

## Scotland's Economic Performance

### Highlands and Islands Enterprise

#### INTRODUCTION

Highlands and Islands Enterprise (HIE) welcomes the opportunity to respond to this important parliamentary inquiry. We have framed our response around the three core factors as they present themselves in the Highlands and Islands.

#### **Regional economic performance – 2007-2017**

Despite the underlying challenges facing the Highlands and Islands region, its economy has proven extremely resilient over the past decade. While the global financial crisis and the collapse in the price of oil have had an impact on the overall rate of economic growth, unemployment has remained low, and the labour force as a whole has continued to expand.

Over the past ten years, compared to Scotland, the Highlands and Islands has consistently had higher rates of employment and economic activity along with lower rates of unemployment. However, in the wake of the financial crash the region's performance against key labour market measures was in line with the negative trajectory that was evident for Scotland and the wider UK.

Headline employment trends for the Highlands and Islands reached a low point in 2013 when the employment level fell to 75.7% (down 4% from 2007) and economic activity dipped just below 80% (down 2% over the same period). At 5.2%, unemployment remained lower than the Scottish average (7.9%) in 2013, but was over 2% higher than the region's jobless rate in 2007 (2.9%).

In the immediate aftermath of the financial crash, challenging lending conditions hit prospects for private sector growth in the Highlands and Islands, while the slowdown in the economy had a particularly adverse effect on the construction sector. The relatively large public sector in the region shielded the economy to some degree from the full extent of the recession experienced across the UK as a whole. This reliance on public sector employment, and on employment related to public sector expenditure, has meant that the impact of the UK Government's austerity programme has had a material impact on growth rates across the Highlands and Islands.

However, since 2013, the regional labour market has recovered strongly. On the jobs front, there has been a return to pre-recession trends, with the latest data (April 2016-March 2017) pointing to an employment rate of 78.8% and unemployment at 3.2%. In particular, there has been a marked improvement in youth unemployment, which has fallen from a peak of almost 15% in 2013 to 8.7% more recently. The latest recording for economic activity in the region (81.5%) is also close to the norm prior to the economic downturn.

Following the recession of 2008/09, median wages in the Highlands and Islands started to decline in real terms, broadly reflecting the trend across Scotland. By 2014 real terms salaries began to stabilise and the region recorded solid wage growth of around 4% last year. However, it remains the case that, as with the wider Scottish and UK economies, falling or sluggish wage growth has been a feature of the Highlands and Islands economy over the past decade.

Productivity in the Highlands and Islands has historically always been below the national norm, due to factors such as a reliance on low paying sectors and the higher proportion of micro and small businesses (which typically have more limited capacity and resources to innovate and find efficiencies in their ways of working). The inability or reluctance of firms to make investments post-2008, has resulted in poor productivity growth across Scotland and the UK, and heightened the productivity challenges for the Highlands and Islands.

Boosting the region's productivity levels will be central to sustaining wage rises over both the near term and long term. There is evidence that, relative to the wider UK, regional performance has improved gradually over recent years. Data from ONS shows that, against the productivity measure of GVA per hour worked, the Highlands and Islands level grew from 87% of the overall UK average in 2008 to 91.5% in 2015. Findings from the July 2017 HIE Business Panel survey of 1,000 members offer further encouraging signs. Around two-thirds (64%) of businesses report that they have introduced more efficient working practices to enhance their competitiveness in the current economic climate. Just over half have invested in innovation, invested in improved plant machinery or automation, and upskilled staff.

Crucially, there is evidence that skills capacity, much of it untapped, already exists within the region to drive productivity growth and innovation. For example, figures on educational attainment show that over 40% of the region's working age population are qualified to NVQ4 level or above – higher than the UK average (38%). Aligning available skills with emerging opportunities and addressing blockages to participation in the labour market (such as childcare provision) could help expand economic output and drive up productivity levels, with a corresponding increase in household income.

Amongst Highlands and Islands exporters, the latest HIE Business Panel survey (conducted between April and May 2017) found that 27% had seen an increase in sales in the preceding 6 months, compared to 12% reporting a decrease.

However, the benefits from sterling's depreciation are counter balanced by the drawback of higher input costs for companies reliant on foreign supplies – evidence of which has begun to emerge among Highlands and Islands firms. In addition, at the consumer level, there is the danger of increased import prices impacting on the purchasing power of household budgets.

Looking at Business Panel survey results across all parts of the business base, firms were generally upbeat about their own performance, with 78% of the region's firms indicating they had performed well (40%) or remained steady (38%) in the last 12 months. This is despite businesses remaining

gloomy about the outlook for the wider Scottish economy. On the labour market front, the latest data from ONS shows the Highlands and Islands continuing to outperform Scotland overall, with unemployment in the region at the very low level of 3.2% and the employment rate sitting at just under 79%. As with Scotland as a whole, however, a drop in the economic activity rate suggests that some working age people have left the labour market altogether.

### **Challenges and opportunities over the next ten years**

Over recent decades the steady removal of trade barriers has made investment decisions by global businesses both harder and more important. The Highlands and Islands (and Scotland more widely) has been very successful in attracting strategic investment into the region in a variety of sectors including Life Sciences, Energy and Business Services. The region's spectacular natural environment, educated workforce and proximity to large and affluent European markets have contributed significantly to that success. Examples of such investment include the CapGemini IT Centre of Excellence, creating 500 jobs in Inverness, and the acquisition of the Rio Tinto facility in Lochaber by the Liberty Group – safeguarding 160 jobs, with significant growth plans for expansion expected to create hundreds more. While none of those advantages will be lost, the uncertainty posed by the UK's withdrawal from the European Union regarding the nature of future trading relationships could act as a barrier to continued success at least in the short run.

While the Highlands and Islands economy has displayed resilience in emerging from the post-2008 financial downturn, the last two years have underlined that the recovery, both regionally and nationally, ultimately remains fragile and vulnerable to challenging conditions that materialise in the economy.

Although there are signs that confidence has finally started to slowly return to the oil and industry, the challenging outlook for the sector from mid-2014 onwards has been a major headwind for the Scottish economy, and the impact has been felt among a number of Highlands and Islands firms reliant on the industry.

Uncertainty following the outcome of the EU Referendum has made firms increasingly cautious around expansion and development plans. A quarter of respondents to the latest Business Panel survey indicating that they will hold off making investment decisions until after negotiations on the UK's exit are concluded. The potential for the EU referendum outcome to generate more economic headwinds in the period ahead is further underlined by the findings that just under half (49%) consider membership European Single Market as important to their business and 39% feel free movement of people is important. Furthermore, the majority of businesses in the region view free movement of people across the EU (75%) and access to the European single market (69%) as important to the Scottish economy. There are anxieties within sectors strongly reliant on migrant workers, particularly tourism and food and drink, that recruitment may become significantly more challenging. There are concerns that any new tight immigration controls could make it difficult to recruit staff, while the on-going uncertainty around the future status

of EU nationals risks making the UK a less attractive prospect for foreign workers.

However, following the conclusion of negotiations and the provision of more certainty regarding trading relationships it will be possible to develop compelling propositions to attract new business to the region and to encourage multi-nationals already located in the region to expand their operations. It is anticipated that Life Sciences and Technology will continue to be important sources of inward investment to the Highlands and Islands, delivering high value jobs across the region. Investments made by HIE such as those at Inverness Campus and the European Marine Science Park in Argyll will help capitalise on new opportunities as they emerge in the future.

In addition, as more indigenous businesses adopt innovative work practices and engage in international trade (across all sectors of the economy) the creation of further high-paying jobs will continue to support and sustain communities right across the region. The unprecedented scale of investment in the region's superfast broadband infrastructure – with coverage having increased from 4% of premises in 2013 to 86% today – provides significant opportunities for companies to adopt new ways of working and optimise their business models, while HIE-led initiatives such as the regional 'Innovate Your Business' service are helping develop the innovation capacity of the SME base across the region. Uncertainty around future trading relationships may create significant headwinds for exporters (both current and potential) in the future. The ability of the public sector (through programmes such as HIE's 'International Highlands and Islands) to support region's internationalised firms to adapt to the post-EU environment will be a critical determinant of long-term prosperity levels across the region.

The way in which opportunities associated with digital technology will emerge and evolve in a more connected world characterised by less certainty around trading relationships is difficult to predict. The challenge for policy makers will be to continually analyse and interpret changing circumstances to ensure an appropriate response which attracts talent and investment and provides access to growing markets across the world.

### **Priorities for action**

Successful regional development requires a holistic and collaborative approach across the public, private and third sectors. In the Highlands and Islands the long-term metric of success is the growth in the population. Implementation of effective policies that will help attract and retain young, economically active people to the region are therefore at the heart of regional development priorities. Research by HIE to understand the attitudes and aspirations of young people across this region gives a clear and consistent picture of the types of interventions that are required if talented young people are to be enticed to live, work, study and invest in this part of Scotland. Young people feel a pride and affinity to their home community (particularly those from island areas) and demonstrate a strong desire to be able to fulfil their ambitions in this part of the world. The top five factors where the public sector can intervene to support are:

**High quality jobs** – the creation of which requires sustained investment in the types of business that seek to grow, expand the markets in which they trade, embrace a culture of innovation, drive up productivity rates and invest in future leaders. Attracting inward investment to more communities across the region – such as BASF to the west of Lewis, or marine energy specialists to Orkney, while also supporting indigenous businesses to capitalise on emerging opportunities related to new investors, such as Liberty Alcan in Lochaber will be key to success here.

**Opportunities for career progression** – demonstrates the importance of a sectoral approach, working with businesses along a supply chain, creating scale through collaboration and establishing a reputation for excellence in some key niche areas (such as marine renewables, digital healthcare, adventure tourism). Investments in regional infrastructure, improving the connectedness of communities and providing competitive sites for businesses to expand and grow will be long-term priorities.

**Good access to housing** – provision of affordable and appropriate housing in communities right across the region is essential to sustained population growth. Tackling the endemic challenge of fuel poverty (particularly for the 110,000 houses in the region that are not connected to the gas grid) can help greatly in reducing energy bills and increasing household disposable income levels.

**Good access to further / higher education** – the growth of the University of the Highlands and Islands has been fundamentally important to the region's increased prosperity in recent years, and is an essential building block to its long-term success. Broadening out provision, increasing the steady stream of graduates into the labour market, investing in research specialisms (marine biotechnology, marine energy etc) and supporting the transfer of knowledge from academia to industry will be essential components of success here.

**Affordable transport links** – In a region heavily reliant on its intra-regional air service, myriad ferry services and a rail and bus network which don't benefit from the critical mass / economies of scale seen in more densely populated parts of the country, sustained investment in innovative and low-carbon technologies will be essential to make all parts of the region appealing to young people.

In addition, developing a culture of innovation within the region will be essential to raise productivity levels across the economy – a key component of the region's long-term competitiveness. Investing in innovation and productivity is essential to sustain employment, increase income impacts and generate additional profits, and to encourage further private sector investment in the region. Providing enhanced support for innovation through the delivery of services such as Innovate Your Business, and as an active partner in Scotland's CAN DO Innovation Forum, will lead to increased regional productivity and the capacity of businesses to innovate.

## **CONCLUSIONS**

While future trading relationships with the EU and other third countries will be a critical factor in the long-term growth and prosperity of the Highlands and

Islands, the region does have some intrinsic comparative advantages which we will seek to invest in and exploit over the next ten years.

Capitalising on the current rollout of digital infrastructure, maximising the benefits of the renewable energy sector, both through development and deployment of technology and through other benefits associated with the provision of abundant low-carbon energy to the economy more widely will be very important to the region. Furthermore, the provenance premium enjoyed by many products associated with region (particularly in tourism, food and drink and the creative industries sector) provides considerable opportunities for job creation business growth in the future.

Technological advancement coupled with unpredictable geo-political change could have a hugely disruptive influence on economies and societies across the globe. Adopting a place-based approach to development and focusing resources on developing a highly-skilled, adaptive and resilient labour market will be essential to ensuring long-term shared prosperity in communities across the Highlands and Islands.

### **Highlands and Islands Enterprise**