Scotland's Economic Performance

Federation of Small Businesses Scotland

Introduction

We welcome the opportunity to respond to the Committee’s inquiry into how the Scottish economy has fared over the last decade and its prospects for the one ahead.

Our submission focuses on the role small businesses have played in the economy; their contribution, how they have adapted to change, and, the challenges they face.

While preparing this submission, we reviewed historic committee reports to consider the extent to which our understanding of economic challenges facing Scotland has changed over the years. In particular, we considered the 2006 Enterprise and Culture Committee report on sustainable business growth.¹ This inquiry sought to explore how to reduce the gap in performance between Scotland, the rest of the UK and OECD nations. It concluded that there was a need for consensus on economic policy, more effective decision-making, an investment-led approach, a better-functioning labour market and more international outreach.

In reaching these conclusions the Committee could not be aware of the financial crisis that would erupt within 18 months. Clearly, any discussion about recent economic performance must consider the implications of the recession.

However, notwithstanding the impact of the global financial crisis and the extent to which it has stalled progress in the economy, we think it likely that the problematic features of the Scottish economy identified in 2006, are unlikely to have changed. Indeed, these same issues were key considerations in the recent Enterprise and Skills Review. Thus, in its review of the evidence received as part of this inquiry, the Committee may wish to consider why, despite apparent consensus about the challenges and concerted action to address these over the last ten years, substantial change remains elusive. Alternatively, a more inclusive and resilient economy may demand a different economic approach.

Scotland’s Economy and the Role of Small Business

Scotland’s rate of economic growth has certainly been lacklustre in the last ten years. Despite initial positive recovery post-recession, there has been little sign of sustained growth in the last three years. That said, the labour market has performed well with record levels of employment, almost entirely due to the private sector,² and a reduction in economic inactivity. Other indicators,

from productivity to business investment, suggest a similarly mixed picture, although it is worth highlighting the notable increases in business start-ups.\textsuperscript{3}

Since 2012, FSB Scotland has been participating in a UK-wide quarterly confidence index survey of our members, called the Small Business Index (SBI). This gives us a useful insight into business conditions for smaller businesses, which are not always adequately reflected in national statistics.

In addition to measuring business sentiment, the SBI tracks a range of other indicators including:

- Gross profit levels
- Cost of running a business
- Capacity utilisation
- Employment and recruitment
- Growth aspirations
- Capital investment
- Availability and affordability of credit

Since its first publication five years ago, our SBI has proven to be a useful tool in forecasting GDP growth. Figures one, two and three below highlight that since 2012 small business confidence and quarterly growth have broadly followed a similar trajectory.

**Figure 1: Scotland vs UK Small Business Index**

Reviewing Scottish SBI data for the last five years suggests a number of key trends:

- The domestic economy has been a tough trading environment for smaller businesses. This is evident in the fact that business confidence has been in negative territory for seven consecutive quarters. Indeed, the SBI currently stands at -15.2 points compared to -4.5 points in the corresponding quarter of 2013.

- Despite an increase in jobs in the small business sector overall, employment growth intentions are muted. As figure four illustrates,

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4 *State of the Economy*, Dr Gary Gillespie, Scottish Government, November 2017
5 FSB Voice of Small Business Index, Q3 2017, FSB, September 2017.
business owners have reported negative employment growth in 12 of the last 20 quarters (since Q3 2013).

- Credit conditions have notably improved for businesses looking for finance. In Q3 2013, 5% of business owners rated the availability of new credit as ‘good’, a figure that climbed 19 points by Q3 2017 (24%). It is now, as figure five highlights, perceived as a surmountable barrier to growth.

- Investment intentions have been positive despite challenging economic conditions. Currently, a net balance of 7% of small businesses intend to increase capital investment levels, ending a downward trend in 2017, as seen in figure six below. Compared to figures recorded in 2013 investment intentions are now 2.2% higher.

Figure four: Net balance of firms reporting employment growth

Figure five: Share of firms reporting perceived barriers to growth
Data on Scotland’s economic performance cannot, however, be seen in isolation. Any review of the last decade should also consider how both gradual and sudden societal, technological and economic changes have affected our economy.

Whether global e-commerce, or the increase in automation, technology, in particular, has led to substantial changes in both trade and employment over the last two decades. We explored some of the challenges the digital economy poses to Scotland’s small firms in a recent report, noting that while digital disruption has already had an impact on business, this change is likely to accelerate.

Yet in the face of the economic turmoil and technological change of the last decade, small businesses have proven themselves particularly resilient. These businesses have created employment, while larger firms have shed jobs.

While Scotland is often referred to as a small business economy (though the figures for small businesses as a percentage of the business population do not differ greatly for the UK as a whole), recent figures highlight the critical role smaller firms play in Scotland as a whole and, crucially, in local economies. For example, 4 in 5 private sector jobs in rural areas are provided by small and medium-sized businesses.

The number of businesses in Scotland has increased dramatically post-devolution, with over 100,000 more businesses now than in 2000. SMEs account for 99% of all businesses in Scotland, with micro businesses alone accounting for half a million jobs. Moreover, the Scottish Government

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6 "Digital Disruption and Small Businesses in Scotland", FSB, November 2015.
estimates that over half of all businesses are now based in the home, with these firms accounting for 10% of all private sector turnover in Scotland.\(^9\)

These statistics underline the crucial importance of smaller businesses in our economy. While this is often recognised in discussions about local or regional economies, it can become less clear when considering economic performance at a macro level. Too often in such discussions our smaller businesses are, disappointingly, regarded as a problematic feature of our economy.

Despite a strategic focus in the very early years of devolution, and the recent increase in businesses, Scotland’s business birth rate still falls behind the UK. Our economy may well benefit from more businesses of scale but having a larger pool of businesses from which high-growth firms can emerge\(^10\) would surely increase the chance of achieving a more entrepreneurial country.

**Inclusive Growth and Small Businesses**

Sustainable economic growth has been a theme of government policy since devolution. More recently, the Scottish Government has set out its aspiration for inclusive growth – ensuring that more people and places experience, and benefit from, economic growth.

As outlined above, a focus on national indicators alone, such as GDP or productivity, often fails to consider the variation in both structure and success of different local and regional economies. For example, West Dunbartonshire has only 24 registered small businesses per 1000 adults compared to Orkney’s 79.\(^11\) The variation in enterprise rates across towns and local authority areas can be explored in more detail on our Enterprising Towns webpage.\(^12\) We therefore welcome the stronger focus on place that accompanies inclusive growth. However, this also raises questions about getting the balance of economic development activity right; between reducing economic inequality of places and people, and focusing efforts on companies or investments which might have a greater impact on Scotland’s bottom line.

With over 40% of those working in the private sector now working for a small business, these firms have a key role to play in creating a more inclusive economy. Policy aimed at influencing the behaviour of business and employers therefore needs to be sensitive to the variation in types and size of business and workplace and the challenges therein. For example, a micro business with three employees, may need a different approach to that which is appropriate for a small business with 49 employees.

Regrettably, recent discussions about employment have come to be seen in simplistic distinction between good and bad jobs – between a high-skilled, high-wage economy, and a low-skill, low-pay economy. Such an approach lacks nuance because it treats all employers the same irrespective of size and

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\(^10\) "High Growth Firms in Scotland", Scottish Enterprise, 2010
\(^12\) See: [http://www.fsb.org.uk/standing-up-for-you/national-offices/scotland/entrepreneurial-towns](http://www.fsb.org.uk/standing-up-for-you/national-offices/scotland/entrepreneurial-towns)
sector and is not underpinned by an objective measure of job quality. In this respect, the report of the Fair Work Convention was particularly helpful in setting out key features workplaces should aim to achieve.\textsuperscript{13}

Again, we believe that the role of smaller businesses in helping to achieve more inclusive employment is often overlooked. Small firms are more likely to provide pathways to employment for disadvantaged groups, creating jobs in hard-to-reach communities across the country, with around 50% having hired people who were out of work in recent years.\textsuperscript{14} Over half of all small employers pay their staff above the Living Wage,\textsuperscript{15} while more than three quarters of all the private sector accredited Living Wage employers in Scotland are small firms.\textsuperscript{16}

The working environment of smaller businesses, which is almost always informal and flexible, leads to higher job satisfaction. Indeed research by the RSA found that employees in micro businesses were the most satisfied group of workers in the labour market.\textsuperscript{17}

We therefore believe that smaller businesses have a strong record in creating fair work, though we recognise that improvements are still required. In particular, challenges remain in competitive, low margin sectors, irrespective of whether the employers are multinationals or micros. Moreover, we need to consider how best to enforce employment rights in such a way as to protect employers and employees whilst recognising the reality of 21\textsuperscript{st} century workplaces.

Looking beyond inclusive growth, it is also worth considering how wider economic and social change have affected the labour market. As we have highlighted, small businesses play an increasingly important role as employers but the increase in self-employment also merits discussion. This group has increased by 66\% since 2000,\textsuperscript{18} with more people now working for themselves in Scotland than for the NHS.\textsuperscript{19} Despite this, self-employment is not mentioned at all in Scotland’s labour market strategy and recent high-profile court cases have tended to present a one-sided debate about the self-employed.

As mentioned above, we recently used data on self-employment, broken down to town level, to explore Scotland’s self-employment hot spots.\textsuperscript{20} This research highlights that self-employment is, in fact, highest where there are most jobs.\textsuperscript{21} Further, the figures suggest a correlation between assets, such as owning your own home and car, and self-employment: poverty is a barrier to starting your own business, not an enabler.

\textsuperscript{13} “Fair Work Framework”, Fair Work Convention, 2016.
\textsuperscript{14} “Back to Work: the Role of Small Businesses in Employment and Enterprise”, FSB, September 2012.
\textsuperscript{15} Unpublished FSB data.
\textsuperscript{16} FSB analysis of living wage accreditation scheme data. See: http://scottishlivingwage.org/accredited
\textsuperscript{17} “The Second Age of Small”, RSA, June 2015.
\textsuperscript{20} See: http://www.fsb.org.uk/standing-up-for-you/national-offices/scotland/entrepreneurial-towns
\textsuperscript{21} Highest rates of self-employment are concentrated in local authority areas with lower unemployment.
While technology has made it easier for individuals to set up a business, changing attitudes to work have also encouraged a shift in employment choices, with an increase in individuals moving in and out of self-employment, or combining business activity with employment. Evidence suggests that self-employed people are often happier than employees, citing a conscious choice to trade in the security of a higher fixed income for flexibility. Indeed 84% of the self-employed think that, overall, their life is better compared with being an employee.\textsuperscript{22}

Future Challenges

While there are clearly a large number of challenges facing Scotland’s economy, we would draw the Committee’s attention to the following issues: the ongoing fragile nature of business confidence; the consequences of Brexit for small businesses; rising costs and adapting to the digital economy.

Our most recent SBI suggests small business confidence remains in negative territory. Following the oil and gas downturn and the uncertainty associated with Brexit, this lack of confidence is perhaps unsurprising. On Brexit, we have previously highlighted the particular concerns of small businesses in relation to the retention and recruitment of EU workers, as well as the impact of potential change on small business’ international trading.

While economic uncertainty continues, businesses have also seen an increase in costs in recent years. Rises in employment costs, through uplifts in the National Living Wage and pension auto-enrolment, have been combined with more recent cost pressures, including inflation, rising interest rates and currency fluctuations. Recent FSB work with the economic think tank CEBR explored the extent to which government policy affects the cost of doing business (i.e. excluding inflationary costs). This index suggests that costs for smaller businesses in Scotland rose by 12.5% (the same as the overall UK figure) between 2011 and 2016, while the consumer price index rose by 7.8% over the same period.\textsuperscript{23} As a consequence, we have stressed to both the Scottish and UK governments the importance of avoiding policy decisions which will further increase the costs of doing business.

Lastly, as referenced earlier in this submission, adapting to the digital economy remains a strategic challenge for our small businesses. This covers a range of issues, from infrastructure to skills, from disruptive technology to regulatory challenges.\textsuperscript{24}

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\textsuperscript{22} “Understanding Self-Employment”, BIS, February 2016.
\textsuperscript{24} We explored this issue in more detail in this report from late 2015. Our response to the consultation on the R100 programme earlier this year also provides a summary of the issues.
About the FSB

FSB is Scotland’s leading business organisation. As experts in business, we offer our members a wide range of vital business services including advice, financial expertise, support and a powerful voice in government. Our mission is to help smaller businesses achieve their ambitions. These micro and small businesses comprise the majority of all enterprises in Scotland (98%), employ around one million people and contribute £68bn to the economy.