

POLICY INSTITUTE

The Voyages of the Starship “Scottish Enterprise”

Lessons and Ideas For Scotland’s Economic Agency

George Kerevan

Gavin Don

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Synopsis

There have been four distinct economic development strategies in as many decades followed by Scottish Enterprise and its predecessors. Plus one abortive road map. **George Kerevan** describes this seemingly endless and so-far fruitless quest to find a state-led solution to market failure – as opposed to repairing the clogged market structure itself. He concludes by suggesting an alternative use for most of Scottish Enterprise's budget, plus a new role for the agency itself. **Gavin Don** analyses three key failings in the Scottish Economy; investment, R&D and entrepreneurialism. He says that Scottish Enterprise must seek to fill the breach in these areas while encouraging a cultural shift in favour of enterprise.

POLICY INSTITUTE

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About the Policy Institute

The Policy Institute is committed to the promotion of liberal market values and solutions and applying these to current economic and social issues in Scotland. Its aim is to investigate, research and promote social and economic ideas that will lift Scotland's performance and prosperity and her standing on the world stage.

It pursues this aim by publishing high quality policy papers and analysis and presenting these to the highest editorial standards through publications, articles, seminars, public debates and other events. Current areas of concern are the Scottish economy; the quality and efficiency of public services; environmental and social issues and the governance of Scotland.

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Introduction

These are searching times for Scottish Enterprise. Its chairman Sir Ian Robinson and its chief executive Robert Crawford, are leaving. Their replacements will find awkward matter in the in-tray. A problematic Auditor General's report on the agency's use of expensive outside consultants will prompt widespread discussion of the agency's role and function. Other reports are likely in the course of the next twelve months.

Few better moments have presented themselves for sweeping change.

What is to be done with Scottish Enterprise? Should it follow the First Minister's advice and seek to do less better? If so, what functions should it discard, and which should it retain? Do we need a publicly funded agency of this sort at all? There is a powerful and compelling case for winding down SE and using its £450 million plus annual taxpayer subvention to relieve the burden of business rates.

The Policy Institute presents two papers, both of which take the middle way between full retention and abolition. But both also call for radical change. George Kerevan's proposals are set out at the end of a fascinating history of the agency and the many changing and conflicting missions that successive chief executives have sought to undertake. And Gavin Don, a corporate financier who works closely with young companies, looks at what SE could usefully concentrate on to help lift the performance of Scotland's economy. They have balanced criticisms with positive comments. And the Institute is pleased to publish them and circulate them for wide discussion.

Bill Jamieson

Director, Policy Institute
December 2003

Part One: The Voyages of the Starship "Scottish Enterprise"

George Kerevan

An Entrepreneur's Vision

Scottish Enterprise (SE) proper began in the early 1980s, when a Tayside businessman called Bill Hughes visited the US and accidentally discovered how businesses were getting involved in helping to create jobs in their local communities. In the black ghettos of Los Angeles and Boston, with their burned out houses and shuttered supermarkets, something creative was stirring. Rather than wait on Federal action that only produced more bureaucrats and the next round of riots, senior business executives across America's urban wastelands were taking matters into their own hands.

Local business action committees were springing up spontaneously. Private cash was being put up, often using federal or local tax incentives, to invest in urban clearance and vocational training. Top business leaders were assigning staff to work on these projects, bring valuable skills and vital contact networks into play. New regeneration models were in vogue including Business Improvement Districts (BIDs) which let local businesses levy taxes on themselves to finance improved local services. This was "can do" American entrepreneurship turned to civic action. Could it work in Scotland, too? Bill Hughes thought so.

Hughes just happened to be the Scottish Tory Party treasurer with the direct ear of the Prime Minister, Mrs Margaret Thatcher. In the early 1980s, the Scottish economy was emerging from a punishing recession that had killed off a fifth of manufacturing employment and left the economy reeling (albeit in much better shape competitively). North of the border, the cosseted middle classes were in alliance with the unions against the Thatcher revolution. Bill Hughes thought he had an answer to winning acceptance of the Thatcher economic miracle by replicating the American experience. It was christened Scottish Enterprise and it became Britain's biggest economic development quango.

Voyage No. 1: The Scottish Development Agency

What happened to the original model of SE proposed by Mr Hughes? In a sentence: it died on the drawing board. And here lies the root of the failure of SE subsequently to modernise the Scottish economy. To understand what happened we need to go back a stage. In 1979, Mrs Thatcher's first Secretary of State (and

confidant) George Younger had decided not to abolish the existing Scottish Development Agency (SDA), created by Labour in 1976. The SDA was the brainchild of a Labour-leaning economist turned civil servant, Gavin McCrone. He conceived it as a sort of state merchant bank pumping North Sea oil revenues into developing local high technology businesses; as opposed to relying on the failed policy of state redirection of industry to Scotland which had prevailed since the 1930s. Despite lacking any business experience, McCrone was appointed to head the new agency. But the economic recession of the 1970s created political pressures that quickly shunted the SDA in the direction of becoming a hospital for sick low technology companies such as carpet manufacturers. The SDA's one shot at picking a high tech winner (a four-wheel drive, cross-country vehicle) failed through under-capitalisation and lack of credible marketing experience. Thus ended the first state-led economic development model.

Voyage No. 2: Urban Regeneration

What was the incoming Tory Secretary of State, George Younger, to do with the SDA's corpse? Younger had been brought up in the traditional corporatist atmosphere of Scottish business that had prevailed since the Depression of the 1930s. He had taken a lot of business criticism for obeying Mrs Thatcher's orders to scrap Harold Wilson's Regional Employment Premium. This subsidised Scottish manufacturing wages through the 1960s and 1970s and protected inefficient local firms from competition. So Younger was in no mood to dismantle the SDA as well. Instead, he made cosmetic changes to the board hoping the SDA would wither quietly.

His successor as Secretary of State, the lawyer Malcolm Rifkind, was more pro-active. He pumped in extra public money to the SDA, which - in search of a *raison d'etre* - then turned to high-profile, urban regeneration in Dundee, Leith and the East End of Glasgow where unemployment was rife as Britain's over-manned manufacturing industries were modernised by Mrs Thatcher's handbag. In this second guise, with the highly capable George Matheson as chief executive - he went on to transform the Royal Bank into a global player - the SDA proved more successful. It focused on a modest programme of clearing derelict land and (novel at the time) providing business advice to new start-ups.

At this point enter Bill Hughes with his idea of handing over the SDA's urban regeneration role to local entrepreneurs as he had seen done in America. Hughes proposed to Mrs Thatcher the SDA should be axed as a socialist quango. In its place should be born Scottish Enterprise on American lines. A series of new regional private consortia would bid for the cash currently going to SDA.

They would bring entrepreneurial flair and local commercial knowledge to developing the infrastructure and vocational training for their localities. Periodically, there would be franchise contests to weed out the groups that failed to perform. And in due course, the public money would be phased out and replaced with private sponsorship. Had it worked, it would have driven a free-market wedge through Scotland's way of doing things. But Hughes had not reckoned on vested interests.

When, in April 1991, the new Scottish Enterprise network was eventually born out of the old SDA, it turned out to be a very different animal from that envisaged by Hughes. Rifkind and the Scottish Office were irritated by Hughes' private lines of communications with Downing Street. They ensured that the fledgling SE stayed very much tied to the political coat tails of St Andrews House. More importantly, the old SDA machinery stayed in place, with its top-down, civil service attitudes, though SE doubled its staff. In addition, the Scottish wing of the Manpower Services Commission (responsible for vocational training schemes) was hived off and packaged with SE.

This modest bit of devolution kept the STUC and trades unions happy. In similar vein, a separate Highlands and Islands Enterprise was created to pacify the northern lobby. However, while the new SE did not embrace Hughes entrepreneurial vision, neither did it turn out to be merely the SDA under a different name. Starship Enterprise was about to embrace yet another voyage.

Voyage No. 3: Clusters And Inward Investment

What made Scottish Enterprise significant compared to the old SDA was the scale of its budget - close to half a billion pounds, crudely one per cent of national income in the 1990s, which is huge for any public agency. This cash gave SE clout. It was not long before the new organisation was moving away from being an urban regeneration agency (the SDA's rationale during the Tory 1980s) to becoming something else - a high-powered inward investment broker. It did this in conjunction with Locate in Scotland (LIS), a Scottish Office agency with offices in America and Asia.

The move was prompted by a variety of influences. With the urban regeneration agenda now in the hands of the local enterprise companies, the huge SE staff at HQ in Glasgow needed something with which to occupy itself and its big budget. Meantime the 1990s were seeing the beginnings of a global boom based on the silicon chip, the mobile phone and the Internet - a boom that offered prospects for a new wave of inward investment to Scotland. These

elements came together in Crawford Beveridge, the first chief executive of the new SE.

Beveridge was a different kind of quango boss. Though a Scot, he was headhunted from California where he had been managing high tech companies. Beveridge was therefore free of the usual Scottish establishment baggage. He targeted high technology inward investment as SE's main task. He was also attracted to the ideas of the American business guru, Michael Porter who preached that national global competitiveness was boosted by having **dense clusters of supporting companies** specialising in particular markets. Beveridge believed not in grabbing just any foreign investment going, but in carefully targeting which firms to attract to create a self-reinforcing cluster in manufacturing semiconductors and the personal computers and mobile phones which use them.

With a skilled, cheap and English-speaking workforce to hand - one that was also easy to fire, thanks to Mrs Thatcher - Beveridge soon tapped into the 1990s high tech boom. The result was Silicon Glen. The cluster strategy seemed to acquire coherence: a raft of chip manufacturers were imported. To use them, Motorola was tempted to Bathgate to begin making mobile phones while, later, Chughwa came to fill in one of the last gaps in the local supply chain, television monitors. The immediate economic gain was impressive: over 40,000 jobs directly and maybe 30,000 in the supply chain; plus nearly £10 billion of hard cash by way of foreign investment throughout the 1990s. Silicon Glen made Scotland one of the world's top exporters per head - better than Japan. In the late 1990s, production was growing at 20 per cent a year.

Then things suddenly went sour in Silicon Glen. What happened? Firstly, the cluster strategy had an obvious but lethal Achilles' hell - a dense cluster of companies in the same maturing market will go into crisis simultaneously. By 2000, the demand for semiconductors had spawned a huge global excess capacity. Ditto in mobile phone production. Add in the meltdown in the Internet boom on the world's stock exchanges and the uncertainties spawned by the September 11 attacks and Silicon Glen went bust. In the four years till the end of 2002, Scotland lost more than 100,000 Scottish manufacturing jobs. Major players Motorola and Chunghwa pulled out altogether, knocking big holes in the cluster strategy.

The second problem with SE's version of the cluster strategy (which is important, given the agency's continued determination to build clusters in the so-called creative industries and biotechnology sector) is that it misses out a key ingredient

identified by Michael Porter. This is the prior existence of at least two competing global players that are locally based. These plug a local cluster into the global market as well as forcing productivity-enhancing competition on the whole structure. They also bring capital and clout. Such a set-up exists in the Scottish financial sector – the one truly successful indigenous cluster - with the Royal Bank group and HBOS. It did not really exist in high tech where even the bigger players like IBM were still branch plants. Nor is there any global player in the media, publishing, computer games or biotechnology.

SE's inward investment strategy in the 1990s certainly bought Scotland jobs and relative prosperity for a decade. But look deep into the economy and the tell-tale improvements that should have been forthcoming as a result of SE intervention are missing. Scottish productivity remains below the UK average and as much as a quarter below our European rivals. Our rate of new business formation remains 30 per cent below even the lacklustre UK average. Inward investment was a sort of success story, bringing Scotland a sizeable chunk of the European computer industry. But much of the true value of these machines was imported. The result is that Scotland has a continuing balance of trade deficit while other small economies like Sweden and Switzerland run colossal trade surpluses.

In a nutshell, the evaporation of Silicon Glen exposed the painful fact that the historic emphasis on encouraging inward investment at the expense of local enterprise had not created a self-sustaining economy. Towards the end, SE realised this and began to shift gear. It began to talk of moving Scotland out of low-value assembly but in a very mechanical, if not utopian manner. There was reference to Project Alba. Central to this project was Cadence Design of San Jose, then a world leader in "computer-on-a-chip" technology. The theory was to create around Cadence a new cluster of industries designing these super chips to make super-intelligent consumer products - for example, fridges that dial the supermarket to re-order your cat food. It was utopian pie in the sky and Project Alba was eventually downgraded to another business park. The stage was now set for a fourth model of state-led economic development.

Voyage No. 4: The Crawford Era

The start of the new century brought SE face to face with reality. The newly devolved Labour Scottish Executive realised that the inward investment strategy was past its sell-by date. A fresh face was brought in to run SE in January 2000: Robert Crawford. He joined SE from Ernst and Young, where he had been in charge of foreign investment. Previously Crawford had been managing

director of SE's Operations Group. Despite his background, Crawford claimed to be highly sceptical of state intervention and talked the language of business and entrepreneurship.

The energetic Crawford began well, aided and abetted by a new Enterprise Minister and kindred spirit, Wendy Alexander, who hailed from a management consultancy background. The overblown SE bureaucracy was cut by 500 and the autonomy of the individual SE local enterprise companies sharply curtailed. The strategy was to downgrade the old policy of subsidising foreign firms to set up screwdriver plants, and switch the emphasis and cash to creating jobs from local industrial research. This, with a bit of reference to e-commerce and exploiting expatriate Scots business executives, was labelled "**Smart, Successful Scotland**". But after barely three years in the job, Crawford announced his resignation. What had gone wrong?

The ostensible reason for Crawford's resignation was a spate of bad press publicity combined with fierce internal resistance to his internal reforms and his alleged aloofness from his staff. Local SE branches and their municipal partners were chafing at Crawford's centralisation, especially in Glasgow, while big companies such as BT and Thus were infuriated by SE's attempt to enter the broadband market by the back door. In addition, after Wendy Alexander's resignation in 2002, a series of weak enterprise ministers, doubtless wishing to avoid responsibility for the recession in manufacturing, pointedly failed to give Crawford public backing.

While all this occupied the headlines, it diverted attention from Scottish Enterprise Mark 4 – the turn towards a localised, research-led development strategy. The new policy took concrete form at the start of 2003 with the creation of ITI Scotland under chief executive Roger Dickinson, a company lawyer by trade. This organisation, wholly owned by SE and its smaller northern sister, Highlands & Islands Enterprise, will operate three so-called **Intermediate Technology Institutes**, or ITIs. These are based in Aberdeen (specialising in energy research), Dundee (medicine) and Glasgow (digital media). The selection of research locations is meant to marry with SE's notion of where Scotland has important 'clusters'. Note the strange absence of any emphasis on the financial sector or Edinburgh. Each unit will have £15 million every year for ten years to invest in commercialising university research.

The ITIs are supposed to make up for the failure of Scottish firms to do their own research and development. Scottish industry invests only 0.5 per cent of national GDP on R&D, half the UK level and a third of the OECD average. In theory Mr Dickinson and

his team will consult international specialists, multinationals and local companies on what “the market” wants by way of new technology three years from now. Then the heads of the three specialist areas will pick out key research “strands” on which to focus with an emphasis on where Scotland already has expertise. Research will be contracted mostly to university groups but local companies with a track record could be brought in. Several problems stand out:

1. This is still the risky business of the state picking winners. Both the EU and Japan spent a fortune on high definition television to give a better picture. Meanwhile US companies, lacking taxpayers support, invented digital television to pack in more programmes – a product the actual customers preferred.

2. How will this research be turned into output? SE statements suggest the fundamental aim is to create a raft of new high-tech companies spun out of Scottish university research labs. But it is not clear you can force any more spin-outs from Scottish universities than we are getting at the moment. This was a point made by respected academics at Heriot-Watt, Edinburgh and Strathclyde universities - three of the leading centres for spin-out companies. They doubted whether SE could achieve its target of 35 new businesses in 2003-4 (itself a reduction on the previous year's target of 50, which SE failed to reach). And there's a penalty if you succeed - the loss of highly-qualified research staff when companies are spun out.

3. How do you grow these tiny spin-outs into companies big enough to replace the recently lost 100,000 jobs in manufacturing? Mr Dickinson says that venture capitalists will be brought in at an early stage. But who will put up the required investment? (Note that there has already been a dramatic fall in inward investment to Scotland meaning our capital needs are anyway much higher than in the 1990s.) And who guarantees these new knowledge-rich firms stay in Scotland?

What emerges is an expensive, ill-thought-through strategy which is missing several key building blocks: (1) how to help existing firms invest in more research; and (2) how to embody new research in Scottish companies to improve productivity. It also seems focused on manufacturing, ignoring the need for incorporating new technology in the low productivity service sector.

This is not to reject the need to encourage university spin-outs as one possible tactic. But there are alternative models for commercialising university research. It is just as vital - perhaps more so - for universities to license new technology. That way they keep their academics and can pay them more from the licence fees.

ITI Scotland could also develop in the direction of the Fraunhofer contract research agency in Germany, which works closely with local small and medium-sized engineering firms to provide them with direct research help. Alternatively, why not use SE's massive research treasure chest to provide Scottish firms with research grants, a model followed with some success in America?

It is also vital to comprehend that commercial research is only good for the economy if you apply it to increase your productivity and profits – and the paramount importance of the application and assimilation of new technology is in danger of playing second fiddle to ITI inventing new widgets. Scotland does not do too badly in terms of assimilating such research. Our financial services industry is a star because it was the first to introduce new technology like automatic tellers. Ditto in the oil industry and manufacturing where foreign multinationals have always brought with them the latest kit - usually giving Scots factories higher productivity than English ones. In part this explains Scotland's supposed low research spending. Much of the research is actually done offshore by the multinationals then brought here in the form of new production facilities. Put that way, our low research budget is a gain, not a loss.

Ultimately, as with any strategy premised on the state picking winners, the problem with the ITI policy still comes down to substituting for market failure rather than fixing it. This remains the fundamental logical weakness of SE. Worse, the bigger SE is, the more it encourages the climate of state intervention by undermining a free-market culture. This cannot be masked by SE's constant use of business rhetoric (“enterprise”, “focus”, or “customers”) which has been dubbed “fantasy capitalism”. Is there an alternative?

Re-launch: a New Direction

Let us begin by trying to state the problem we need to solve. It is not “how to create jobs?” Rather, it is **“how to reinvigorate Scottish entrepreneurial capitalism?”** Put that way, one part of the solution has to be to create a risk-taking capital market. We could discuss in detail many obvious micro reforms in this connection:

- developing structures to help new Scottish companies float in New York and tap US venture funds;
- the reinvigoration of a separate Scottish stock exchange;
- the abolition of inheritance taxes to protect family capital;
- the abolition of double taxation on profits.

However, the degree to which Scottish culture is wedded to an interventionist approach suggests that a more political option might be to find a better way to deploy the immense funds currently available to SE and other state agencies like Community Scotland, whose budget is almost as big as that of SE.

Suppose we closed SE and its like and set aside **an annual billion pounds** for the next decade. We allocate this cash to five equity venture funds whose management will be put out to competitive franchise. The management groups will have to invest some of their own money so that they share the risks. The funds are forced to compete against each other - the management incentive could be a lottery-sized personal bonus for the winner.

Each fund is tasked with investing in new or expanding companies. These companies can be Scottish-based or, if foreign, must register their HQ in Scotland. This will in part make up for the current loss in foreign investment. The fund managers must maximise the share value of their holdings over a given period, say ten years. The key goal is not jobs but share value. Why? Because real jobs, and lots of them, follow on from building successful companies based on exciting new ideas. The task is to build world-class global companies here in Scotland.

If you compare Scotland to other small European nations during the great 1990s boom you immediately see a difference. Many created and exported their own multinational hi-tech companies. Finland created Nokia and Sweden created Ericsson. We want to gamble (the word is used advisedly) on creating a Scottish equivalent. Just one would justify the whole investment. Suppose we invest this cash and don't create a Scottish Microsoft or its equivalent? We will be no worse off than now.

Our equity funds will start generating profits from the companies they have invested in. In other words, tax money does not disappear in a puff of smoke. You actually get it back. If, being conservative, only half our investment bets pay off, we could still see a billion pounds a year cash return. What to do with this profit? Put it to work.

The other thing Scotland needs apart from risk capital is investment in education. So we could use the accumulating profits to create modern-day Carnegie Trusts. Pay the dividend income from the five funds into several competing educational trusts. Competing because we want to make sure they are under pressure to think creatively. The trick would be to stop the politicians using this cash as surrogate tax money to cheat on normal education spending. These trusts will make grants to individuals or groups in Scotland for any purpose that improves education. Or they could

endow our universities to free them of state control. What if we do create a local Microsoft? The profits could turn our education trusts into serious big spenders – in perpetuity.

What do we do with the accumulating share holdings? Think forward two or three business cycles and they would be worth a lot of money. We might give every child born in Scotland in the new century a parcel of shares - a sort of instant People's Capitalism. Or we could sell blocks of shares to fund infrastructural investment, especially in times of recession. Or borrow against them, buy a Microsoft or its like and move its HQ from Seattle to Sutherland.

Conclusion

Where does SE go next? If the Executive is sensible, it will use Robert Crawford's exit as an opportunity to review the agency's function. If it is becoming a nimble, long-term, enabling agency - the essence of Crawford's redirection - then it does not need to be burdened with a lot of the day-to-day mechanics of managing vocational training. That could be hived off to the universities and further education colleges. Similarly, business advice activities are best handled through local chambers of commerce. Next, there is a huge duplication in economic research functions between SE and the Executive. Why not concentrate the best brains in a single Executive economic policy unit?

Strategy wise, we need to recognise that the days of a big, "stand-alone" development agency are over. With a Scottish Parliament and Executive, we need more intelligent and forceful political leadership of economic strategy to clear the roadblocks to enterprise. In this regard, it is interesting to note that England has not tried to replicate the SE model.

Down south, policy has followed a different path, returning in many ways to the old SDA model. In England, economic development has focused on urban regeneration, spearheaded by a new organisation called **English Partnerships** (EP).

EP has a unique focus. It melds together brownfield land redevelopment and social housing provision with community economic regeneration. Thus the physical, economic and community dimensions of regeneration are joined up. EP also has the financial and political clout to deal directly with other agencies and local authorities and mobilise joint initiatives. As a result, major new urban projects are moving forward across England. Witness the successful rebuilding of central Manchester after the IRA bombing, or the transformation of Newcastle and Gateshead into the cultural capital of northern England. Crucial to the

success of EP has been a determination to work in conjunction with local business – an echo of the old Bill Hughes strategy for SE.

In Scotland, matters have proved less well ordered. With SE set to concentrate on commercialising research, the Executive has set up yet another agency, called Communities Scotland, to spearhead urban regeneration. But despite a massive half billion pound budget, this lacks the clout or leadership to follow the success of its English model. Delivery of urban regeneration is now hopelessly divided between Scottish Enterprise, Communities Scotland and the local authorities – a criticism reiterated in the Executive's Cities Review, published in the autumn of 2003. Worse, these agencies have a history of rivalry and fractious relationships.

Scotland needs to examine closely the English Partnerships model. That will not be too difficult – EP is chaired by Margaret Ford, who has previously run the Lothian Health Board and Scottish Homes. There is a case for redirecting Communities Scotland along the lines of EP, giving it a stronger leadership team, and transferring to it some of the duplicated powers and resources of Scottish Enterprise.

Which brings us back to why SE failed. Partly because it did the reverse of what Bill Hughes originally divined as necessary – it institutionalised state intervention rather than getting out of the way of the private sector through lower taxes and less red tape. Partly, because its glitzy inward investment strategy grossly distorted the way the Scottish economy works, diverting attention and scarce resources from the inevitable productivity realignment that Scotland is going to have to go through to stay in business. Twenty years on, Bill Hughes' entrepreneurial revolution is still waiting to happen.

Part Two: Filling the Breach

How Scottish Enterprise Can Kick-Start The Economy

Gavin Don

Beneath its prosperous skin Scotland has acute economic problems. A short look at a few central economic statistics shows these up in sharp relief.

Where We Fall Short

First, Scotland's GDP per head is near the bottom of the European league – only Spain, Portugal and Greece are poorer. Next, the gap

is growing every month. Scotland's GDP growth rate over the last 28 years is also at the bottom of the league – at 1.6 per cent per annum. Ireland leads with 5.2 per cent, and the rest range from 2 to 3 per cent.

There is a growing consensus that we have a problem. There is less agreement on why these numbers are so bad. For as soon as the question “why” enters the room, political preconceptions also enter. This can make the question “what do we do about it” all the more confusing. But we do have some cold hard apolitical answers to that “why”.

Comparing numerous economies – large countries and small, young countries and old, high tax and low tax, shows three numbers which correlate best with rates of economic growth: **Investment** as a percentage of GDP, **research and development (R&D)** expenditure as a percentage of GDP, and measures of **entrepreneurial activity**.

High growth economies **invest** 18-20 per cent of GDP each year. The UK invests 16 per cent. A disproportionate amount of this is invested in housing. The best estimate available for Scotland is that we invest less than 10 per cent of GDP each year, much of it, too, in housing.

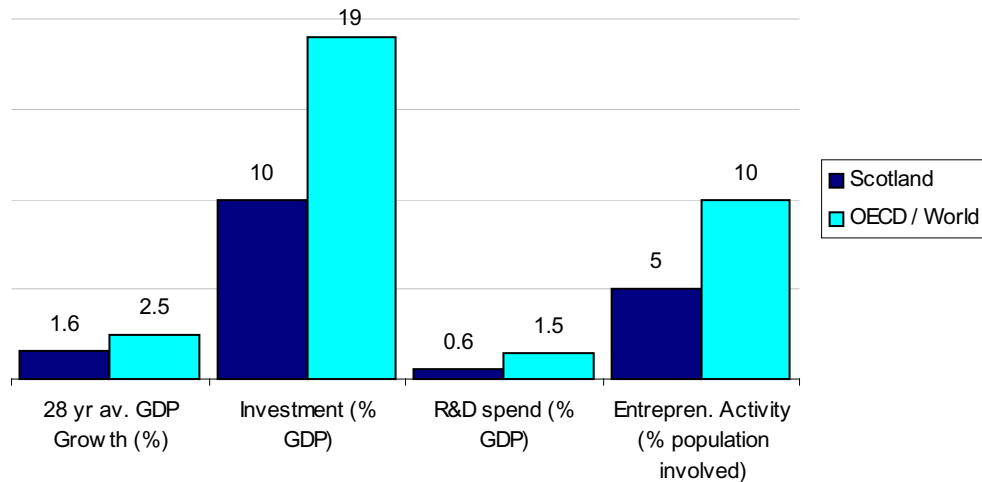
Meanwhile, the USA spends roughly 2 per cent of GDP on **R&D**. In Scotland we spend 0.6 per cent - a money shortfall of roughly £900m per annum. Even the OECD average is above 1.5 per cent.

Lastly, The Babson Global Entrepreneurship Monitor (GEM) measures **entrepreneurial activity** worldwide each year, sampling 74,000 people and 1,000 experts in 29 countries representing 95 per cent of global GDP. GEM is the gold standard for understanding entrepreneurial activity around the world. The 2001 GEM report showed that the world average percentage of adult working people active in creating or running young companies (less than 42 months old) across those 29 nations was around 10 per cent. Scotland barely reaches 5 per cent on the same measure – a shortfall of about 150,000 entrepreneurs at any one time.

So, on those three key drivers of economic growth – investment, R&D spend, and new firm formation – Scotland is respectively **50 per cent, 75 per cent and 50 per cent below average**. It is no surprise that we are coming last in the growth stakes and dropping further behind all the time.

Falling Behind

Three key indicators are behind Scotland's low growth rate



Sources: OECD, GEM, Scottish Executive

The Breach – A Missing Generation Of Entrepreneurs

Finding a solution should begin with understanding *why* we see the three key rates underperforming as we do.

Investment is a big numbers game. It demands investable cash in large lumps in the hands of people comfortable with risk. Young companies have small numbers, and generally lack investable cash. Hence, to cure the investment rate problem, we need to look to large older companies whose futures depend on whether they invest or not. Back in the 1970s, when the problem was no different, Scotland's large potential investors were (for a multitude of reasons) generally in no state to invest.

With an economy on the verge of industrial cardiac arrest, strenuous efforts were made to attract foreign companies. The attempt succeeded, and has over the past couple of decades acted as a welcome and effective pacemaker, buying Scotland some valuable time in which to solve the bigger investment problem. If, at the time, foreign investment was billed as a means to create spin-off high value jobs in sunrise industries, their billing was at best ill-informed. We still needed the pacemaker whatever the spin. Indeed, looking at the numbers, we still need it now, for we now lack an entire generation of large commercially successful re-investors. Inward investment is not a cure, but it continues to buy us time to find one.

Research and development is also a big numbers game, made harder by the absence of personal relationships between our academics and our business people. We lack a generation of wealthy risk-taking private companies willing to invest in long-range research. Here again it is a case of systemic heart failure which is unlikely to cure itself.

New company formation is not a big numbers game. It is a business that demands large amounts of fairly small numbers and a high level of social and cultural reinforcement. Starting a new business is a scary activity, in which entrepreneurs risk not just cash but also self esteem, reputation, future employability, their homes, marriages and even health. The activity is made easier if the nascent entrepreneur hears ringing cries of encouragement from friends, relations, the press and the government. Until 1993 few such cries could be heard. As a result Scots entrepreneurs are half as numerous as the average in OECD countries, and one third as numerous as in the USA. Yes, the problem is nothing like as acute as it was a decade ago, but we still have a problem. Companies don't start themselves. They are started by people, and we are about 140,000 people short as a result of a generation of "stinking thinking" (as Sir Tom Farmer puts it).

The deficit is not just in the number of people willing to start companies, but the number of people who will invest in startups. In successful economies, for example, between 3 per cent and 5 per cent of adults invest money in young private companies, investing on average 1.1 per cent of GDP. In Scotland the GEM report reveals that we average 0.2 per cent of working age adults each year – approximately 6,000, of which nine tenths in turn invest only in businesses within their own family. Total investment by individuals in other people's companies in 2002 was a tiny 0.03 per cent of GDP. On this measure Scotland is thirty to forty times lower than it should be. "No startups, no growth" is a message that comes over loud and clear from economies all over the world.

How Scottish Enterprise Can Help

Three Big Problems. Having worked inside them for a decade, my view is that they are as much cultural as numeric. In markets other than fund management and banking we lack big-gun companies to drive change in investment and research. In company formation we lack the culture in which everyone with any investable cash is hunting for an entrepreneur to back, and everyone with an idea for a new product or service wants to take it forward in their own business. Cultures do not spontaneously change.

What tools does the Scottish Executive have to effect a fundamental transformation of our economic culture? We live in a world governed by Byzantine rules on how tax revenues may and may not be spent. Any strategy executed by the Executive has to live within those rules and structures, and is therefore going to be less effective than we would like. Total escape from the rules would require not only complete devolution of all economic powers from Westminster, but also the departure of Scotland from the European Union, as many of the relevant restrictive rules are born in Brussels.

Short of constitutional revolution, therefore, we have no choice but to live with both the problem and the rules. The Executive lives with them by devolving significant powers and budget to a body which is less restricted by the rules, and has greater freedom to act – Scottish Enterprise. Being a public body, Scottish Enterprise is of course an imperfect answer. Its execution is never as fast as we would like, and its cures are permanently hampered by political agendas of “equality”, “social inclusion” and “regionality”. But this fact, that Scottish Enterprise is shackled by its environment, does not mean the economy’s problems can be ignored. They have to be solved by someone. If Scottish Enterprise did not exist we would have to invent it.

One role of Scottish Enterprise is to kick start a culture of enterprise in Scotland. This role has two sides to it. First, there is an educational task. Scottish Enterprise has since 1993 lead the charge to say that starting a business is a cultural and social good. But the message is useless without the means, so Scottish Enterprise also works to foster and create higher levels of investment by you and me, sometimes by leading with the chin and setting the example.

So how does its current policy match up to these goals? Scottish Enterprise has a large family of strategies aimed at the three core problems. Among these is the creation of three large well-funded organisations (ITIs) to promote and fund research and development. It is too early to tell if this will work. Its execution, led by three completely commercial people with a high degree of autonomy, has been well set-up. It is certainly aimed at a problem which has clearly not cured itself so far.

However, if these three vehicles do indeed create an upsurge in Scottish innovative companies, then the payback from those companies will leak overseas unless we change the way the market works a bit further downstream. The reason for this is simple. Innovative companies are created only with large lumps of investment - £10 million to £20 million is common, £40 million to £50 million is not unheard of. While we do indeed have a market

that can provide these kinds of sums, it often comes from people who have a three year agenda - invest this year, sell out within three. The buyers in those “sell-outs” are often not based in Scotland, so the innovative babies are sold abroad.

In short, as George Kerevan says, we need to create a small family of very large very Scottish investment companies with longer time horizons. Given the sums involved these need to be big – at least £400 million each, preferably £700 million. They need to be brutally commercial, led by commercial people with commercial agendas to create serious personal wealth for themselves out of the success of their vehicles. They need to be focused exclusively on Scottish companies, but also to have clear global vision when it comes to exploiting the opportunities that those companies find. And finally they need to have serious (majority) private sector participation in order to avoid the lethal traps set by rules on the use of taxpayers’ money.

Does that mean we should simply re-allocate Scottish Enterprise’s budget into these three new mean investment companies? No, for the three systemic problems in the Scottish economy still need to be solved. There is still a long-term cultural change to effect. As an economy we need to walk, talk and chew gum all at the same time. We have to solve all these problems in parallel if we want to get back in step with a more successful world beyond the Tweed.

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