Engineering and Machinery Alliance

12 October 2006

The Rt Hon Gordon Brown MP
Chancellor of the Exchequer
HM Treasury
1 Horseguards Road
London SW1A 2HQ

Dear Chancellor

**Re: EAMA Pre-2007 Budget Submission**

## Introduction

The Engineering and Machinery Alliance's submission represents the views of companies in eight trade associations:

- British Automation and Robot Association (BARA),
- British Paper Machinery Suppliers Association (BPMSA),
- British Plastics Federation (BPF),
- British Turned Part Manufacturers Association (BTMA),
- Gauge and Toolmakers Association (GTMA),
- Manufacturing Technologies Association (MTA),
- Printing, Papermaking and Converting Suppliers Association (PICON),
- Processing and Packaging Machinery Association (PPMA)

Together we represent over 1,000 SME manufacturers with a turnover of some £3 billion split pretty evenly between finished capital goods and components for capital goods. Typically these firms export 60-80% of their production.

Our sector is characterised by research and particularly development in a continuous 4-5 year product innovation cycle, providing tailor-made solutions with a high degree of specialisation, mostly based either on complex products or a high degree of precision. Our customers are worldwide in industries such as food, aerospace, printing, paper, motor, medical, plastics and general engineering.

***Some comparisons***

| | UK Mechanical engineering | EU Mechanical engineering | UK Basic metals & fabricated metal products [1] | UK Chemicals | All UK manufacturing [2] |
|---|---|---|---|---|---|
| **Average company sales** | £2.6 million | £22 million | £1.4 million | £13 million | £3.0 million |
| **Exports as % of sales** | 70% | 28%[3] | 28% [1] | 64% | 41% |
| **Sector trade balance** | + £3.8 billion | +£53 billion[3] | -- £733 million | + £3.8 billion | -- £65 billion |
| **Value added per employee** | £40k | £43k | £36k | £72k | £44k |
| **Average no employed per firm** | 23 | 110 | 14 | 60 | 22 |
| **No of firms in sector** | 12,906 | 23,000[4] | 29,543 | 3,736 | 154,946 |

Sources: UK Sector data – Annual Business Inquiry (June 2006, reporting 2004 data)
UK Exports – UK Trade 15.2.06
EU Eurostat Fact and Figures 2005 edition
Notes: 1 Export data: iron & steel, non ferrous metals and other metals
2 Export data: trade in goods
3 Exports outside the EU25
4 EnginEurope estimate (based on VDMA data) for 25 Member States

***Conclusions from the data***

- UK mechanical engineering firms sell a higher percentage of their products abroad (75% more) than the average for UK manufacturing as a whole.
- With relatively limited resources (23 employees per firm), the sector's trade balance has been consistently positive and is the same as the chemicals sector, where companies are much bigger (60 employees per company).

Priorities for the sector are therefore: investment, exporting, skills and red tape. We also have concerns about the 'planned cuts' at the Department of Trade and Industry.

**1. Investment**

We reiterate the following from our Budget submission earlier this year:

- UK manufacturing has reduced its capital expenditure by 42% since 1997 (37% per company).
- Your decision to raise capital allowances to 50% is welcome.
- This or indeed a higher rate should be maintained for the longer term so that companies can plan their investments and linked export activity/expansion with confidence.
- Under the current system, the capital cost of assets cannot be treated as an allowable expense to be set off against taxable profits. A company has to claim a 'capital allowance' (CA), which is then set off against the company's profits like an allowable expense. This prevents 100% depreciation of costs in the first year. In most cases capital allowances allow a percentage of the capital cost to be offset against profits over several years. CAs range from 0% to 100% depending on what the company is buying.
- The problem from our perspective is that current 100% allowances are typically for equipment that may be included in a building to provide a perfectly laudable environmental benefit, rather than increasing the productivity and competitiveness of UK manufacturing's performance.
- Granting 100% allowances would have two benefits:
  1. Boost productivity of industries buying the equipment
  2. Increase the cash turnover of the engineering sector, which generally increases prosperity and employment opportunities.

Again we urge you to look at the evidence worldwide on 100% capital allowances. After all, no money would be lost to the Government's coffers with the increase in output that will flow from businesses that have raised their productive capabilities. And the supplying companies will increase their sales and with that their tax exposure.

***Alternatives***

SMEs typically use cash to fund their investments. So an additional route to encourage investment is through the tax system, enabling companies to retain more of their turnover and thereby strengthening their confidence in the longer term and with it their investment and exporting performance.

We propose action on Insurance Premium Tax, because of the way premiums have moved against manufacturers, and Corporation Tax to help SMEs develop their export servicing potential.

***A 2% reduction in Insurance Premium Tax (IPT*)** for manufacturing companies employing less than 250 people (SMEs) under SIC codes 15-37, which are the classifications that the insurance companies use to base their premium rates on. The tax could be levied directly as now, but at the reduced rate.

***Corporation Tax (CT)***. We understand (from the report entitled "Partial Regulatory Impact Assessment for Changes to Corporation Tax Structure" www.hmrc.gov.uk/ria/ct-structure.pdf ) that one of the Government's "objectives for the business tax system is that it should promote productivity and growth by supporting business competitiveness, whilst ensuring that business contributes its fair share to the funding of public services."

However, the current system discourages SME companies from setting up operations to handle client after-sales care in export markets.  Here's why:

1. Companies are responsible for assessing their own liability to corporation tax and for ensuring that all the money that is due is paid on time.
2. Most companies have to pay CT within 9 months of the end of their accounting period. This rule applies to SMEs with profits up to £1.5 million.
3. This £1.5 million threshold is reduced for every active company under common control within a group. For an SME active say in five overseas markets, the figure of £1.5 million reduces to £250,000.
4. Larger companies have to pay the tax due in quarterly instalments. This is very onerous on cash flow in the transitional year, as the company has to pay its CT liability under the '9 month' rule and a quarter of its estimated liability for the following year in the first 6 months on the new accounting year.
5. All this means that the simplest way to minimise your CT bill is to limit the number of subsidiary or associate companies, which hampers a UK SME trying to grow its international capability in areas such as servicing machinery, which is an increasingly important and competitive part of the higher value added export sale.

Since our earlier letter, ONS and other organisations have published data showing that manufacturing investment performance has improved.  Some anecdotal data has reinforced this positive impression.  We are currently surveying our member companies to better understand the situation and what the causes actually are.  For example, we have been made increasingly aware by our member companies that the changes in environmental (e.g. WEEE, RoHS) and HSE regulations over the last 12 months have forced companies to 'invest' in those areas, leaving less money for value adding process plant and skills.

**Local delivery vs. international competition**
As we have seen, most companies in our sector are SMEs.  They compete as part of international sometimes global supply chains, integrating with UK or foreign companies to deliver products specified to international standards.  They don't tend to be based in any one region above all others.  They are widely dispersed across the UK.  They tend to 'come in under the radar' of the Regional Development Agencies.  So they don't feature as a priority sector or even necessarily as an eligible sector in an RDA's economic development plan. (This despite their communal contribution with over £25 billion of export sales going back directly into the communities where the goods have been produced.)

Regional development strategies and the selection of priority sectors at a regional level have therefore not helped UK mechanical engineering companies very much if at all, while in some activities they have actually been unhelpful (e.g. in exporting and skills/training).

In the summer, we published a report which uncovered how UK mechanical engineering SMEs typically access grants and other supports at a local level (please see Grassroots Survey http://www.eama.info/downloads/Grant%20report%204%20Final%207.6.06.pdf)

It shows that grants do affect firms' investment behaviour in that 50% of companies' activities in R&D, training, investment in new machinery and even exporting would not take place without a grant or support.  Further, the system is so complex and the criteria so variable from region to region that as much as 20% of the grants are paid out to consultants, who are drafted in by companies to help with their applications.

**2. Exporting**
I believe that we share common goals in this area, namely to increase UK exports (and thereby reduce the UK's trade imbalance).

However, as UKTI implements the new strategy agreed with you, I have to say that we would like to see some flexibility in the way they employ the criteria applying to key markets and the number of times a firm can benefit from representation assistance overseas (which we understand is to be limited to as little as three occasions).

All markets are different, so developing a new business to business market successfully may take several visits over perhaps two to three years. If it's not tightly managed it will be costly to the company. Advice and support that reduce the risks involved are therefore helpful in these opening stages which have to be financed before there is any return.

On their first visit to a new market, the company will look at all the relevant parameters, the competition, the size of the market and some potential customers and probably agents (particularly if the firm is new to exporting). The second visit might lead to the firm appointing an agent from a shortlist and then agreeing sales and marketing activity. So it is quite probable that it will take at least three 'visits' before a company can expect to see any return in a new market. All or some of these steps will be repeated in neighbouring markets. In large national markets (e.g. China, USA, Russia), 'neighbouring markets' may be other regions in the same country, rather than other independent states.

The 16 countries listed as key markets on page 33 in "Prosperity in a Changing World" are sensible targets.

However, we hope that this will not blind UKTI and others to:

- The export potential of markets like the USA, where it may be very sensible for a company to make its first export sales given the similarities in language and culture.
- The fact that companies in different sectors may have different views about where their export priorities should be (informed by other sector companies' experience).

One of our members has just completed an outward mission to China 9-13 October 2006. Through its links with another trade association they managed to get the Engineering Sector Specialist in China to be the group leader and arrange visits to component-making factories in Shanghai and Guangzhou. Initially there were 17 companies committed to go based on an estimate of about £2000 total costs less an anticipated grant of £750. The grant had to be claimed individually from each company's Regional International Trade Team. In June 2006 just 3 months into the fiscal year the South East and the Scottish regions were apparently 'spent out' resulting in no grants to the companies in those areas.

Of the 17 original companies, three dropped out with at least one saying that it was just all too complicated to apply for, especially as he believed he might be refused assistance anyway.

***Recommendations***

We recommend actions to:

- Simplify the system, so that it is easier to find the help that's needed/available.
- Consolidate support to a common national standard.
- Alter the time restrictions so that companies can plan their export activities, including trade show participation, more than 12 months in advance.
- Recognise that all markets are different by product as well as geographically.
- Flex the system according to:
    - the size of the company (and therefore the resources that it is able to devote to a new market without a return).
    - the company's/sector's export performance.
    - the characteristics of the export market (e.g. well established/close to home; emerging markets; cultural differences; market size/potential).
    - according to the type of product (innovative, niche, common standard).

## 3. Skills/Training

***Background***

There is a skills shortage amongst UK mechanical engineering firms. It manifests itself in the average age of the employees, the number of immigrants filling vacancies and the poor UK turnout in events such as the skills challenge at past MACH shows at the Birmingham NEC.

The causes are generally considered to be:

- Young people's lack of interest in engineering
- The sector's low starting wages

- Poor educational standards in Mathematics and English
- Teachers' personal lack of interest in manufacturing
- A general decline in the availability of apprenticeships.

And this despite a big infusion of funds into education at all levels.

Lack of skills and the costs involved in 'up-skilling' an existing employee or taking on an unskilled person and then preparing them for a productive future are difficult decisions in any company, but all the more so for SME manufacturers, where the aim is to raise productivity by getting the most out of existing equipment or by using new technology. It is not uncommon for companies going through the recruiting process to find that there are no suitably motivated applicants with the requisite skills out there. When the situation persists, companies poach from each other, ultimately leading to wage inflation.

This problem has been resolved, at least superficially for the moment, by employing immigrants from countries like the recent accession states that were part of the former Eastern Europe. Our view is that the problem remains and as long as it does, the skills scarcity is another drag on SMEs, stopping them using new technologies in the way they should.

Again the insertion of a regional layer, this time to improve local skills/training delivery, has been a complicating factor for mechanical engineering firms, where skills have to be benchmarked on an (inter)national basis, not at a regional level.

Looking at the multiple layers of skills and training providers, EEF concludes in its recent report aptly titled "Learning to Change": *"There is a clear need to move from this fragmented approach to a system which genuinely understands the skill needs of business and can influence provision accordingly. Employers need to be able to make informed choices about what training their business needs, how they access it and be sure that it is of a high quality. In order for this to be achieved there is a need to rationalise the number of institutions engaged in this process. This will not only make policy easier to understand but it will also reduce the duplication and waste ingrained in the current system."*

Our members agree.

Again, simplification and clarity in the system are what is required. As is flexibility. Keep in mind that most SMEs have their own way of doing things. Employees are expected to be flexible in a way that might appear novel in a larger company. So the training and skills development that the firms seek may not be covered by the local providers in the depth that the firm wants. Sector training organisations clearly have a role to play here, not necessarily as direct training providers but as assessors of locally relevant training provision and as signposting services.

***Recommendations***

1. What would be helpful to underpin young people's initial enthusiasm for apprenticeships would be some form of tax relief for the apprentices on what they earn while they go through their three-year course. (This should be specifically limited to training schemes where there is documentary evidence of regular assessment and progress.) After all, Government is prepared to allow university students to repay their loans once they are earning over £15,000 year. Such a provision would also enhance the image of apprenticeships amongst young people, their parents and guardians, giving the vocational stream equal status with the academic.
2. Training doesn't come cheap. The cost to the company of running an apprenticeship scheme, in supervisory time and money terms encourages SMEs (the smaller firms in particular) to feed off the training schemes run by the larger companies. We believe that it would be useful to find out whether these are serious hurdles or whether they could be cost efficiently overcome with an enhanced tax relief on the company's training costs, perhaps against National Insurance. Such a scheme will be useful if it encourages the firms to implement the training in a planned and timely way, providing extra revenue through the increased wages of the employees who have undergone the training successfully.

3. The sector is concerned at the way engineering and engineering related subjects (such as maths and physics) have been eroded at secondary schools and university departments. We await the practical launch of the Manufacturing Academy to see what difference this makes. Meantime, extra resources are required to ensure that these subjects are taught to an excellent standard in UK secondary and tertiary establishments.

**Regulatory simplification**

We are fully committed to regulatory simplification and to helping in any way we can. Our report last year contained over 20 instances, where some form of simplification would be helpful. We have received feedback on some of these ideas..

However, our members have not seen much benefit if any so far. The initiative's credibility hangs in the balance. Ministers need to highlight progress and ensure that their departments make real cuts in red tape, rather than grabbing headlines with figures that on closer inspection turn out to be savings to be made over a ten year period.

Amongst our solutions we focused on a way to tackle the extended absence of a skilled staff member (e.g. six/or nine months parental leave). We suggested that Government work with business to look at retiree tax incentives to develop a pool of skilled, trained personnel able and interested in taking on short-term work contracts (e.g. as parental leave cover). This pool could be registered on a Government accredited website with previous employer's references made available. (This initiative would also act as a pathfinder offering people the opportunity to work beyond the normal retirement age in a structured and encouraging framework.)

This scheme could be made attractive to retirees and limited entirely to them. For example, while the income derived from the temporary work would be taxed at the normal level, pension income could be excluded from that equation and taxed separately. And on that basis we don't foresee such an initiative running foul of Age Discrimination legislation.

**4. Department of Trade and Industry cuts**

While we support Government's efforts to continuously improve its efficiency we are concerned that the continual round of reviews and re-organisations at the DTI don't actually help improve its effectiveness. From our perspective they are doing the reverse. The section looking after our industry is now down to six where it used to be 22 strong ten years ago.

This on-going erosion makes things more difficult for us and all levels working at the Department, with some understandable but unhelpful side-effects.

We can point to a clear example with the new strategic plan for UKTI, which our members see as inward-looking; while the strategy focuses on doing more with less resource, there's no clear rationale for trade and investment support, no radical initiatives to help promote UK plc overseas. Instead it appears to give us an introspective 'this is what we're going to do to UKTI over the next 4-5 years to approach the problem'. That's not what's needed for the DTI. We needed a strong vision for their role as the cabinet-level department that represents the wealth creating section of the economy (namely business in general and manufacturing in particular).

***Recommendation***

Having said all that we see the Capabilities Review as a positive initiative and recommend that any changes are delayed at least until the Review Team reports. In this way changes will be implemented against a longer term plan which can be shared with other stakeholders beyond Whitehall.

Yours sincerely

Graham Hayes

Graham Hayes
Chairman