OFFICIAL REPORT
AITHISG OIFIGEIL

Economy, Jobs and Fair Work Committee

Tuesday 15 November 2016

Session 5

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Pàrlamaid na h-Alba

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ECONOMY, JOBS AND FAIR WORK COMMITTEE
11th Meeting 2016, Session 5

CONVENER

*Gordon Lindhurst (Lothian) (Con)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

Jackie Baillie (Dumbarton) (Lab)
*Ash Denham (Edinburgh Eastern) (SNP)
*Liam Kerr (North East Scotland) (Con)
*Richard Leonard (Central Scotland) (Lab)
*Dean Lockhart (Mid Scotland and Fife) (Con)
*Gordon MacDonald (Edinburgh Pentlands) (SNP)
*Gillian Martin (Aberdeenshire East) (SNP)
*Gil Paterson (Clydebank and Milngavie) (SNP)
*Andy Wightman (Lothian) (Green)

*attended

THE FOLLOWING ALSO PARTICIPATED:

James Brodie (China-Britain Business Council)
Neil Francis (Scottish Development International)
Professor Jeremy Peat (University of Strathclyde)
Gareth Williams (Scottish Council for Development and Industry)

CLERK TO THE COMMITTEE

Alison Walker

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Economy, Jobs and Fair Work Committee

Tuesday 15 November 2016

[The Convener opened the meeting at 10:00]

Decision on Taking Business in Private

The Convener (Gordon Lindhurst): Good morning, everyone, and welcome to the 11th meeting in session 5 of the Economy, Jobs and Fair Work Committee. I have apologies from Jackie Baillie and from Dean Lockhart, who is slightly delayed—I think that he will join us shortly. I remind everyone to turn off all electronic devices—or, at least, to turn them to silent so that they do not interfere with the committee's work.

Agenda item 1 is a decision on taking business in private. Do members agree to take items 3 and 4 in private?

Members *indicated agreement.*

Economic Impact of Leaving the European Union

10:00

The Convener: Today, we continue discussing the economic impact of leaving the European Union. We have with us to give evidence four guests, whom I will introduce in no particular order. Jeremy Peat is visiting professor at the international public policy institute at the University of Strathclyde; James Brodie is Scotland manager and China business adviser for the China-Britain Business Council; Gareth Williams is head of policy at the Scottish Council for Development and Industry; and Neil Francis is international operations director of Scottish Development International. I thank you all for coming to the meeting.

We now move to questions from committee members. If the witnesses wish to come in on the discussion, they should do so as matters flow, please, or simply indicate to me that they wish to come in on a particular issue, question or discussion.

Gil Paterson (Clydebank and Milngavie) (SNP): Good morning, everybody. I have a general question that will leave the witnesses free to come in on any particular area that they are interested in.

The committee has been out and about. We have just started taking evidence from different sectors out in the field throughout Scotland: I did it yesterday. The people who gave evidence have already started to plan, so I asked them what they are planning for. The witnesses may be aware that a document has been leaked into the public domain that suggests that the United Kingdom Government does not know what it is planning for at this stage, although it is quite clear that it is doing some work. In the Scottish context, what should we be planning for? What are the red-line areas? What should we be concentrating our efforts on?

Gareth Williams (Scottish Council for Development and Industry): We have been careful to try not to talk about red lines in the political context, but rather to think about what our key asks would be. I suppose that the challenge is that many of our members want things to be as close as possible to what we have now—in particular, in terms of access to the single market and availability of skills at different levels to meet the needs of businesses and the economy.

We are still going into the detail of those particular asks, but a message that I would like to get across at the start is that many of our members say that we need to rethink what we mean by "competitiveness" post-Brexit, and that we should not be distracted to too great an extent by thinking about Brexit. There is a big agenda around our competitiveness that we need to get right. If we do that, we can be successful under a range of different scenarios.

Professor Jeremy Peat (University of Strathclyde): If I might add my two-pennyworth at this stage, my first point is that we should all be preparing for an extended period of uncertainty—which is one of the few certainties in this respect.

We are talking about a two-year timetable from March next year. Next year, there will be major elections in two or more major European Union member countries, and it is difficult to see how detailed negotiations can take place when changes in Governments are possible or pending. That is going to produce a lot of pressure to move negotiations into 2018, and who knows how long it will actually take to get everything sorted? There will be extended uncertainty, with no one knowing what the final outcome is likely to be, which is not good for investment either within the UK or for inward investment to the UK.

My second point is that it seems to be very unlikely that we will achieve the same level of free and unfettered access to the single market that we have experienced as a member of the EU, and there are limitations on the possible alternatives. There is also often a cost to participating in the alternatives, and there are indications that the UK Government would be unwilling to pay them. We would have no influence whatever over the rules and regulations in any of those alternative arrangements: you take what you are given. The outcome on access to the single market is likely to be less full and satisfactory than what we have at the moment.

The final area is the critical importance for the Scottish financial services sector of access to employment from other countries in Europe, which matters—at the unskilled end as well as at the skilled end—to a number of Scottish sectors. The Scottish financial services sector is very keen to see strong, high-value-added sectors in Scotland, and those are very dependent on existing use of skilled labour from Europe and elsewhere. If that is not sustainable, there would be a real question mark over our ability to maintain those very important high-value-added sectors.

Those two issues—access to the single market and continuing access to the skilled labour that is required for different parts of our economy—are critical. I am sure that the First Minister will make every effort to influence the UK position on them and to look for ways in which Scotland can perhaps take a different line, but those are the areas of significant concern to me.

Neil Francis (Scottish Development International): To add to what Jeremy Peat said, I agree that we should be planning for a long period of uncertainty. We need to work through the various potential outcomes at the point of completion of the negotiations. As Jeremy Peat said, uncertainty is not a great thing in respect of trade and investment. As elements of uncertainty decrease, we need to factor them in and to work alongside our investors and companies to help them to plan a way forward.

When there is such uncertainty over a prolonged period, and when we are not fully in control of achieving any particular set of outcomes, we need to plan for a number of outcomes and to consider how each will affect various strands of both economic and cultural life in Scotland.

Gil Paterson: On planning, whom should we be aiming at? Who is really calling the shots? Is it the UK Government or the European Union?

I know how important the financial sector is to Scotland—although I gather that the Scottish interest and the London interest are perhaps slightly different—but we do not know what planning we need to be doing for, say, passporting. Is it in Luxembourg's interests or Germany's interests to have a hard, rather than soft, Brexit, given that they are competing in the same market? Things might be a bit difficult for them in the short term, but in the long term, a hard Brexit might be the answer. How does that square up with regard to planning and the question whether we should be engaging with the UK Government or others further afield?

Professor Peat: Perhaps I can respond to that first. The answer, of course, is that we should do both. This is not a one-sided discussion; it is at least two-sided, and the interests of individual countries in the EU as well as the interests of the EU as a whole will be taken into account in the negotiations.

There is a difference between Scottish financial sector interests and UK financial sector interests with regard to passporting. When I worked with Owen Kelly of Scottish Financial Enterprise on this, I was surprised to find that the impact of the loss of passporting would be less in Scotland than it would elsewhere. The main impact of Brexit will be on the major investment banks and possibly on some of the exchange arrangements that exist. Some of those great exchanges might remain in the UK, because their doing so might be in the interests of the whole of the EU, but there are still a number of areas that could depart. Passporting will not be formally present for the UK, and the informal or alternative arrangements will be less satisfactory.

One can try to make the case that it is in Europe's interests for London to be successful in the financial sector, but I am not sure how far that goes, because many organisations in Germany and elsewhere are already working very hard to recruit high-quality staff and, indeed, to look for headquarters away from London. The balance is between the two elements, so if Scotland is going to be influential, it needs to maintain contacts on both sides of the debate.

The Convener: Other members might want to ask about the financial aspects in more detail, but I want to ask Neil Francis a follow-up question. Is "flexibility" the watchword for Scottish businesses?

Neil Francis: "Flexibility" is a key word. As I have said, when a business has no or limited influence—and certainly no control—over the eventual outcome, it has to plan for multiple outcomes and ensure that it is gearing itself up to survive and thrive regardless of the outcome. That is what businesses do really well.

That said, there is a difference with regard to how one negotiates, which is what I think Gil Paterson was asking about. When you negotiate, you try to make gains in areas that are of more value to you, and concede in areas that are of less value. One of the big jobs is to understand what are the most valuable things to Scotland. Jeremy Peat mentioned passporting and how the Scottish perspective might be slightly different from the UK perspective. Given the wide range of sectors and other interests that we have, we have to get consensus on the things that are most valuable to us in our relationship with the European Union.

The Convener: I know that China is not in the EU, but it might—as far as forward planning is concerned—be helpful if James Brodie could comment on the Chinese dimension.

10:15

James Brodie (China-Britain Business Council): Since Brexit, we have surveyed the companies that we represent—primarily British companies that engage with China either here in the UK or operationally in China—on their opinion about what Brexit might mean for them. Perhaps somewhat surprisingly, they came back rather positively and optimistically in terms of the opportunities that Brexit might offer them—most concretely in the form of the possibility, in the medium term, of forming some kind of free-trade agreement with China. Because the EU currently has no such agreement in place, it may be one of the countries with which the UK Government chooses to negotiate a free-trade agreement. Planning for that should be about people engaging with their industry sector and with the Government in order to alert it to obstacles that lie in the path of trade with China. It should also be about making sure—as Neil Francis suggested—that when it comes to negotiating with the EU and perhaps, as I said, with other trading partners, we can prioritise correctly by establishing where the greater interest lies.

Aside from that, I would also say that at this time it is very much business as usual. We can try to plan, but because there is so much uncertainty about potential outcomes, it is a very challenging process, so we must be flexible. Listening to and maintaining existing partners and clients in China in the foreseeable future is probably the key—we have to make sure that we are servicing our trading partners as best we can.

John Mason (Glasgow Shettleston) (SNP): I have read the very interesting paper by Jeremy Peat and Owen Kelly on Brexit and the Scottish financial services sector. I want to ask one or two questions about that. You have mentioned passporting and access to non-British staff, which appear to be two of the key features. Can you explain a little about passporting? If I understand it correctly, it means that once a company is operating in one part of the EU it can operate anywhere in the EU—although that is maybe a bit simplistic. Am I right in saying that some parts of the financial services sector would be more affected by the lack of passporting than others?

Professor Peat: I will do my best. Owen Kelly is the great expert on this, so I relied on him very heavily. Your definition of passporting is basically correct. Via the passport, any financial institution that is based in a member state of the EU can operate equivalently across the other member states, so it will have rights and can operate as if it were based in that nation.

Why does that matter differently for some parts of the sector? First, in some cases the financial sector is pan-EU and in other cases it is not. For example, pensions are primarily single-nation based. Because of the difference in tax regimes among member states, it is difficult to sell a pension product from country A to country B because tax is what determines how the pension works. We have a very successful pensions industry in Scotland, but it is selling almost entirely into the UK market, so we do not need passporting for it and we do not expect the loss of passporting to have a major impact on pensions concerns.

On the banking side, remaining in Scotland we have essentially retail and commercial banks that also work mainly within a single-nation context so—again—they do not need the passport, whereas the big investment banks and the major corporate banks that lend at the top level require those international passports.

Wealth management is a very important sector, but services in it are regulated at member-state level, so direct provision across borders is unusual. Again, therefore, there is unlikely to be any impact on it from the loss of passporting.

That demonstrates that you need to look at each subsector of financial services and work out whether passporting matters to it, and then look at the breakdown of Scottish financial services activities and see whether Scotland is going to be affected in those different sectors by the loss of passporting.

It is not just whether we are selling to the rest of Europe that is important; it is also whether we are selling to other UK-based entities that are exporting to Europe. For example, as I understand it, in asset servicing, most of the high-skilled, value-added entities in Scotland are selling to institutions that require passporting in order to sell their services across Europe. Although we do not need passporting in order to sell our services to a London-based entity, that entity will not, after Brexit, be selling across Europe, so the market for our activities among the UK institutions might dry up.

You have to go down to the micro or sector level to work out whether passporting matters. The relatively good news is that the sectors that are most important here are ones in which the impact of passporting is likely to be somewhat less substantial than it will be in London.

John Mason: That is helpful. Your paper also says:

> "Providers in countries outside the EU, like the UK postBREXIT, either have to establish their funds within an EU member state, and 'passport' throughout the EU from there or market their funds from the UK under a more complex procedure."

Is the process of a provider establishing itself in Luxembourg, Dublin or somewhere else a difficult one or is it relatively easy?

Professor Peat: With regard to asset managers, it is already happening. The assets that are managed in Scotland tend to be based on funds that are set up in a range of European countries, so it is happening already and can take place quite readily. However, the same does not apply in sectors such as investment banking. What would be feasible for those sectors would be very much a second-best route. Again, you have to look at the detail and discover what can work. For example, asset management is an important sector for Scotland and it is unlikely to be dramatically affected by the loss of passporting because Scottish asset managers have already established entities across Europe that, as I understand it, will continue to operate after Brexit.

John Mason: I am also interested in the issue of access to non-British staff, which you spoke about. The other panel members might want to answer this question, too, as it is less specific.

To play devil's advocate, I might say that companies are just employing foreign staff because it is easy to do so and to train them, and that, perhaps, it might be better if we trained more of our own staff instead of being dependent on staff from elsewhere. What do you think about that view?

Professor Peat: In an ideal world, that is right, of course. However, we are not in that ideal world. Obviously, the more that we can develop highly skilled and highly specialised people, the better, and there should be a great emphasis in the financial services sector and elsewhere in the economy on developing the skills that are required. However, when push comes to shove, in very specialised areas, there are certain people who are particularly good at those jobs, and if they are doing a good job now, we want them to stay and to continue to do that job. There will definitely be skills areas in which you will look for people worldwide. At the top of the tree, you want the best people, so that Scotland can be highly productive and competitive. In our paper, we describe cutting off access to the people with those skills, wherever they come from, as "unduly masochistic". What is the point of denying ourselves access to highly skilled people who can make our economy more efficient and can, therefore, bring benefits across Scotland?

Neil Francis: We also have to take into account the wider benefit and impact that those highly skilled and talented people can have on the wider Scottish economy and how their skills can rub off on their colleagues. There is a big ripple effect, which feeds back into the other part of your question. Of course, we need to carry on investing in our own talent, upskilling and supporting our own people so that they can reach the level of specialism that can add so much value to the companies that are located here.

James Brodie: There is another ripple effect from foreign nationals coming to work and study in Scotland. Even if they do not stay here their whole careers, when they return to their country of origin they are a huge source of investment in the longer term. We will potentially be impacting on that.

The Convener: When you say "foreign nationals", do you mean people from any country—EU nationals and non-EU nationals?

James Brodie: Yes.

Gordon MacDonald (Edinburgh Pentlands) (SNP): I want to ask a number of questions about inward investment. In Scotland, we have 4,500 businesses that are owned by EU nationals. Do we have any indication of their views on the impact of Brexit?

Neil Francis: As I said during last week's committee meeting, since June we have spoken to all our existing inward investors in Scotland. To summarise, most people are still saying that it is too early to make any definitive statement on how they view the future of their activities in Scotland. That is the general point.

We have had no indication of any of our existing investors cancelling projects. Certainly, people are reflecting on future investment plans, which you would expect, but in general the volume of activity with our existing investors remains the same as it was pre-Brexit. Our activity to attract new investors to Scotland has been a little bit stronger in the first three months of this year compared with last year.

As the convener rightly pointed out, 25 per cent of our investment comes from within the UK—I am talking about companies that are already established elsewhere in the UK. That is an important source of future investment for us.

Gordon MacDonald: If nobody else wants to comment—

The Convener: Sorry, Gordon. I know that you want to move on to another question, but other members want to come in on inward investment.

Ash Denham (Edinburgh Eastern) (SNP): We know that Scotland has been doing quite well on inward investment, in terms of the UK picture as a whole—it is third, after London and the south-east. I assume that once investors have decided that they want to invest in the UK, they pick Scotland. We can see a list of reasons for that in the EY survey. A typical reason might be that Scotland has high levels of skills and education, or is seen as being a bit more affordable than London and the south-east. However, if we look at the top 10 countries that invest in Scotland, we see that six of them are outside the EU.

The EY survey also says that for 79 per cent of investors who invest in the UK, a key reason for their decision to invest is the single market. What is the future for inward investment in Scotland? If we are not in the single market, will that have an effect on countries that invest because of the single market?

Professor Peat: It is inevitable that there will be some impacts, initially because of the uncertainties. Further, if foreign investors from a range of non-EU member states come to Scotland in order to access the single market, a constraint on that access would have to be a negative factor in their considerations. How important that would be in the overall balance of their decision making would depend on each individual case. We know that Nissan decided to go ahead with its investments. We do not yet know quite why, although no doubt we will find out in due course exactly what was on the table. Of course, Nissan was looking at the EU market in a very big way. There is nothing to say that we cannot attract inward investment from outside the EU if Scotland is outside the single market, but that must act as a deterrent, at least at the margin.

Inward investment projects are exceptionally important to Scotland for a number of reasons. We still do not export anything like enough from Scotland to the rest of the world, whether to the EU or to non-EU locations, including China. A lot of the high-productivity, high-skill, export-oriented businesses are based on inward investment as much as domestic investment, so that matters to Scotland, and we have benefited hugely from being very successful in the past. We need to look to the ways in which we can continue that, through the good offices of SDI and others.

10:30

Gareth Williams: As has been said, our performance on inward investment has been strong, but we should not pass over some of the challenges. In particular, although we have been very successful in securing repeat investment, we have been less successful in attracting new investors. The figures from the trade and investment strategy showed that 37.5 per cent of investment in Scotland was from new investors, compared to 68 per cent in the rest of the UK. It is encouraging to hear that interest is picking up from new investors, even after the Brexit vote.

As Jeremy Peat says, there will undoubtedly be challenges but, to go back to my initial point, that means that we have to reconsider how we can have the most competitive environment possible in Scotland. For example, we know the strength of our universities and the key role that they play in attracting inward investment. We know that cities and their quality of life are increasingly important in attracting inward investment. We therefore need to consider how, in a post-Brexit scenario, we can maintain the links on innovation, research and so on with the European Union and ensure that our cities are best placed to be at the cutting edge of developments—for example, in digital and mobility terms. In addition to the discussion that we are having today, we have to look again at those areas.

Neil Francis: The statistics relating to inward investment are quite complex. A number of people produce reports on relative performance, and they use slightly different methodologies. The Ernst & Young report excludes all intra-UK inward investment—that is why the figures are as Ash Denham recalls. In general, we get about half our inward investment from Europe, the middle east and Africa: half of that comes from within the UK, about 10 per cent comes from the Asia-Pacific region and about 40 per cent is from the Americas. That has been our historical pattern of inward investment.

As Gareth Williams said, we have historically generated about 70 to 80 per cent of the benefits through existing investors expanding and reinvesting, which is a really good thing, and around 20 to 25 per cent from new investors. In the past few years, it has been a priority for us to adjust that balance a little to get more new investors into Scotland.

On Ash Denham's point about why people invest here, there are two main rationales for inward investment: access to market and access to resources. Companies come to Scotland for both. As Jeremy Peat said in relation to financial services, we have to get into the detail sector by sector or even sub-sector by sub-sector. For some sectors, access to market is really important. Up to now, one of our selling points has been that companies access the whole of the European single market when they locate in Scotland.

On access to resources, we have a great story to tell about our business environment, as Gareth Williams said. There is stability—doing business from Scotland is seen as low risk—and there is access to skills and to research and development. Jeremy Peat talked about the importance of inward investment. Inward investors account for about 70 per cent of business expenditure on research and development in Scotland. That is an important point. Of course, companies that focus on doing research and development here might be less impacted by issues to do with access to market.

James Brodie: Ash Denham asked about the relevance of access to the single market as a reason for investment in Scotland; my response relates to Chinese investment into the UK—not just Scotland. The model that has been described in the press, whereby Japanese investors based manufacturing in the UK so that they would have access to the single market, has not been an investment strategy that China has used thus far in the UK and does not appear to be on China's agenda. China would prefer to bring high-value manufacturing back into its own supply chain and export from China rather than use the UK as a base.

The one area where the approach might differ is financial services. In the past few years, particularly more recently, there have been a number of financial services investments, primarily into London. That is where passporting comes in, and I defer to Jeremy Peat's knowledge about how much that will affect Scotland.

The Convener: We have two more questions on inward investment, from Liam Kerr and Gillian Martin.

Liam Kerr (North East Scotland) (Con): I want to explore the Chinese angle, in relation to comments that James Brodie and Neil Francis made. The EY survey showed that in 2015 China was the UK's third largest investor, with a 79 per cent increase in projects. Is there any reason to think that that will not continue, whether as a function of Brexit or not?

James Brodie: Because the change in leadership at Prime Minister level took place around the same time as the Brexit vote and one of Theresa May's first actions was to press the pause button on the Hinkley Point C decision, there was a huge conflation of Brexit with Hinkley Point C in the press and the two issues became far more merged than they are in reality. The decision that Hinkley Point C would go forward came as a great relief for many people in the UK-China business and investment world, as it reinforced the work that had been put into creating the so-called golden era in UK and China relations. From all the Chinese Government public announcements that we have seen, there is every intention for that investment to continue.

Whether Brexit impacts on China's investment in the UK remains to be seen but, as I say, because of the nature of that investment, that would not necessarily be quite as direct as the impact on Japanese investment has been.

In financial services, there are concerns around passporting and Euro denomination in the city of London but, broadly speaking, we have a very positive relationship at the moment between the UK and China on trade and investment. We have not seen any noticeable slowdown. In many instances since Brexit, a 10 or 15 per cent discount on a lot of assets has been brought about by the fluctuation in foreign exchange. Especially in the property sector, a lot of deals have gone through quicker than otherwise expected. It is very difficult to know how much Brexit is affecting the pipeline of investment. As Neil Francis mentioned, no doubt investors will be looking at the long-term picture and taking stock of what the changes will be. There is so much uncertainty over exactly what the situation will look like.

Liam Kerr: That is the UK level. The EY report also talks about Scotland not establishing a reputation with China and India for foreign direct investment projects. Why is there that difference between the UK and Scotland? What can be done to address it? Should the five-year strategy be reissued or has the strategy not worked? What needs to be done at the Scotland level?

Neil Francis: I will have a go at answering that. James Brodie has covered quite a lot of this; it is partly about understanding the investor's motivation, our capability and assets, and whether there is a strong match between the two.

We know that Chinese foreign direct investment is financially led. The Chinese like to enter a new market by investing through the acquisition of companies, partial investment in companies and the acquisition of assets such as real estate. Those are their motivations and their preferred operations of market entry. The United States, however, tends in new territories to set up operations under its own control. It is less inclined to lead by trying to acquire either assets or companies. It is very important that we understand such motivations.

We must then do two things. First, we must understand what we have that matches the potential investor's motivation and desire and, ultimately, understand the benefits to Scotland of that undertaking. Secondly, we must understand that China is a difficult marketplace. It is further away from us, it is complex, it has a very different business culture and it takes time to establish relationships.

Ultimately, we would like to see inward investment performance improve in relation to both India and China. We are working towards that, but it is quite difficult. You have to be patient, persistent and balance the effort against our opportunities elsewhere in the globe.

10:45

Professor Peat: I should perhaps declare that I am a board member of Scottish Enterprise and chair of its economic policy committee. I am not speaking as a representative of Scottish Enterprise but I should declare that interest.

I agree with what Neil Francis said about it taking time. The efforts that are being made to build up an understanding and relationships with China and India are first rate, but it takes time. I worked in Asia a lot back in the seventies and eighties and I understand how different they are and how difficult it is to build those relationships. It is happening and it is working, but we need to give it time.

I also reinforce what James Brodie said about the importance of the links with Scottish universities. The alumni of Scottish universities, who are out there in the business communities of China and India, are a tremendous asset. We must make best use of them for Scotland as a whole, not just for individual universities to build their relationships. Those people can be tremendous ambassadors for Scotland and they can also start the process of building interest in investing in Scotland and in taking imports from Scotland. The building of high-tech exports to China and India as part of their supply chain is perhaps as important as inward investment. As James Brodie explained, the desire is to have most of the capacity in China.

The Chinese who have studied and worked over here will know a great deal about what Scotland is capable of that can be built into developing export markets in China and India. That comes from making sure that our universities continue to pitch and that more of our Scottish companies have the ambition and drive to go out there, sell their products and develop their relationships.

There is a battle to be fought to make sure that Scotland is out there selling its wares and developing the best relationships with China and India through the people on the ground and through Scottish companies and the links with Scottish universities.

Liam Kerr: I would like to finish on that point. You talk about relationships. This is an obvious question but it needs to be asked. A lot of good work is being done to build relationships but what impact will the business with the memorandum of understanding have on long-term relationships? Will it have any impact?

Neil Francis: James Brodie will come in on that in a minute, I am sure. It is really important that we do not let it have a long-term impact on relationships. As Jeremy Peat said, everything is based on having a consistent, long-term approach to that particular market and showing due respect to the time that it takes to build those relationships.

China is a vast country with a huge number of opportunities. We just have to take our time to ensure that everything that we do reinforces the perspective that we are open for business, and that we value trade and investment with our counterparts in China. We will not let the situation with the memorandum of understanding have a detrimental impact.

The Convener: We would like to take another few questions, but the witnesses should feel free to come back on anything in their comments because these areas are interlinked. Do not hesitate to comment further as we move on. Gillian Martin has a question on inward investment and Andy Wightman will come after her.

Gillian Martin (Aberdeenshire East) (SNP): Because of what you have just said, convener, I have changed my mind about my question. I want to pick up on some of the things that Jeremy Peat said.

My question is about Scotland's global reputation as a result of Brexit. I was interested to hear what Jeremy Peat said about students coming from other countries to Scotland and almost being ambassadors for Scotland when they go back. The post-study work visa situation is not in any way helping our reputation with students for being open and it is not facilitating those relationships. In the United States presidential election, the president-elect pursued an isolationist approach and the reputation of the UK perhaps also looks isolationist because of Brexit. Will you find that difficult to overcome when you go out to attract people to work in Scotland?

Andy Wightman (Lothian) (Green): I want to follow up on the question about inward investment. You talked about companies in China and elsewhere having different reasons for investing in the UK and I wonder about your use of the term "investment". Some of those companies are simply acquiring UK assets or UK companies in takeovers, to asset strip or to export intellectual property to their home country. When you talk about investment, do you discriminate between money that comes from foreign countries simply to buy UK companies—in and of itself, that is not investment, it is merely a transfer payment to a UK owner or another foreign owner—and money that is invested with a view to making a return and, therefore, generating economic activity in the UK?

Neil Francis: It is always easy to forget the first question and focus on the second.

Gillian Martin: Please do not. [*Laughter*.]

Neil Francis: I will deal with Andy Wightman's first, since it is a very good question. I will give you two answers. There are official, globally accepted definitions of what makes up inward investment and so on. If a company simply acquires another company in a new territory, it would be counted as inward investment in those official statistics.

The SDI perspective is to always think about why we want to do something, and we want to attract inward investment for all the reasons that we have already said. To summarise, it helps to grow the Scottish economy. If a project does not help us to grow the Scottish economy, there is no reason for us to be involved with supporting it. You are absolutely right that a simple acquisition is just a transfer payment; there is no added benefit to the Scottish economy.

We are interested in acquisitions in two situations and the first is when there is distress. We have touched on this before, so you will be familiar with the example of Texas Instruments and its desire to sell up in Greenock. We are actively working to find a buyer and that project would simply be an acquisition. However, that is a distress position and finding a buyer would help to retain some valuable employment in Scotland.

The other situation in which we would support an acquisition-led strategy is when the acquisition comes with a defined plan for growth with further investment that can take the company beyond where the existing management team has said that it can take the company. The important thing is for us to step back and reflect, to understand why a situation would be good for the Scottish economy, and to let that understanding guide our decision making on whether to support a project.

I will quickly go on to the other question. As we know, reputations are very hard to build; they take a long time to build and they can be crushed in a moment. Even with the decision of the UK to exit the European Union, Scotland still has a very strong international reputation for things that we are all proud to stand behind—our integrity, honesty, hard work and innovation—all those kinds of things. We need to do everything that we can to carry on building that in the international communities and the international business sectors that we work in. Doing that will be important.

Our pipeline of potential inward investment opportunities is stronger now than it was last year. As we have gone out and engaged with potential new investors, we have not seen any kind of adverse reaction in terms of our reputation. People understand that leaving the EU is a decision that the UK has made, but they engage with us on a person-to-person level and often form their understanding of whether Scotland is a good place to do business partly on that the basis of that personal engagement. We are still seeing a lot of empathy and resonance with Scotland from the international community.

On the post-study work visa, anything that we can do to enable some of our students to stay longer so that they can, as Jeremy Peat said earlier, connect with businesses here and then connect back in their home markets, would be a great thing for us.

Professor Peat: I reinforce a lot of what Neil Francis said. On asset stripping versus beneficial acquisition, what matters, in dreadful jargon, is what the counterfactual would have been—what would have happened had that inward investment not come in. If you have a continuing, successful Scottish business that might disappear after an acquisition, or you have far less certainty about whether it will carry on in Scotland in an effective way, you might consider that there are downside risks. If you have a business that is in terminal decline and that can likely be saved by inward investment taking over the business, that investment could be extremely beneficial. We have seen that in several examples that Neil Francis has articulated and could articulate further. It is another example of needing to look at the particular case in order to form a judgment.

Going back to Gillian Martin's point, I agree that it is very important that we try to get back the post-study work visa. That is an outstanding recommendation from Robert Smith's report, as I remember—a recommendation that is still sitting there. I believe that it would be a small but important step to take for further education and indeed higher education. It is an opportunity when students stay on, reinforcing their relations in Scotland and the gains that we get from their study and involvement here, and then go back to their home countries and with an even better view of Scotland. They will have established business relations that they can build on when they go back to China, India or wherever. The visa programme would be a small step and I do not understand why it cannot be achieved. It would be part of the whole process of trying to demonstrate that Scotland is by no means heading towards isolation. It would be part of saying that Scotland is and will remain open to business. That message has to be hammered hard and long. Small steps such as the post-study work visa would be one way of demonstrating that we are up for it—that we want to continue to be engaged and are doing everything that we can to achieve that end.

11:00

Gareth Williams: I recognise that the challenges that we see globally and in politics affect Scotland, but they also present an opportunity for leadership to bolster our reputation. Whether by economic, social or environmental action, we can be seen to be effectively addressing some of those challenges and taking people with us as we do so.

On the post-study work visa, as I have said to the committee previously, we have been involved in work on developing the proposition around that visa, following on from the Smith commission recommendation. We were disappointed that the UK Government responded quite negatively to the Scottish Affairs Committee on the matter, after a long period of silence. However, we continue to develop what we think is a reasonable ask of the UK Government and, in particular, to probe whether, in relation to the limited pilot that was announced more recently, the Scottish universities could have access to that at as early a stage as possible.

James Brodie: I can only endorse what has been said about building reputation. A cliché that we commonly hear about doing business with China is that it takes a long time to build relations. However, it is not just about the time that it takes to build up an interpersonal relationship; it is sometimes also about the time that it takes for a student who has studied in Scotland and goes back home to develop their career to get into a position where they can influence an investment decision further down the line.

In the case of North America, from where 40 per cent of our inward investment has traditionally come, we have a centuries-long relationship with the United States of America and Canada, and have family ties with them. We have all sorts of hooks and levers to draw on when speaking to potential investors there, as well as a very large contingent of North American students and alumni who have gone back to live there. The cohort of alumni from Scotland going back to non-European countries in the far east is increasing every year by 4,000 or 5,000.

We have to impress on our universities—I think that they get it—the importance of maintaining those links with their alumni, rather than just chapping on their door 15 years down the line when the universities realise that they are very famous and asking, "Could we have some money?" The universities should support them in those interim years in the development of their careers, which will lead to a natural progression as those relationships develop.

Off the top of my head, I do not know how many Chinese students have returned to China after having studied in Scotland, but we have about 8,000 or 9,000 currently in Scotland, and the number going back to China increases every year. That is a huge pool of resource that we should be confident will bring us returns in the future.

Gillian Martin: Is there not more to this than just the post-study work visa? Is it not about making Scottish universities attractive to study in? Is it not also important that the kind of research that Mr Peat mentioned continues at Scottish universities so that they remain at the top of their game?

Professor Peat: That is absolutely critical. I would make two points, one of which is that Scottish universities have to develop their links with Chinese universities so that joint research can be undertaken in various areas. Given the potential of the Chinese universities, there must be great opportunities. I know that the University of Strathclyde, where I work, Heriot-Watt University, the University of Edinburgh and a wide range of Scottish universities are working very hard to develop links with different universities in China and, now, in India, not just via students but via relationships between universities, which is important.

The second point is on the research front, because it still annoys me that Scotland is at the top of the league as far as generation of patents, ideas and intellectual capital is concerned but is way down the list in terms of the utilisation of that intellectual capital to the benefit of Scotland.

Anything that can be done to increase the extent to which the intellectual property that is developed in Scotland is used in Scotland or used generally to the benefit of Scotland has to be of value. That could mean working more closely with Chinese graduate students and researchers, Chinese and Indian companies or, indeed, Chinese and Indian universities, which would be to our benefit. We are simply not making optimum use of what is happening and the intellectual capability in our universities. We must build on that in any possible way we can.

The Convener: Might that be partly because the number of companies is falling in Scotland at the same time as it is rising in the rest of the UK? Is there an issue with translating research into business?

Professor Peat: We just do not have enough companies in Scotland that are ambitious and growing and which are seeking to be high-productivity, high-investment, high-skill and exporting businesses. That is a continuing challenge. Fifty per cent of Scottish exports come from 15 companies, or something of that order. We have a very narrow company base, and we need to develop it by whatever means we can.

Through SDI, SE and every opportunity we have, we must encourage more and more of our high-quality Scottish companies to become more ambitious, which means wanting to grow, wanting to export and wanting to diversify those exports. That needs good management, good skills, the opening of some doors and the building of relations with areas that companies can potentially go into.

I am sorry—I am preaching; but this is terribly important, and we are still not doing well at it. I certainly would not say that this is a good time to change the model for doing this. We are getting there but, as everyone has told the committee, it takes a long time to develop these links and we really need to reinforce our efforts in every possible way. Whether in the EU or post Brexit, a successful Scottish economy will be a high-productivity, high-skills, efficient and evolving one, and we are not going to get that unless we put more and more effort into the areas that I have just highlighted.

The Convener: Does not that include the Scottish Government looking at taxation and, instead of increasing the burden of taxation on Scottish companies, seeking to go in the other direction?

Professor Peat: I have a strange feeling that the other areas are actually more important than minor changes in taxation. What really matters are the ambition, the drive and the outward-looking nature of Scottish companies. We have seen some Scottish companies doing it—and doing it brilliantly—but we need not just to double but to treble or to quadruple the number of such companies. If that means working with China and India and keeping their students here to help to develop our companies, so be it. We have to do that if we are to have a successful Scotland and to enhance economic welfare in Scotland.

The Convener: So you accept that taxation has something to do with this, even if it is not the main driver.

Professor Peat: It is always there but, like all of these effects, it is at the margin. I am not a great believer in the Laffer curve, if that is what you are asking about. [*Laughter*.] That is going back a long way, is it not? Andrew Wilson, all is forgiven.

Marginal changes in taxation are less important than a focus on challenging, encouraging and assisting Scottish companies to become more ambitious and outward looking.

The Convener: I will bring Gordon MacDonald back in, because I think that he has some questions about what might be referred to as proximity. Richard Leonard could then ask about outward investment, which might also relate to what you have just been saying.

Gordon MacDonald: Last week, Neil Francis said:

> "Proximity will always be an advantage".

He also said:

> "Usually, the further away a market is, the harder it is to penetrate"

and that

> "it is important that we carry on developing relationships with those closest to us".—[*Official Report*, *Economy, Jobs and Fair Work Committee*, 8 November 2016; c 14.]

Given those three separate statements, how difficult will it be post Brexit for us to continue to get inward investment? If I picked Neil Francis up right, I believe that he said that roughly 25 per cent of inward investment is from the EU.

Neil Francis: Well, 50 per cent is from Europe, the middle east and Africa, but the majority of that comes from Europe. Fifty per cent of that 50 per cent—in other words, 25 per cent—comes from within the UK.

Gordon MacDonald: So how do we continue to attract inward investment if we are no longer the gateway into Europe and we turn our back on many European companies that might previously have decided to come here?

Neil Francis: There are a couple of thoughts there. You will recall that I said earlier on that, broadly speaking, the motivation for inward-investing companies is access to a market or to resources. When companies that are already headquartered in Europe invest in Scotland, in the majority of cases, they invest for access to resources, not access to the market, as they are already in the marketplace. I would say that, on balance, there will be less of an impact on those companies that invest in Scotland, because their motivation is more around our resources and our research and development capabilities, for example. They will be less concerned about access to the single market, because they have a footprint in it anyway.

Richard Leonard (Central Scotland) (Lab): We have covered the freedom of movement of labour, especially at the high-skill end—as, I think, Jeremy Peat described it. Our witnesses might want to reflect on whether they have any observations on freedom of movement of labour at the lower-skill end.

We have also quite rightly focused on inward investment. The latest annual survey came out just last Tuesday, I think, and told us that 34 per cent of the Scottish economy is externally owned—that is, is owned from abroad. Is that a good place for us to be? Is it just the way it is? We have the highest level of external ownership of any part of the UK.

My main question is about outward investment, which is the other side of the inward investment equation. Freedom of movement for working people and freedom of movement of capital were pillars of the creation of the single market. What might happen to freedom of movement of capital if we are outside the single market?

Neil Francis: That is a really great question that, to be honest, we probably have not thought about as much as we should have hitherto, although, with Brexit, it is coming into sharper focus.

As Jeremy Peat has said, one of the things that we have focused on is how to create globally competitive, Scottish-owned businesses. That is part of what we want to do. We have some successes there, but not nearly as many as we want.

I have spoken about the motivation of inward investors. As a company becomes more global, there is the reverse question for our Scottish-based companies. A company such as the Wood Group will be thinking, "How do I enter my new market in Brazil? Will I service it from elsewhere or put down a footprint there?" That would be outbound investment.

As we see, I hope, more of our Scottish-owned companies growing and attacking and penetrating more international markets, there will naturally be an element of deciding how best to enter the new markets, which may result in outbound investment. That is a good thing, as it ensures that those companies will remain globally competitive and will grow their business internationally, which will bring back benefits to Scotland.

I am not sure whether that is what Richard Leonard was asking about. He does not look as if I have answered the question that he asked; rather, he looks as if I have answered some random question.

Richard Leonard: No. I subscribe to the view that we should probably be doing more than we are doing to invest in the growth of indigenous businesses and to support middle-sized businesses. We concentrate too much on the bottom end—the birth rate or the formation end—and on the higher-level inward investment end, and probably do not put sufficient resources into the middle.

Neil Francis: To link back to the convener's previous question about middle-sized companies, or companies that have the ambition and wherewithal to grow, I wonder whether members saw at the weekend the announcement of the risk capital investment report for 2015, which showed that £430 million was invested last year. That is 70 per cent up, and almost a four-fold increase in the value invested since 2012. That is a really good sign because, in addition to the things that Jeremy Peat mentioned, if companies are going to grow internationally, they need investment capital to help them. As a side note, £290 million of the total came from venture capitalists from outwith the UK—overseas investors investing equity in our Scottish-based companies.

11:15

Professor Peat: On Mr Leonard's point about lower-skilled labour, there are significant areas of the Scottish economy where access to seasonal—or non-seasonal—labour is utterly critical. That is not my greater area of expertise, so I focused on the high skilled in relation to financial services, but I would hate to see the Perthshire raspberry trade going down the tubes because of a lack of fruit pickers, for example. We have to be very aware that there are certain sectors of our economy in which obtaining all of the labour that is required from within Scotland is problematic.

I would like to see a building up of individuals' skills in Scotland so that people can move up the chain. The hollowing out of the labour market is something that worries me immensely. I do not want to have Scottish workers filling only lower-skilled jobs; I want them to develop so that they move and progress within our economy and can add greater value.

On the high level of overseas ownership, my point is very similar to the one that I made about acquisition. One needs to look at each case to make sure of a maximisation of the value added within Scotland, both directly and through interrelationships with the business, whoever owns it. What is wanted is not the overseas owner who takes the profits and runs, but the overseas owner who tries to build and enhance the business and its links within Scotland. That varies case by case.

Dean Lockhart (Mid Scotland and Fife) (Con): There seems to be consensus that we need Scottish companies to be more ambitious and, perhaps once they get to a certain size, to look to export markets.

It would be really useful for panel members to give us a brief description of what they see as the main opportunities available for Scottish investment or exports in each of the sectors or areas that they cover, and to say what practical steps we or the Scottish Government agencies can take to encourage Scottish companies to explore those opportunities.

James Brodie: On trade, the opportunities that currently exist in China for Scottish businesses are diverse, ranging from healthcare, particularly elderly care, to childcare at the other end of the scale. There are also a lot of retail opportunities in childcare and in luxury products, such as textiles and food and drink in particular.

On investment, there is an increasing number of Chinese investors looking for high tech, in sectors such as oil and gas, where we have a great deal of strength, renewable energy and offshore wind and marine energy. Traditionally, engineering has been a very strong sector for Scotland in China. The education sector, which we have talked a great deal about, continues to be strong for Scottish institutions in China.

Last but not least, there is perhaps financial services, although a relatively limited number of Scottish companies are in an operational position to take advantage of the opportunities. That is a snapshot of some of the emerging and existing opportunities in China.

I have another comment that does not directly address Dean Lockhart's question—it is on Liam Kerr's point about whether there will be a residual effect of the MOU in China. I just emphasise the vastness of China and the difficulty of making any kind of a splash, positive or negative, in the Chinese media. I reassure Mr Kerr on that. I suspect that the impact on the wider investment community will not be of any significance.

Gareth Williams: It is challenging to identify specific sectors and geographies. We believe that there are opportunities in Commonwealth countries, where more could be done, although not as an alternative to doing things in Europe, for example. Given the make-up of the populations in some Commonwealth countries—they are young and growing—and the relative familiarity of things such as the language, business culture and governance, we could look at co-ordinating more activity there.

We have not mentioned tourism. There is a massive opportunity for that in the Chinese market, but that comes back to thinking about visas. It is relatively difficult to get visas processed in the UK compared with in countries such as New Zealand, which put a lot of effort into that.

Another issue on visas relates to inward investors. We often hear that, because it is so difficult to organise meetings in the UK for people coming from all parts of the world, meetings have to be organised elsewhere. Over time, that has an effect on people's knowledge of the Scottish economy and the assets that are here.

There have been a lot of reviews of export strategies over the past few years. The committee and its predecessor have done a lot of good work. We now have a chance to see some of that through and to keep a focus on it. Given that there is much more political engagement than there has been at any point, we need to up the profile of our international activities through the involvement of ministers, MSPs and others on overseas trade visits, for example.

Neil Francis: To build on what Gareth Williams and James Brodie have said, the opportunities present themselves slightly differently depending on the sector and whether we are considering trade or investment. For some sectors, the opportunities are predominantly in trade. For example, with food and drink, we see our international play mainly in terms of trade whereas, with financial and business services, the play is predominantly on inward investment, in terms of our internationalisation approach. Other sectors such as life sciences, technology and engineering and oil and gas are much more balanced, in that the opportunity falls on the trade and the inward investment sides.

As with a number of the issues that have been raised today, we really have to drill down a bit on that. We do not consider simply what the opportunity for a sector is. For example, with life sciences, we have identified three priorities, which are pharma services, regenerative medicine and medical technology, and the specific international opportunities are different for each of those sub-sectors.

That is a bit about how we look at the opportunity.

What can we do to accelerate things? The great thing about outward trade is that it is in everyone's interests and it is non-competitive. We need to mobilise as wide a partnership as possible across

Scottish business life, whether that be the private or the public sector, to build the narrative that supports companies becoming more ambitious to trade internationally.

Interestingly, last week in Glasgow an event called get connected was delivered by a range of partners. About 400 companies participated to learn about all the different aspects of trading internationally. It is important to have more events like that.

Inward investment is much more competitive—it is a competitive sport. We are pleased to get such investment, but it probably means that other locations have lost out on that opportunity. Our resources are small globally, so we need to be very focused on the areas that offer the greatest opportunity.

We are focused on London, which is a very big opportunity, and on California on the west coast of the US. In both those locations, we are focused on two sectors: technology, particularly its digital and software subset, and financial and business services.

We have talked quite a lot today about relationships and reputation, which are both very important. When we ask companies that we have successfully attracted to Scotland why they came, they give us a wide range of reasons. A strong common thread seems to be that they have had a prior connection to Scotland. As James Brodie said, they may have had some of their education here, their grandparent may have emigrated from Scotland or there may be an existing business or research relationship with the universities. We need to find ways of exploiting that connection and using not only our universities, but our wider global networks to help find the opportunities. That is a big thing for us to do more of.

The Convener: Does the professor want the last word?

Professor Peat: That is very kind of you. Let me simply endorse what my three co-conspirators have said about the importance of making the most of a range of sectors and opportunities. I do not rule out any opportunity, and the higher up the value chain it can be and the more that we can make use of the skills and the resources available in Scotland, the better it will be for the Scottish economy. Let us go out there and be ambitious.

The Convener: That is a good point to end on. I thank Professor Peat, and his co-witnesses—if I may call them that, rather than co-conspirators—very much for coming.

We now move into private session, so I ask those in the public gallery to leave.

11:28

Meeting continued in private until 12:18.

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