
SCOTLAND'S ECONOMIC PERFORMANCE, TRENDS AND CHALLENGES

1. Introduction

In our role as Scotland's economic development agency, we are pleased to contribute to this important inquiry. In a challenging and changing economic climate, this inquiry offers a timely opportunity to inform the Committee's consideration of potential actions that can deliver a step-change in Scotland's economic performance.

In-depth knowledge of the economy and an understanding of challenges and opportunities are essential to helping Scottish Enterprise achieve its primary purpose of supporting sustainable and inclusive economic growth for Scotland.

Robust economic performance data, evidence and underlying economic trends sit at the heart of what we do. Understanding performance, trends and challenges helps us focus our efforts on where we can make the greatest difference and add greatest value, and is critical to our business planning process and prioritisation.

The most significant current challenge facing Scotland is its productivity performance. While improvements have been made, Scotland's rate of growth in productivity continues to lag competitors, and the gap with top performing economies is widening. To catch up, Scotland needs a significant increase and improvement in its productivity performance.

We know from our evidence base what works well and what can help drive that improvement, which, in turn, informs our day-to-day activities and work with companies, sectors and partners in both the public and private sector.

This submission seeks to share with the Committee our knowledge and understanding of Scotland's economic performance within the scope of the inquiry. It particularly focuses on the productivity challenge and seeks to provide an insight into the contributing factors that will help drive positive change in the performance of Scotland's economy.

2. GDP Growth & Productivity

What have been the main drivers of growth in the Scottish economy since 2007? How does Scotland's growth rate compare with the UK as a whole, other regions/nations of the UK, and other countries in the EU?

GDP growth is driven by consumer spending, business investment, government spending and export activity. Of these four, GDP growth in Scotland since 2007 has been driven primarily by increased levels of consumer spending. Between 2007 and 2017, the Scottish economy has grown, on average, at 0.8% per year compared to 2.5% over the 2000 to 2006 period¹. The post 2007 performance reflects the effects of the financial crisis and impact of the downturn in the oil & gas sector.

Scotland's annual average growth rate compared to the UK and small EU nations has been mixed, and lower than both since around 2014.

Between the first and second quarter of 2017, the gap between annual Scottish and UK GDP growth remained stable, with Scotland 1.5 percentage points lower than in the UK. In quarter two of 2017, GDP growth in Scotland was 2.6 percentage points lower than in the Small EU Countries.

In terms of international competitiveness, Scotland faces a key challenge based on its position compared to others (2nd quartile of OECD countries) on **productivity**.

Scotland has been closing the productivity gap with the UK since 2007, and by 2015 Scottish productivity was 98.5% of the UK level². However, internationally, Scotland ranks 16th of 36 OECD countries³. To match the OECD top quartile, Scotland's productivity would **need to be 27% higher, equivalent to almost £40bn more GDP**⁴.

In working with companies to help them improve their productivity, realise their growth potential and improve their international competitiveness, we have concentrated our efforts on the particular drivers of productivity noted below:

- **Business Investment:** which currently lags nearly all other OECD economies⁵;
- **Management & Leadership Skills and capacity:** which evidence shows to be an all important determinant in the growth, innovation and productivity of a company;
- **Innovation activity rates:** as economies that are innovative are more productive, resilient and, because of being adaptable in the face of changing circumstances, are better able to support higher living standards⁶.
- **Trade and Exporting:** which has strong links to productivity
- **Fair Work:** which supports the behaviours and attitudes of employees that can lead to improved performance, innovation and productivity, and can lead to better quality jobs.

Where will we see future growth in our economy – exports, sectors, regions and innovations?

It is forecast that there will be almost 65,000 more jobs in the Scottish economy by 2024⁷. The sectors that are forecast to create the largest number of jobs include administration and support services; professional services and construction. The largest declines in the number of jobs are expected to be in public administration and manufacturing.

It is important to strike the balance between support in existing key sectors as well as developing **emerging opportunities in subsea, fintech, data and advanced manufacturing** to capitalise on Scotland's unique natural assets, talent and research excellence.

- The **subsea** engineering sector currently employs 20,000 people in Scotland (14% of the sector globally)⁸ and is set to grow from £50bn to £140bn over the next 20 years.
- Scotland has the potential to benefit from the disruption arising from greater application of technology. Developing Scotland's **fintech** opportunity could create almost 15,000 new jobs over the next 10 years⁹.
- Scotland has world class **data** science and informatics research capabilities and the skills and talent that are attracting global investment. Data driven innovation has the potential to deliver £20bn of business benefits to the Scottish economy over the next 5 years¹⁰.
- The **Advanced Manufacturing** sector currently employs 195,000 people, has international exports of £15.1bn and contributes £13.2bn GVA to the economy. Scotland's Manufacturing Action Plan (MAP) helps build a global competitive industry, leadership, supply chain capabilities and innovation that companies need to be more competitive. The National Manufacturing Institute for Scotland (NMIS) will advance skills in digital manufacturing and help improve productivity in the sector.

Growing investment in automation technologies will help to boost productivity but will require companies to also actively invest in workplace skills (e.g. up skilling, redeployment) to reap the full benefits. In turn this will lead to greater competitiveness, new jobs and businesses as well as disruptive innovation opportunities, enabling Scotland to become a higher value, higher income economy. Our research indicates that many companies are already investing in automation technologies but levels of investment vary by firm and sector¹¹. With around 80% of Scotland's 2030 workforce already in work, a strong focus on the existing workforce is needed.

The UK's exit from the EU will be the most significant economic change affecting Scotland's economy over the next 2-3 years. While Brexit will affect every aspect of the economy, with regards to talent and skills and movement of labour, we recognise that attracting talent and skills and helping companies and sectors respond to the new environment will be a key focus for us.

How have Scotland's key sectors performed over the past decade? What is Scotland's industrial composition and what are the barriers to diversification and growth?

Scotland's Economic Strategy identifies six sectors where Scotland has a distinct competitive advantage (creative industries, energy, food & drink, financial & business services, life sciences and tourism)¹². Four out of the six had GVA growth at a faster annual rate than the average for the Scottish economy as a whole (+0.7%) over the 2007-2016 period:

- Life Sciences (2.6%);
- Energy (including Renewables) (2.0%);
- Food and Drink (1.3%) and
- Financial and Business Services (0.9%).

GVA for the remaining two sectors Sustainable Tourism and Creative Industries (including Digital) were, on average, flat during this period.

Growth sectors accounted for 53.5% of Scottish international exports in 2015, compared to 48.1% in 2007. Between 2007 and 2015, five out of the six growth sectors increased their share of total Scottish international exports: Energy (including Renewables) (+4.1 percentage points); Financial and Business Services (+0.7 of a percentage point); Food and Drink (+0.5 of a percentage point); Creative Industries (including Digital) (+0.2 of a percentage point); and Life Sciences (+0.1 of a percentage point).

Wages tend to be higher in growth sectors. Between 2011 and 2016 three sectors had faster annual average median earnings growth than the Scottish average of 2.0%: Life Sciences (3.6%); Sustainable Tourism (Tourism related Industries) (3.5%); and Food and Drink (2.9%)¹³.

Manufacturing continues to make a disproportionate contribution to Scotland's exports, investment and economic growth as well as helping maintain a balanced resilient economy¹⁴:

- **Internationalisation:** over 50% of Scotland's exports come from manufacturing. Growth in manufacturing output will have a strong impact on export performance.
- **Innovation:** in 2015 59% of Business Expenditure on Research and Development (BERD) was from manufacturing organisations.
- **Wage levels** across the manufacturing sector are higher than the Scottish median level and are significantly higher in some sub-sectors e.g. Pharmaceuticals and the repair and installation of machinery and equipment.

Scotland's manufacturing sector is diverse and has particular strengths in areas such as food and drink, aerospace, space, and subsea engineering. The size of the sector is relatively small in comparison to similar economies, although this is proportionally due to the very large financial service sector in Scotland.

What role has Government support for innovation played in growing Scotland's economy and boosting productivity?

We know that increasing innovation is a key driver of improving productivity and competitiveness. Working alongside Scottish Government we have been focusing on innovation to improve Scotland's performance on business and sector innovation and R&D. We refreshed and sharpened our approach to innovation in 2014 and this led to a refresh of the portfolio of companies we support, particularly in relation to their innovation activity.

This approach is leading to real impacts on Scotland's economic performance. Since the launch of the strategy:

- 3,000 more companies are innovating for the first time from a wide variety of sectors and stages of development.
- SE's R&D investment to support company activity has increased from £11m in 2014/15 to £22m in the current year.
- £1.2bn of additional company turnover generated by companies supported to innovate by SE.
- £0.6bn of that additional turnover came from sales outside of Scotland.
- 51% of Scottish companies with more than 10 employees are innovating, up 7 percentage points since 2012.

Beyond direct SE support, we have worked in partnership with Innovate UK and the EU to increase levels of innovation:

- **Horizon 2020:** which helped 22 Scottish companies secure €18.7m in European or other innovation funding, contributing €24.8m to Scotland's BERD (2016/17).
- **Innovate UK:** working with our partners to both maximise our collective impact and reduce duplication and inefficiencies. This has resulted in two unique 'firsts' for Scotland that we could not have delivered without collaboration – a new £10m Biomedical Catalyst jointly funded by Scottish Enterprise, Innovate UK and the Medical Research Council, and a £500k healthcare SBRI programme with Innovate UK that resulted in two Scottish companies shortlisted as part of the five finalists.

In the last year, Food & Drink and Oil & Gas companies in particular have benefitted from enhanced innovation assistance:

- **Food & Drink:** Make Innovation Happen is a new service developed over the last year in partnership with a range of public and private sector organisations and was launched in May 2017. The service provides food & drink businesses with simplified access to innovation support across the public and private sector to supports the industry's 'Ambition 2030' strategy. The goal of which is to double turnover in the sector to £30 billion by 2030. Results from the service show that there were 106 new Innovation Active Companies, £6m of additional turnover from innovation and £20m additional BERD.
- **Oil & Gas :** Generated almost 300% more innovation investment from Oil and Gas companies in the last year compared to 2015-16 through SE delivery of £15.9m of innovation support which leveraged £43m of investment in 111 new innovation projects across 82 companies.

3. Inequality and Labour Market Issues

How does income and wealth inequality in Scotland compare to other countries/regions and what are the policy responses to income and wealth inequality in Scotland and abroad?

Scotland currently ranks 19th out of 34 OECD countries for income equality. The annual incomes of lower earners would need to rise £4bn (+13%) for Scotland's to match the best OECD's performers for income equality¹⁵.

As the national economic development agency, our focus in this area is on how our work with businesses, sectors and places can help address income and wealth inequality, for example:

- Helping businesses and sectors to increase **productivity levels**, a key driver of raising wages. This includes working with industry leaders in sectors where in-work poverty is concentrated, e.g. food & drink and tourism, to raise productivity as the route to higher wages and better quality employment.
- Promoting the **Scottish Living Wage** to businesses to help tackle in-work poverty and deliver a positive impact on business performance.

- Promoting the **Scottish Business Pledge** to businesses. In addition to payment of the Scottish Living Wage, the Pledge focuses on other important components of fair work.
- Advising businesses on the benefits of fair work through our **Workplace Innovation service** which builds business advice around the five characteristics of the Fair Work Framework.
- Working with businesses to include **opportunities for young people**, who suffer disproportionately from in-work poverty and unemployment, in their growth plans.

Our response is based on learning from other economies, and translating these lessons for the Scottish Economy. For example, the development of our Workplace Innovation Service is informed by the positive impact workplace innovation, fair work and employee engagement has had in countries such as Netherlands and Sweden.

How has the labour market in Scotland changed over the past decade?

A key trend in Scotland's labour market over the last decade has been the increase in self-employment, accounting for almost half of overall employment growth. However, self employment still only accounts for 10% of jobs in Scotland, among the lowest rates in the OECD. There are a range of drivers for this increase in self-employment, including the economic environment, demographics, technology and changing business models of employers¹⁶.

It is likely that the increase in self-employment plays a role in the relatively slow growth in Scotland's productivity as evidence shows that self-employed businesses perform slightly less well in factors such as innovation, internationalisation and investment when compared to businesses with employees¹⁷.

Low productivity levels in self-employed businesses are reflected in lower earnings, although it should also be noted that the strong growth in part-time self-employment has also been a contributor.

While headline labour market figures have been positive since the downturn in 2009, the changing nature of, and rewards from, employment present different challenges:

- Real wages in Scotland remain significantly **below** their level in 2008 following a decade of decline and stagnation.
- **underemployment** in Scotland (people working less hours than they would like) has risen by around a quarter, alongside rising part-time working and self-employment
- Labour market **polarisation** may be restricting the ability of some low paid workers to move to higher paid occupations¹⁸.

The combination of reduced hours and dampened real wages has hit those at the bottom of the labour market hardest, increasing inequality and in-work poverty. For the first time, the majority of people in poverty in Scotland are in households which include someone in-work.

Looking forward there is a real need to continue to grow skill levels across the current and future labour market, working with employers to help them harness the full potential of their workforce through workplace innovation. We also need to continue our relentless focus on the actions to promote Scotland's high level skills and capabilities in new sectors to attract inward investment e.g. data, life sciences and advanced manufacturing.

Automation will increasingly transform the workforce and labour market, as many routine, predictable and hazardous tasks will be automated, freeing up staff to manage the technologies and carry out high value and more complex tasks. Helping companies address the 'people' dimension of automation will help improve job quality, employment engagement as well as productivity, and therefore wages.

What are the different models of business ownership in Scotland and what is their importance to Scotland's economy?

Most businesses in Scotland are private limited companies (50%). 28% are sole proprietorships/traders, with a further 17% which are partnerships¹⁹.

Family businesses comprise a majority (73%) of all SMEs in Scotland²⁰. Collectively, they generated £16.6bn turnover in 2016, and employ more than 100,000 people. The top 100 family-owned businesses generated £1 billion profit and 11% of Scotland's onshore GDP²¹. However, data suggests that family owned and run businesses have, on average, weaker management practices and productivity levels than those that are not family owned²².

With over **2,300** foreign-owned companies employing almost **317,000** staff (approximately 17% of all Scottish employment in registered companies) and realising a combined turnover of **£92 billion**, Foreign Direct Investment (FDI) plays a vital role in Scotland's economy. Key factors attracting investors to Scotland are the availability of skills and talent (most important), the right infrastructure and the availability of business partners and suppliers. Overseas owned companies on average have significantly higher levels of productivity, pay higher wages, are more likely to invest in R&D activities, and make a significant contribution to exports.

Evidence suggests that co-operative models can be more productive than traditional business models, as employees that have a stake in the future of the organisation²³. SE, through Cooperative Development Scotland (CDS)²⁴, supports cooperative models with businesses in Scotland.

Employee Ownership, for example, is a model in which the employees (rather than external shareholders) hold the majority of the shares either directly or through an employee benefit trust. Employee-ownership tends to root businesses firmly in Scotland, driving business performance and productivity while also promoting more wealth equality in our society. In Scotland 86 employee-owned businesses (45 headquartered in Scotland) collectively generate £925m turnover and employ approximately 6800 staff.

4. Inclusive Growth – Bringing it all Together

High productivity/more inclusive economic growth is a 'win-win' approach for employers and employees and creates both economic and social value. It is at the heart of SE's approach, for example:

- On **fair work**, we help companies and industries develop fair and more productive business practices, helping their business growth and improving the quality of people's jobs.
- On **equality between people**, we help companies and industries draw on as wide a pool of talent as possible, helping their business grow and opening up job opportunities to groups that find it difficult to enter and progress in work, for example through developing invest in youth strategies.
- On **equality between places**, we work with partners to help local economies grow, delivering opportunities across Scotland and helping connect more people to these opportunities.

The economic evidence, as summarised in this paper, indicates that Scotland requires a step change in the performance of a number of the drivers of productivity that will underpin growth that is inclusive.

The evidence further highlights the interconnectedness of the various drivers of productivity. Improved performance in one can depend on or drive improved performance in others – delivering increased economic impact. For many of these drivers Scotland's performance is improving. However, the scale of the challenge remains significant, and our work

5. Conclusion

We trust that this submission helps to inform this inquiry and we look forward to continued engagement with the Committee on this topic and other important aspects of economic development.

Annex – Reference Notes

¹ <http://www.gov.scot/Resource/0052/00526498.xlsx> Annual GDP growth rates for Q2 each year (rolling 4Q on 4Q)

² <http://www.gov.scot/Topics/Statistics/Browse/Economy/PROD17Q2>

³ <http://www.gov.scot/About/Performance/scotPerforms/purposetargets/productivity>

⁴ SE calculation.

⁵ Scottish Government and OECD

⁶ <http://www.oecd.org/publications/the-innovation-imperative-9789264239814-en.htm>

⁷ Oxford Economic Forecasting.

⁸ Subsea uk

⁹ Strathclyde University

¹⁰ CEBR (Scottish Enterprise estimate)

¹¹ See for example <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=609>

¹² <http://www.gov.scot/Topics/Economy/EconomicStrategy>

¹³ <http://www.gov.scot/Topics/Statistics/Browse/Business/Publications/GrowthSectors>

¹⁴ Scottish Government data

¹⁵ SE calculation.

¹⁶ <https://strathprints.strath.ac.uk/61145/>

¹⁷ https://strathprints.strath.ac.uk/61145/1/FEC_41_2_2017_Richmond_Slow.pdf

¹⁸ <https://strathprints.strath.ac.uk/53548/>

¹⁹ <http://www.gov.scot/Topics/Statistics/Browse/Business/Corporate/tableb07>

²⁰ <http://www.gov.scot/Resource/0052/00523509.pdf>

²¹ Family Business United Scotland in 2017

²²

<https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/articles/experimentaldataonthemanagementpracticesofmanufacturingbusinessesingreatbritain/2016>

²³ See for example <https://www.uk.coop/resources/what-do-we-really-know-about-worker-co-operatives>

²⁴ <https://www.scottish-enterprise.com/services/develop-your-organisation/co-operative-development-scotland/overview>