

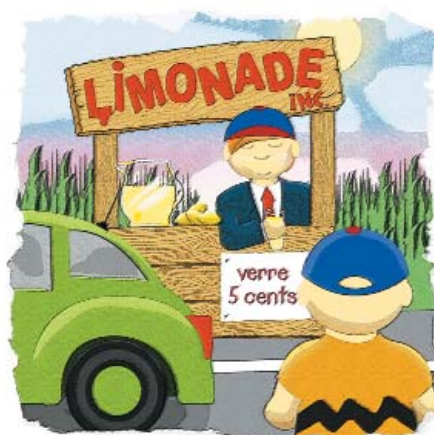


Obstacles to entrepreneurship in Quebec

We often hear that people in Quebec are less inclined to become entrepreneurs than other Canadians or Americans. This difference is sometimes attributed to cultural or religious factors that assigned a low standing to entrepreneurial activity. Although such factors may still have a certain influence, Quebec stands apart mainly because of regulatory and tax burdens that are higher than elsewhere and that penalize entrepreneurs.

A number of indicators depict this relative sluggishness in entrepreneurial activity in Quebec. For example, figures from Statistics Canada show that between 1991 and 2001 the number of businesses with employees increased far more slowly in Quebec (3.4%) than the Canadian average (9.4%).¹ By way of comparison, in the most dynamic provinces, growth was 31.5% in Alberta, 15.4% in British Columbia and 9.5% in Ontario. In Alberta, the growth rate in the number of businesses was thus more than nine times higher than in Quebec. Part of this dynamism, of course, is due to faster-growing populations in these other provinces, with a business attraction capacity fed by more favourable economic conditions.

Not only has the number of businesses been rising more slowly, but the proportion of new entrepreneurs in the Quebec population seems lower than the Canadian average. According to the *Global Entrepreneurship Monitor*, an international study program on entrepreneurship, Quebec has indeed experienced a level of entrepreneurship below the Canadian average in recent years. For example, new entrepreneurs accounted for 7.3% of the Quebec population aged 18 to 64 in 2003, including self-employed workers, compared to 8% overall in Canada, 9.6% in British Columbia, 9.9% in the Prairies and 11.9% in the United States.²



Quebec also lags behind in the proportion of self-employed workers in the labour force, with 120 self-employed workers per 1,000 economically active inhabitants in 2004, or nearly 15% fewer than Ontario and 45% fewer than Alberta and British Columbia. The Canadian average is 18.6% above the proportion of self-employed workers in Quebec (see Figure 1).

The role of entrepreneurship

Quebec is thus deprived of the existence of numerous business people and businesses that could be playing an essential role in its economic development. Entrepreneurship consists in effect of an ability to assess economic conditions and circumstances continuously, latching onto business opportunities and offering higher-quality, lower-priced new products and services.³ Entrepreneurs reorganize economic resources and apply them to higher value-added uses. They innovate by looking for better production processes and ways of reducing costs. They also lie at the very root of economic dynamism and of the ability to respond effectively to consumer desires and to the needs of other producers and intermediaries on the market. In short, they are the source of wealth creation.

1. Statistics Canada, “Business Dynamics in Canada, 2001,” February 2005.

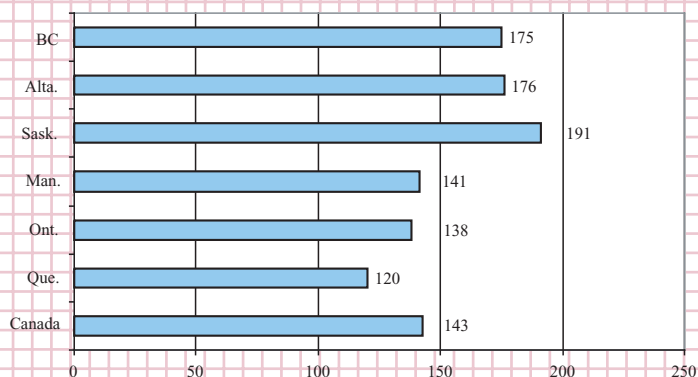
2. Nathaly Riverin and Louis Jacques Fillion, “Global Entrepreneurship Monitor Canadian National Report 2003,” p. 22, available at <http://www.gemconsortium.org/download.asp?fid=387>; Zoltan Acs, Pia Arenius, Michael Hay and Maria Minniti, “Global Entrepreneurship Monitor 2004 Executive Report,” 2005, p. 17, available at <http://www.gemconsortium.org/download.asp?fid=364>.

3. All human activities have their entrepreneurial side: for example, a student investing in studies is betting on finding a desirable job, a home buyer in a trendy new neighbourhood is counting on property values rising, etc. See Izraël Kirzner, *Competition and Entrepreneurship*, University of Chicago Press, Chicago, 1973, pp. 30-88.



Figure 1

Number of self-employed workers per 1,000 persons in the labour force in 2004



Source: Statistics Canada, Table 282-0012: Labour Force Survey; calculations by the author.

Entrepreneurs can act in various ways: some achieve their projects as self-employed workers, others create new businesses or lead the expansion of existing businesses. By buying machinery and equipment, by hiring additional labour, by testing new products on untried markets, they are betting on the future and exposing themselves to possible failure. If they assess demand correctly, they will achieve profits; if the opposite holds true, they will suffer losses. As stated by economist Ludwig von Mises, “The only source from which an entrepreneur’s profits stem is his ability to anticipate better than other people the future demand of the consumers.”⁴

Losses and profits – with the latter being the main reward for entrepreneurs – play a major role in terms of information and incentives. Not only do they induce entrepreneurs to stay vigilant and avoid errors, but they also make it possible for them to know which projects they were justified in undertaking because they indeed created wealth, and which ones added little value or even resulted in a waste of economic resources.

As a fundamentally risk-taking activity, entrepreneurship can flourish only in a context where risk-taking is valued, encouraged and rewarded. By increasing tax and regulatory

burdens, governments create an environment where risk is increased, where achieving results becomes harder, and where rewards are less certain. This deters entrepreneurial activity.

A suffocating regulatory burden

Regulation is a means used by governments to intervene in the economy, with goals ranging from the strictly economic (setting prices, wages and profits, or imposing quotas, permits, authorizations, etc.) to the social (environmental protection, labour laws, wage equity, etc.) or simply involving tax formalities.

Copious and complex regulations have repercussions going well beyond the laudable goals that may have motivated the adoption of certain measures. They deter entrepreneurs from going into business and constitute a major cost for established companies, which are required to devote time and resources to compliance instead of investing to satisfy their customers. A Canadian study in 2002, for example, found that more than seven small or medium-sized businesses out of ten considered that regulations were too complex and formed an obstacle to their growth.⁵ In Quebec, the direct costs that have to be borne by businesses to comply with regulations – federal, provincial or municipal – were estimated at \$7.4 billion in 2003.⁶

Excessive regulation can even push some businesses into bankruptcy. According to a Statistics Canada study conducted in 1997, 22.2% of bankrupt companies in Canada indicated that government regulation played a large, very large or crucial role in their failure. Similarly, 7.7% of them attributed their bankruptcy to labour or industry legislation.⁷

Not only has the number of businesses been rising more slowly, but the proportion of new entrepreneurs in the Quebec population seems lower than the Canadian average.

4. Ludwig von Mises, *Human Action. A Treatise on Economics*, 4th Edition, Fox & Wilkes, San Francisco, 1996, p. 290.

5. Study sponsored by the Canadian Federation of Independent Business, Canadian Manufacturers & Exporters and RBC Financial Group, “The path to prosperity: Canada’s small- and medium-sized enterprises,” October 2002, p. 17, available at <http://www.rbc.com/nouvelles/pdf/20021007CanadaSME.pdf>.

6. Pierre Emmanuel Paradis, “La réglementation dans les PME du Québec,” Canadian Federation of Independent Business, October 2003, p. 5, available at <http://www.fcei.ca/quebec/pdf/Rapport2003.pdf>.

7. Statistics Canada, “Failing Concerns: Business Bankruptcies in Canada,” 1997, available at <http://www.statcan.ca/english/freepub/61-525-XIE/61-525-XIE1997001.pdf>. See also the report of the Groupe conseil sur l’allègement réglementaire au premier ministre du Québec (3rd Lemaire report), titled *La simplification des formalités administratives : une nécessité pour l’économie*, May 2001, Government of Quebec, p. 11, available at <http://www.mce.gouv.qc.ca/allègement/documents/simplification.pdf>.



Table 1

Punitive tax rates in Quebec (%)

	B.C.	Alta.	Ont.	Que.	N.B.
Personal taxes (top combined marginal rate – federal and provincial)					
Ordinary income and interest	43.7	39.0	46.4	48.2	46.8
Capital gains	21.8	19.5	23	24	23
Business taxes					
General provincial tax rate on income	13.5	11.5	14	8.9	13
SME rate (up to \$300,000)	4.5	3	5.5	8.9	2.5
Investment income	13.5	11.5	14.0	16.2	13.0
Effective tax rate on capital*					
Combined rate (all sectors together)	29.0	24.2	32.8	30.2	23.8

Source: Pierre-Pascal Gendron, *op. cit.*, 2005, pp. 7-8.

* This measure combines capital tax, sales tax on capital items, corporate tax, amortization and inventory cost standards, etc.

Although there exists no precise measure to quantify the size of the regulatory burden, the volume of laws and regulations provides a general idea. In April 2003, there were 473 laws and 2,345 regulations in Quebec, filling 15,000 and 21,000 pages respectively.⁸ According to a Canadian comparison, Quebec is far ahead of the other provinces in terms of the number of pages of regulations (excluding laws) that it produced annually between 1990 and 1999, with more than 5,000 pages per year on average compared to fewer than 1,600 pages in Ontario or Alberta.⁹ Even though part of these regulations cancel or amend previous texts, this still brings additional uncertainty into the business environment for entrepreneurs who have to devote considerable effort to looking into the new measures and complying with them.

This regulatory burden risks being particularly damaging to small and medium-sized businesses, which often engage in highly entrepreneurial activities. It costs more in relative terms for these companies to comply with regulations, and the per-employee costs of regulation are higher. If such costs have

already been taken on (in hours spent on paperwork plus fees paid to outside consultants), it is easier for a company operating on a large scale to recover them than for a small company with more limited activities.¹⁰

Punitive tax rates

A heavy tax burden results in certain entrepreneurial projects that would otherwise have been worth the risk of undertaking simply being abandoned. Studies generally show that lower personal tax rates encourage entrepreneurship, encouraging SMEs to grow more quickly, to hire more workers and to invest more.¹¹ Moreover, the progressive nature of personal tax rates also deters the entry of new entrepreneurs. As a U.S. study indicates, “progressive marginal tax rates discourage entry into self-employment and business ownership.”¹² What good is there in taking risks, creating a project, investing in and developing it, if the product of this labour is largely confiscated by the tax authorities?

From this angle, Quebec residents are among the most heavily taxed in North America and face highly progressive rates. Not only are personal income tax rates higher than elsewhere in Canada, but the top marginal rate comes in at a lower income in Quebec than anywhere else in the G7 countries. Quebec also has the highest tax rates on capital gains (see Table 1).¹³ A heavy burden on capital gains has a particularly harmful effect, deterring entrepreneurial effort as well as support for new businesses from investors providing venture capital.

Quebec is far ahead of the other provinces in terms of the number of pages of regulations that it produced annually between 1990 and 1999.

- See the Note from the Montreal Economic Institute, “Quebec’s tax and regulatory burden,” July 2003, p. 3, available at http://www.iedm.org/main/show_publications_en.php?publications_id.
- Laura Jones and Stephen Graf, “Canada’s Regulatory Burden. How many regulations? At what cost?,” Fraser Institute, August 2001, pp. 11-23, available at <http://www.fraserinstitute.ca/shared/readmore.asp?sNav=pb&id=150>; calculations by the author.
- See the OECD study, “Businesses’ Views on Red Tape,” October 2001, pp. 24-25, and Mark Crain, “The Impact of regulatory costs on small firms,” U.S. Small Business Administration, Office of Advocacy, September 2005, pp. 5-6, available at <http://www.sba.gov/advo/research/rs264tot.pdf>. For Quebec, see Pierre Emmanuel Paradis, “La réglementation dans les PME du Québec,” Canadian Federation of Independent Business, October 2003, p. 4, available at <http://www.fcei.ca/quebec/pdf/Rapport2003.pdf>.
- See Duanje Chen, Frank Lee and Jack Mintz, “Taxation, SMEs and Entrepreneurship,” OECD, Science, Technology and Industry Working Papers, 2002, p. 7, available at http://hermia.sourceoecd.org/vl=11114100/cl=31/nw=1/rpsv/workingpapers/18151965/wp_51gsjhvj7lmr.htm.
- William Gentry and Glenn Hubbard, “Success taxes, entrepreneurial entry, and innovation,” National Bureau of Economic Research, Working Paper 10551, p. 2. See also their previous study, titled “Tax policy and entrepreneurial entry,” *American Economic Review*, Vol. 90, No. 2, May 2000, pp. 283-287.
- Pierre-Pascal Gendron, “A Taxing Issue: Enhancing Quebec’s Investment Attraction,” C.D. Howe Institute, Backgrounder No. 89, March 2005, p. 4, available at http://www.cdhowe.org/pdf/backgrounder_89_english.pdf.



In addition, the higher business taxes go, the greater the costs increase for entrepreneurial projects by penalizing production processes, investments and accumulated capital. Even though its general tax rate on corporate income compares favourably with the rates in other provinces, Quebec is the only province that does not have a reduced rate for SMEs. A tax holiday had existed prior to March 30, 2004, for new businesses. On January 1, 2006, a reduced rate of 8.5% for the first \$400,000 in company income will be introduced, with the top rate going from 8.9% to 9.9% in 2006, 11.4% in 2008 and 11.9% in 2009. This is a step toward lightening the tax burden on SMEs, but this reduced rate is still considerably higher than in the other provinces. And larger companies will see their burden grow when it comes to the provincial tax on corporate income.¹⁴

Moreover, taxes on business investment income are among the highest in Canada, penalizing investments in new entrepreneurial projects. Economist Pierre-Pascal Gendron concludes that, “relative to most other provinces and to the U.S., Quebec’s current effective tax rates do not make it an attractive jurisdiction to invest private capital.”¹⁵

A heavy burden on capital gains has a particularly harmful effect, deterring entrepreneurial effort as well as support for new businesses from investors providing venture capital.

How can entrepreneurship be encouraged?

Although it may be obvious that entrepreneurs should not be penalized through taxation or regulation, this does not mean that new subsidy programs should be created or that they should be financed with public funds. Entrepreneurship remains a risky activity by its very nature, and it is impossible to know ahead of time which projects will succeed in creating wealth. When entrepreneurs propose projects that seem likely to be profitable, financing is easier to obtain. Unless there are tax or regulatory obstacles to be surmounted, funds go where entrepreneurial activity exists. It is the presence of such activity that attracts risk capital and not the other way around.¹⁶

In the end, entrepreneurship depends on the level of economic freedom, which is what enables entrepreneurs to move their projects ahead, with no useless hindrances. Quebec comes in dead last, ranking as the place with the least economic freedom in North America in 2002.¹⁷ Public policies aimed at reducing the regulatory and tax burdens would no doubt enable Quebec not only to climb higher in this ranking but also to become a more promising place for entrepreneurs and thus for wealth creation. Located where it is, at the confluence of American and European, French-speaking and English-speaking spaces, it could be doing much better if only its entrepreneurial potential were freed up.

14. See *2005-2006 Budget*, Section 6, p. 13, available at <http://www.budget.finances.gouv.qc.ca/budget/2005-2006/fr/pdf/PlanBudgetaire.pdf>.
 15. Pierre-Pascal Gendron, *op. cit.*, p. 9.
 16. Steven Kreft and Russell Sobel, “Public policy, entrepreneurship, and economic freedom,” *Cato Journal*, Vol. 25, No. 3, Fall 2005, pp. 595-616, available at <http://www.cato.org/pubs/journal/cj25n3/cj25n3-15.pdf>.
 17. See Armela Karabegovic and Fred McMahon, *Economic Freedom of North America: 2005 Annual Report*, Fraser Institute, 2005, available at <http://www.fraserinstitute.ca/shared/readmore.asp?sNav=pb&id=776>.

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