As seen from the Statistics Canada survey, small businesses don't have much financial cushion. And interest rates may not start to come down for several quarters. We therefore expect more insolvencies in the first half of 2023, especially among small businesses.

There will continue to be other short-term challenges as well, including energy prices and rising wages. The Canadian Federation of Independent Business (CFIB) regularly surveys small and medium-sized businesses on these issues. In November,

**GRAPH 4**
**Quebec may see business insolvencies continue to rise**




NOTE: Data seasonally adjusted by Desjardins Economic Studies
Sources: Office of the Superintendent of Bankruptcy and Desjardins Economic Studies

energy prices and wages were again a bigger concern than borrowing costs.

### Small Businesses Will Have to Be Proactive and Creative

Oil, natural gas and other energy prices spiked after the first lockdown ended in the spring of 2020. They held relatively steady after that, then shot up again when Russia invaded Ukraine. The looming global economic slowdown will cool demand and send oil prices lower in 2023, but they could still remain elevated and volatile. Businesses are dealing with much higher costs. Take trucking companies and other logistics firms. After they spent years working to improve truck aerodynamics (adding deflectors, for example), changing the way big rigs are driven, switching to lower-emission fuels and optimizing routes, it's now time for them to make the energy transition. Some companies have already taken the lead by gradually electrifying their vehicle fleet. It's one way to address rising fuel costs and price volatility. It also helps to reduce greenhouse gas emissions, which are a growing concern.

But it's unclear if others will follow suit anytime soon. The technology is still being developed, and up-front costs (buying electric vehicles, installing charging stations, ensuring sufficient power capacity) remain a barrier despite government assistance. After three years of pandemic uncertainty and now faced with a poor short-term economic outlook for 2023, many small businesses just don't have the stomach for it.

The steep rise in wages is partly related to the labour shortage, and partly a result of the soaring inflation brought on by the COVID-19 pandemic. Although businesses have no real control over wage inflation, relief may be on the horizon. The year-over-year change in Quebec's average hourly wages has been declining since the end of summer 2022.

The current labour shortage isn't new, and although the third quarter of 2022 saw job vacancy numbers and rates fall, the labour market remains very tight. Wages have been driven up by employers competing for talent—yet another issue for businesses to contend with. Additionally, with many small businesses carrying high levels of debt and struggling to take on more, they're not really able to invest in solutions to automate or digitalize their operations. Still, some have been able to turn to technology to meet their labour needs. A recent development in food services, for example, has seen some restaurants start to accept orders and process payments via smartphone, or use robots to help with table service.

To adapt to the labour shortage, businesses and industry associations have been getting creative. One strategy that's become popular is providing in-house training with a view to promoting internal resources. It's seen as a way to retain workers and give them opportunities for advancement, while also diversifying their marketable skills. We've also seen a growing number of "labour-sharing" initiatives in the industrial and tourism sectors in particular. It's a way for participating employers to retain employees, ensure no breaks in their employment[2] and give them a wider variety of job experience. While these kinds of strategies do help boost the labour force participation rate, they're only a band-aid solution. The labour shortage is both a short- and medium-term challenge. We'll look at this in the next section.

### Four Key Long-Term Challenges and Resilience Factors

Accounting for 98% of businesses and nearly 60% of jobs, small businesses are key to driving economic vitality and increasing the standard of living in communities. The future of Quebec's collective wealth will be determined by their resilience, their competitiveness and their ability to overcome challenges and crises. In other words, the decisions made by businesses today will influence the trend and composition of tomorrow's investments.

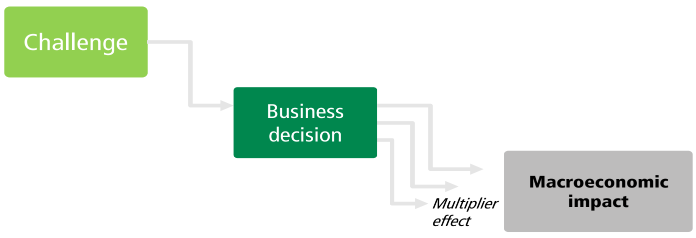
In this section, we'll address the following questions (illustrated in figure 1 on page 4):

1. What are the main medium- and long-term challenges faced by small businesses?
2. Considering these challenges and the unique characteristics of small businesses, what factors are most often associated with resilience and sustainable growth?
3. How do these factors, which manifest themselves as business decisions, affect the broader economy (macroeconomic impact)?

There's a direct link between business investment in productivity-enhancing assets and improved standard of living. Increases in labour productivity have accounted for nearly 90% of Canada's per-capita GDP growth over the past 40 years (Statistics Canada, 2022). So it should come as no surprise that

[2] This is achieved through voluntary employee exchanges between businesses. It's a way for employees to remain on the labour market, with no (or limited) interruption, following the seasonal demand of the businesses that take turns employing them.

**FIGURE 1**




many of the success factors for business prosperity also result in increased productivity. This will be crucial in the coming years as the population ages and we need to produce more with fewer workers.

There are several long-term challenges for businesses to contend with. If small businesses address them now, it will have a significant macroeconomic impact: GDP growth and per-capita GDP growth, improved productivity, increased revenue flows from export and foreign direct investment, real wage growth, etc. (table 1). The main challenges can be broken down into four categories.

**TABLE 1**

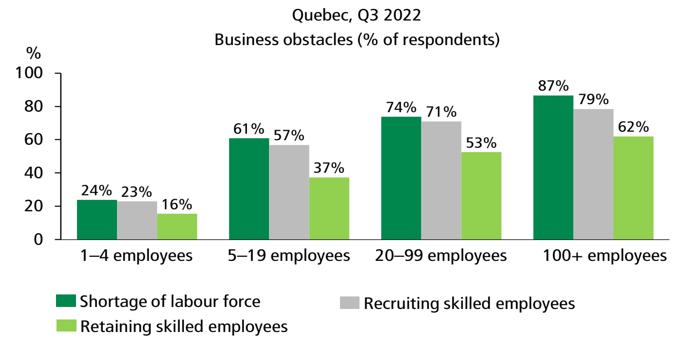
| LONG-TERM CHALLENGE | BUSINESS DECISION | MACROECONOMIC IMPACT |
|---|---|---|
| Labour shortage and labour productivity | • Investing in:<br>○ Automation<br>○ Technology/digital solutions<br>• Attracting, retaining, training talent<br>• Overhauling production and delivery methods for goods and services | • GDP growth<br>• Improved labour productivity (per-capita GDP)<br>• Real wage growth |
| Competitiveness, profitability, longevity | • Innovation (business model, products, processes, R&D)<br>• Anticipation<br>• Agility<br>• Technology/digital solutions<br>• International trade and participation in global value chains | • Productivity gains<br>• GDP growth<br>• Export growth<br>• Real wage growth<br>• Attraction of foreign capital<br>• Repatriation of FDI income |
| Green transition | • Mitigating climate risks<br>• Measuring and reducing their carbon footprint<br>• Participating in green supply chains<br>• Eco-design<br>• Reusing by-products/waste as inputs (circular economy) | • GDP growth<br>• Sustainable growth<br>• Positive effect on wellbeing indicators<br>• Lower GHG emissions |
| Securing supply chains | • Reshoring production<br>• Risk management and mitigation plans<br>• Real-time information-sharing tools | • Impact on productivity may be negative (short term) but then positive (long term)<br>• Lower GHG emissions from transportation |

Source: Desjardins Economic Studies

The first is the labour shortage, which has not subsided despite the economic slowdown. This challenge isn't unique to small businesses. Even with all the resources at their disposal, large companies say they're having more difficulty recruiting (graph 5). Based on 2022 data, smaller businesses (1 to 19 employees) and

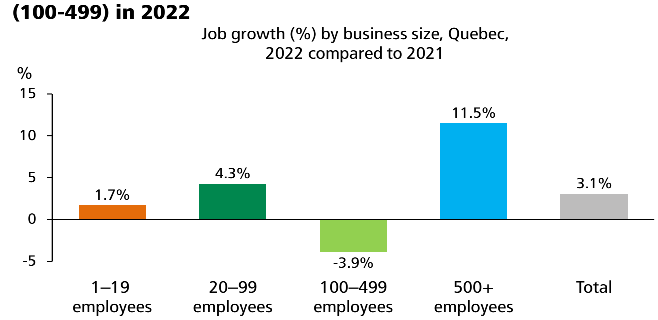
[3] We've used the term "SME" when citing studies that look at both small and medium-sized businesses as opposed to just small businesses.

**GRAPH 5**
**In Quebec, larger businesses are most concerned about the labour shortage**




Sources: Statistics Canada and Desjardins Economic Studies

**GRAPH 6**
**Employment growth was below average in Quebec's smaller-sized (1-19 employees) and medium-sized enterprises (100-499) in 2022**

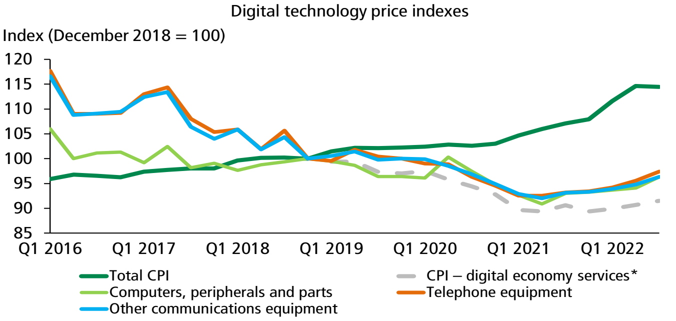



Sources: Statistics Canada and Desjardins Economic Studies

mid-sized ones (100 to 499 employees) had weaker employment growth than average (graph 6). Among the measures used by SMEs[3] to address staffing problems, automation has proved to be the most successful, according to a recent CFIB survey. Small businesses will also depend on an influx of skilled labour—if only to implement new tech. Immigration offers a welcome solution, and businesses that are able to take advantage of newcomer integration programs will improve their prospects.

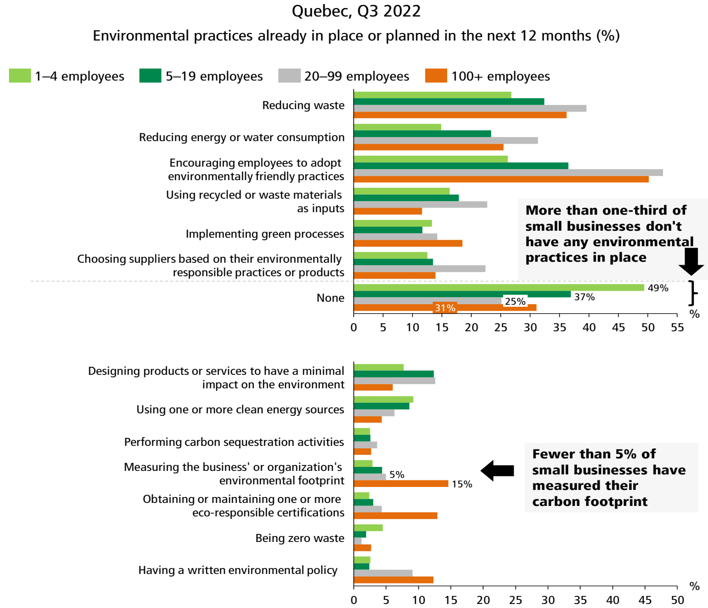
The second challenge for small businesses will be maintaining and increasing their market share in a profitable way to ensure their long-term survival. To be competitive, businesses need to anticipate market trends, keep innovating (not just in their products and services but also in their processes and business models) and adopt cutting-edge technology in order to fend off international competition and participate in global value chains, particularly those in North America. There are a number of characteristics associated with businesses that adopt digital technology. A study by BDC (2022) found that SMEs with greater digital maturity tended to grow faster, be more resilient, export more, have less difficulty accessing credit and invest and innovate more. The same study, however, found that larger companies tend to be more digitally mature (17% of businesses with 100 to 499 employees are considered mature, compared

**GRAPH 7**
**Good news for small businesses: tech prices are generally on the decline**




* Series begins in 2019
Sources: Business Development Bank of Canada, Statistics Canada and Desjardins Economic Studies

**GRAPH 8**
**Businesses with 20+ employees are more likely to adopt environmental practices**




Sources: Statistics Canada and Desjardins Economic Studies

to 15% of those with 50 to 99 employees and 10% of those with 5 to 50 employees). Small businesses would be well advised to invest in tech solutions, which are becoming increasingly affordable (graph 7). In terms of innovation, R&D spending is associated with a greater likelihood of scaling up, according to an Industry Canada (2021) study. (See box 2 for more characteristics associated with scale-up.)

The third challenge is the green transition. As shown by a recent analysis of small businesses in Ontario, they're less likely to take climate action than larger companies. The same applies to Quebec, where more than one-third of small businesses don't have any environmental policies in place or planned in the next 12 months, and fewer than 5% have measured their carbon footprint (graph 8). Yet small businesses have a critical role to play in achieving carbon reduction targets. According to a UK study, SMEs account for about half of all industrial emissions. Additionally, large companies are increasingly looking to create sustainable supply chains and will need to rely on their suppliers (small and medium-sized businesses) to achieve their targets. According to a BCG-HSBC study, some 20% to 30% of the total investment needed to build carbon-neutral supply chains will need to come from companies with fewer than 50 employees. Small businesses that anticipate these trends will reap a range of benefits: new growth vectors, lower costs, increased demand, stronger community ties and interest from young talent. Take the example of a Quebec-based cheese and wine producer that has embraced the circular economy, repurposing almost all of the waste from their manufacturing process into inputs for other products (spirits and beer).

The fourth challenge faced by small businesses is shifting supply chains. Over the past two years, we've seen the kind of disruption supply chains are exposed to and the massive impact it has on small businesses. According to Statistics Canada's survey on business conditions (third quarter 2022), the main plans Quebec businesses have to adapt their supply chains over the next year are to partner with new suppliers (36% of respondents), substitute alternate inputs (36%) or work with their suppliers to improve timeliness (31%). Interestingly, 19% of Quebec businesses plan to shift to local suppliers, which is higher than the Canada-wide figure (15%). It is true, however, that there's less of a trend toward reshoring production in Canada than in the United States. There does appear to be a move toward local manufacturing in a handful of sectors such as beverages, machinery and medical supplies and equipment (BDC). But working against that trend are other manufacturers moving some of their production to other parts of the continent.

**BOX 2**
**Small, but for How Long?**

An Industry Canada analysis studied cohorts of businesses that entered the market between 2002 and 2006 and followed them for at least nine years. What they found:

Nearly 75% of businesses that scaled up to a different size category (in terms of number of employees) did so within the first five years of being established. That suggests businesses are more likely to expand when they're younger. The authors highlight the importance of not only nurturing the startup ecosystem, but also supporting the growth of young firms in their early years.

Another interesting observation: very few businesses actually scale up, with 87% of Canadian businesses remaining in the same category during the observation period. What's more, very few ever cross the 100-employee threshold.

It remains to be seen what direction things will go in the coming years, but it seems likely the labour shortage will put a damper on the reshoring trend. We may also see businesses that got burnt by shortages and delayed deliveries during the pandemic decide to store more inventory to secure their supply. One thing's for sure: there are a range of proven strategies small businesses can use to strengthen their resilience. Some strategies used in recent years include diversifying their supplier base, finding alternatives for their usual inputs, and working more closely with suppliers and using technology to share real-time information.

### David versus Goliath

There are some additional challenges small businesses face due to their size. But there are also strengths and resilience factors they can draw on to make up for that, as shown in table 2.

**TABLE 2**

| SMALL BUSINESS CHARACTERISTIC | RESILIENCE FACTORS |
|---|---|
| Don't benefit from economies of scale | • Using business culture and flexibility to attract and retain top talent<br>• Industry associations<br>• Local and regional development agencies |
| Managers and employees are generalists who wear many hats | • Pooling resources with other small or medium-sized businesses<br>• Automated digital solutions<br>• Outside expertise<br>• Manager training |
| Limited financial/borrowing capacity | • Finding and using programs/incentives for small businesses (public & para-public agencies, financial institutions) |

Source: Desjardins Economic Studies

Unlike large companies, small businesses don't benefit from economies of scale. That has impacts in several areas. It means they have less purchasing power and negotiating leverage, they're less likely to achieve cost savings from dedicated functions (HR, accounting, administration) and they're less able to compete with large organizations in terms of wages and benefits to attract talent. To overcome these challenges, industry associations can help small businesses pool expertise, access centralized resources and share knowledge. They can also offer business development support and other services in areas such as training, mentoring, recruiting and industry outreach. Regional development agencies offer another layer of support, providing free or low-cost resources.

Without the critical mass needed to form specialized departments, small business owners (and sometimes their employees) often wear many different hats. That means there's room for efficiency gains by investing in digital solutions or technology that can automate certain day-to-day management tasks. And small businesses can also benefit from looking for outside help in areas where they lack internal expertise or resources. According to BDC (2014), only 6% of Canadian businesses have an advisory board,[4] but 86% of business owners who do say it's had a significant impact on their business.

As previously mentioned, small businesses are also more likely to report lacking financing capacity. That can limit or rule out investments with big long-term potential but high short-term costs, like environmental upgrades or a production overhaul. But there's a wide range of financing programs and products suitable for small businesses, from both public and private sources. It's in business owners' interests to do their research and take advantage of what's available to them to finance smart investments with long-term payoffs.

### Looking Ahead

In light of these challenges, it's fair to wonder what the next few years will look like in terms of business investment. Automation and the green transition are likely areas of focus. Increased investment in intellectual property products could also be a sign that businesses are focusing more on innovation as a means of remaining competitive.

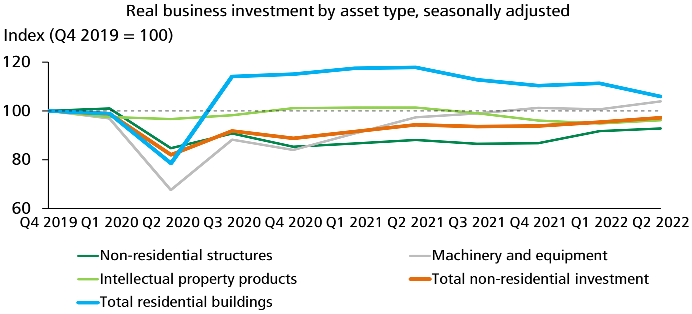
According to a Deloitte (2022) analysis of US non-residential investment data, some clear trends are already emerging: less investment in structures and more in intangible assets, sharp growth in information processing equipment over other machinery and equipment, and a rebound in intellectual property investment. In terms of building investment, the results are less clear-cut: while there's less need for offices and retail spaces (and hotels, to a lesser degree, due to the drop in business travel), demand for storage is up. Supply chain management could also lead to more storage facilities being built in order to secure the supply of inputs.

In Quebec, real investment in residential buildings rebounded, and then slowed, whereas overall non-residential investment hasn't yet returned to pre-pandemic levels. The only category of non-residential investment to rise above its Q4 2019 level (by +4%) is machinery and equipment (graph 9 on page 7).

It remains to be seen whether there's enough investment to support improved labour productivity in the business sector, which has seen slowing growth over the past decade (with the exception of the 2020 boom). Between 2014 and 2021, average annual growth stood at 0.7% for Canada and 1.0% for Quebec, compared to 1.8% for the United States, maintaining the gap with our neighbours to the south (graph 10 on page 7).

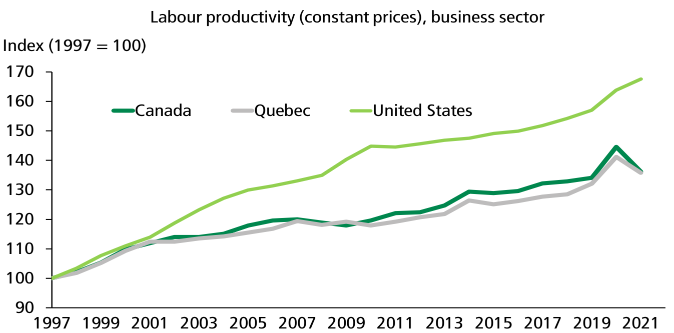
[4] An advisory board is an informal body of outside experts that a business owner can use as a sounding board or to fill in gaps in expertise and contacts. Unlike a formal board of directors, advisory boards have no legal responsibility for the company's governance (source: BDC).

**GRAPH 9**
**Quebec: Real non-residential business investment hasn't yet returned to pre-pandemic levels**




Sources: Institut de la statistique du Québec and Desjardins Economic Studies

**GRAPH 10**
**The productivity gap between Canada and the US persists**




Sources: Statistics Canada, US Bureau of Labor Statistics and Desjardins Economic Studies

## Conclusion

As Quebec heads for a recession in the first half of 2023, the resilience of small businesses will once again be tested. But most of them should make it out unscathed, just as they've weathered past crises.

Whether it was pivoting to online sales during the pandemic or reshoring production to prevent inventory shortages and reduce their carbon footprint, we've seen just how resourceful Quebec's small businesses can be when the going gets tough.

The businesses that have already taken action to address long-term challenges will be in a stronger position: those that have found skilled labour, made climate and energy transition investments, secured their supply chains, and invested in technology to remain competitive. Other, less tangible, characteristics may also prove valuable: the ability to think ahead (anticipating customer preferences and market trends) and take a long-term view, the agility and adaptability needed to quickly implement new processes, and a culture of constant innovation.