eama
Engineering and Machinery Alliance

10 October 2008

The Rt Hon Alistair Darling Esq MP
Chancellor of the Exchequer
HM Treasury
1 Horseguards Road
London SW1A 2HQ

Dear Chancellor

Re: Engineering and Machinery Alliance Budget Submission

EAMA represents 1,300 mechanical engineering firms in nine subsectors covered by:

- British Automation and Robot Association
- British Paper Machinery Suppliers Association
- British Plastics Federation
- British Turned Part Manufacturers Association
- Confederation of British Metalforming
- Gauge and Toolmakers Association
- Manufacturing Technologies Association
- Printing, Papermaking and Converting Suppliers Association
- Processing and Packaging Machinery Association

Together these mostly SME firms have a turnover of some £7 billion split pretty evenly between finished capital goods and components for capital goods.

UK mechanical engineering sector turnover is some £37 billion, over 70% of it from exports -- we are one of the few UK manufacturing sectors to regularly run a trade surplus.

As suppliers of 'enabling technologies' to other manufacturers (e.g. the automotive, aerospace, medical and food industries) our members are well placed to compare UK performance with manufacturers in other countries.

A BACKGROUND

The current business environment

Two-thirds of firms in our energy survey over the summer said that they were looking forward to a good second half's trading.

However, more recent anecdotal evidence shows that the business environment is increasingly characterised by uncertainty. Investment decisions are being put back. Companies are hanging on to cash. Tougher times are looming ominously. With banks under pressure there are some firms reporting that their overdraft facilities are being changed almost overnight. In addition margins are being squeezed by higher energy and raw material prices. (Half the firms had electricity contracts up for renewal before the end of the year.)

In summary, cash is king. And the imperative is to do all that is necessary to trade through the downturn.

The Government's manufacturing strategy and international competitiveness

Baroness Vadera and her team at BERR are to be congratulated on the speedy and successful way they have created a strategy that dovetails with the essentials of modern manufacturing in a competitive world. It is important that the recently launched *Manufacturing: New Challenges, New Opportunities* is now implemented. It will help firms take international advantage of the upturn when it comes but only if they are able to sustain their investment in productive capacity. This is particularly important for the development of strong value chains supporting leading edge UK industries such as aerospace. If these OEMs don't receive locally the product and service quality they need to remain globally competitive, they will have to relocate or fail. So there is a lot at stake.

The strategy recognises this and how competitiveness is now shifting to greater capital intensity, as machines are developed to complete multiple operations in one pass. For example, a firm using leading edge technology will produce turbine veins on one machine instead of taking the work through four or five process stations, with their attendant handling and down-time costs.

This world leading capability however comes at a price – a price about ten times higher than leading edge technology cost ten years ago (i.e. £600,000 instead of £60,000).

At the end of the day, the company that doesn't invest in this way it is going to have to compete on the cost of labour.

Maintaining high quality, high intensity investment are key features underpinning a successful manufacturing strategy.

In view of this and the immediate pressures affecting many companies' cash flow including the knock-on impacts from the credit crunch, we lay out our views and recommendations in two parts, first as an overall long term vision and then within a shorter term framework.

UK manufacturing is winning in terms of productivity growth, but total output is pretty much static.

Data modelled on the EU's AMECO database clearly shows the UK leading productivity growth per employee over the last ten years, but the size of its manufacturing output is pretty much unchanged, while France, Germany and Spain have all grown theirs by about a fifth over the same period.

From a macro perspective, this means that those countries may have a more broadly distributed economy, as between manufacturing and services, which may make it easier for their people to get through the current challenging environment

France, Germany and Spain have increased their real manufacturing output, the UK hasn't

(manufacturing gross value added comparison constant 2000 Euros and Sterling)

Country	1997		2006		**% change 1997 - 2006**	
	Sector billion	**Per employee '000**	**Sector billion**	**Per employee '000**	**Sector**	**Per employee**
Germany (€)	391	51	475	71	**22**	**38**
Spain (€)	94	37	114	39	**21**	**6**
France (€)	182	50	222	67	**22**	**36**
UK (£)	145	32	149	46	**2.8**	**43**

Source: AMECO

One of the main reasons for this smaller pot is the fall in UK manufacturing investment.

Manufacturing investment has fallen 48% since 1997

Year	1997	2006	**Change 1997-2006**
No of companies	169,663	151,371	**-18,292**
Investment	£ 20,314 million	£10,592 million	**-48%**
Investment per firm	£119,731	£69,973	**-41%**

Sources: Annual Census of Production/Annual Business Inquiry

But it wasn't always that way.

Again using data from the AMECO database, we can see that, in constant money, the UK increased its manufacturing output by nearly 50% in the ten years to 1997. (German data aren't included as unification, which occurred during this period, makes comparisons difficult.)

UK manufacturing output grew significantly in the '90s
(manufacturing gross value added comparison constant 2000 Euro and Sterling prices)

Country (billion)	1988	1997	Change % 1988 - 1997
Spain (€)	79	94	**19**
France (€)	146	182	**25**
UK (£)	99	145	**46**

Source: AMECO

This out-performance coincided with a major increase in manufacturing investment. (Note: while there are now 15,000 more manufacturing firms than in 1988, investment per firm is broadly £20,000 lower today than it was 20 years ago.)

UK manufacturing investment grew two-thirds in the 90s

Year	1988	1997	Change % 1988 - 1997
No of companies	135,474	169,663	**25**
Investment	£12,170	£ 20,314 million	**67**
Investment per firm	£89,837	£119,731	**33**

Sources: Annual Census of Production/Annual Business Inquiry
Data 1985-1992 SIC Divisions 2-4; Data 1993-2002 SIC Section D

B RECOMMENDATIONS

Taxation and investment

In manufacturing, retained earnings are by far the most common source of investment finance. So Government action on tax can have a direct impact on firms' ability to invest.

Not only that, through a judicious mixture of some tax reduction and incentives for entrepreneurs to keep their money in their businesses rather than taking it out to pay themselves and get taxed (as a short-term measure) you could help firms maintain some much needed liquidity.

Tax policy

It is vital that you do not increase taxes on business.

In the recent past SME manufacturers have had to face a series of tax increases (Corporation Tax up from 18 to 21 per cent, withdrawal of Industrial Buildings Allowance, cuts in Empty Buildings Allowance and a cap on investment allowances) all of which reduce cash flow at a time when as mentioned earlier cash is vital if companies are to trade through this downturn. And that's not all. It is well established that SMEs carry a disproportionate share of the tax admin burden, so they have suffered a 'double whammy'.

We therefore recommend that tax policy should flex to:

- Reduce corporation tax levels so that they are more competitive with others in the OECD and restore the UK as the country of choice to do business in.
- Stimulate entrepreneurial growth by encouraging SME business owners to keep their money 'in' to develop their company and tax them when they take the money out of what will then be a much bigger company for the investment that they will have made in it.
- Reinforce long term investment with reasonable offsets for the 'losses' that occur over time due to inflation (even at 2%, inflation over ten years reduces the value of the original investment by nearly a third).

Accounting standard FRS 5

An amendment to FRS 5 designed to stop the irregular invoicing practice adopted by fee earning businesses has had unintended consequences on some manufacturers forcing them to pay Corporation Tax on work in progress and finished stock.

This affects companies in particular supply chain relationships, e.g. those running a continuous, just-in-time manufacturing Kanban system to support a draw down contract, which would be regarded as the ‘ultimate’ in modern supply chain efficiency and integration.

However, suppliers (mostly SMEs) in this sort of relationship will find it very difficult to renegotiate these contracts with their (much bigger OEM) customers who rather than change terms would take the business away to another supplier prepared to offer the same sort of efficiency. So at the moment they either loose a part of their cash flow or their contract.

But it is also important that the tax system encourages and supports these types of contract relationships, which are designed to increase manufacturing efficiency, which itself depends on the ability to invest over the longer term.

What happens is that the amendment captures the firm’s work in progress and finished stock which is then grossed up and added to sales. The resultant increase in profit adds to their Corporation Tax liability, but excludes associated costs of final manufacturing and of course delivery. This inflates their profit line and reduces their cash flow by a similarly distorted figure. These can be big numbers for an SME, e.g. £1 million.

- We recommend that this distortion could be rectified fairly simply by limiting the liability for tax to work that is invoiced by any business whose primary source of income is from fees earned from clients.

Manufacturing investment
Currently too many UK manufacturers prefer to take on cheap Eastern Block labour to reduce their costs of manufacture rather than investing in more modern, automated plant that will allow them to compete in world markets for the longer term.

Through BERR officials we are working with the Manufacturing Advisory Service to change this bias, but the tax structure isn’t helpful here.

The Annual Investment Allowance
We welcomed the introduction of 100% capital allowances. However, the cap at £50,000 is far too low for manufacturing. (As mentioned earlier, average investment per UK manufacturing company is £70,000, or over £100,000 in the 1990s when investment was increasing.) We accept that it is generous for service sectors (e.g. average per firm in the business services sector is under £10,000 per annum).

(Note in the case study BERR used during its manufacturing strategy consultation the SME in question was recorded as investing £1.2 million every year and our investment survey last year showed a fifth of mechanical engineering SMEs investing the equivalent of 20% of sales.)

- Recognising that the downturn also puts pressure on the public finances, we recommend that the cap be raised to £250,000 immediately to encourage firms to keep investing.

Ultimately the cap should be raised to £500,000 to encourage investment in more substantial, leading edge equipment and eligibility should be extended to companies with a maximum turnover of £50 million. At this level you will capture those firms that have significant global potential but are still constrained by access to finance from competing with the really big global companies.

In the *HM Treasury Productivity in the UK Series*, the UK’s lower levels of capital stock per worker are believed to account for some 80% of the 1990s productivity gap with France. It is therefore important that manufacturing investment is carefully targeted.

- We see an incentive aimed at automation (perhaps along the lines of the 100% allowances for energy-saving plant and water conservation machinery) as being of little interest to most service firms but of considerable help in directing manufacturing

investment into technologies that will enhance competitiveness, not just simply increase output.
- Funding is already in place for skills training as highlighted in BERR's *Manufacturing: New Challenges, New Opportunities* so that firms maximise the opportunities these new technology investments will bring.

Corporation Tax, Empty Buildings Allowance and Industrial Buildings Allowance
CT rates increased to 21% in April this year and are due to go up to 22% from April 2009. Reducing the Empty Buildings Allowance to a period of six months and the staged withdrawal of IBAs are all taking cash out of manufacturing businesses, undermining their ability to deal with the current 'crunch' and prepare competitively for the future.

The changes to the Empty Buildings Allowance mean that industrial buildings become eligible for rates after standing empty for six months. Supermarkets and other landbank accumulators avoid paying the rates by simply taking down the buildings. Firms genuinely looking to fill (part of) a property don't have that option. The changes are therefore poorly targeted, badly timed (given property market sentiment) and have unintended consequences from increasing blight and vandalism to making it more difficult for firms to plan their expansion (as the rates on a property which will enable a firm to grow by 20% have to be paid before the growth has been achieved).

In the PBR you have an opportunity to build business confidence by demonstrating that you understand these pressures and are designing policy to help meet the immediate problems while also enabling firms to shape their operations for the future as companies in the newly industrialising economies are doing right now.

We therefore recommend that you announce:

- The SME CT rate will not increase to 22% in April 2009 but will be reduced to 20 per cent. This will buy you some time as a clear indication that you are considering reducing the overall rate in April 2009.
- Plans to introduce an enhanced (e.g. 150%) maintenance allowance on empty properties/buildings to help stop vandalism and blight.

The hit that firms are going to take on IBAs will be direct on retained earnings (depreciation), which is the main source of investment finance. Industrial buildings are rarely constructed for a '100-year' life. Typically when sold after 25/30 years they have little or no value, quite different to the land on which they stand, or indeed commercial buildings where the seller expects to make a return. Industrial buildings need to be written down so that they can be replaced at the end of 25/30 years.

- We therefore suggest that withdrawal of IBAs be offset by permitting firms to consider a proportion of the buildings as long term assets for tax purposes.

Energy
Member companies report facing 100% increases in their energy costs as they renegotiate their contracts.

In its consultation on renewables (published June 2008), BERR states that Climate Change policies are responsible for a fifth of the increase in electricity prices so far and that they will cause a further 55% increase by 2020. On gas the current impacts are much lower (about 4%) but by 2020 they will push prices up an estimated 24-49%.

In our opinion it is not right for Government to introduce such inflationary pressures into the economy, without offering companies some viable alternative that enables them to counteract the increased costs, especially when the market prices are already on a steep upward curve.

Companies in energy intensive sectors have been eligible to participate in Climate Change Agreements (CCAs) since the introduction of the levy in 2001. Experience has shown that the CCAs have been particularly effective in encouraging firms to reduce their energy consumption and thus their carbon footprint. An EEF report *"Manufacturing Performance 2006/7"* published in March 2007, found that 91% of firms in CCAs undertook energy audits and other energy reduction measures compared with only 54% amongst non-participant companies. The report pointed out that this applies especially to SMEs.

The UK plastics industry have applied for a CCA, but the way the criteria are formulated means 20% of the industry will be excluded. Furthermore, the EU is tightening up the environmental criteria for State Aid so all CCAs coming up for renewal could be negatively affected if we don't act – potentially therefore here's another hit on cash flow in the offing.

Eligibility anomalies abound already as far as which sectors may and which may not take part in a CCA. For example, manufacturers of heavy presses aren't eligible, but users of the presses are eligible. Other value added processes such as metal cutting (e.g. turning and laser, water and diamond cutting) however are excluded. So it goes on.

- Every industrial sector ought to be able to enter into a climate change agreement, committing to reduce emissions and in the process obtain a rebate on the climate change levy. This would be good for the environment and good for business.

We believe that such a framework would have to be agreed at EU level. Given Germany's recent rebuttal of the proposed EU ETS (carbon trading scheme) if it damages industry, we believe that the broader application of climate change agreements could be well received by other member states including Germany as providing climate change policy leadership that helps domestic industry at the same time.

- We recommend that you announce the Government's intention to follow CCA discussions in the EU and in the meantime freeze all environmental taxes on industry at their pre-April 2008 levels.

Skills/Training
We support the Government's push on skills and training. This is vitally important to a sector that has to sell its output internationally. Member firms are committed to training. They have to be because 87% of them struggle to find the people they need. Nine in ten of the firms in our skills survey agreed that they 'trained to survive'.

The Government's laudable plans to encourage larger numbers to take a university education and the practice of making funds available to assist them have set benchmarks for parents and guardians by which they and their charges judge alternatives. The low interest funding (£2,000-£5,000) available for the 'academic route' makes a clear practical statement about that route as a priority.

Employers taking on apprentices have to overcome an apparent 'image problem' because the young apprentice is not currently blessed with a similar Government-backed incentive.

- To underpin young people's initial enthusiasm for apprenticeships we suggest some form of tax relief on what they earn while they go through their three-year course or grants and loans structured on similar lines to the university related loans (e.g. re-payment to start when earnings reach £15,000 a year).
- This support should be limited to training/apprenticeship schemes where there is documentary evidence of regular assessment and progress.
- It will enhance the image of apprenticeships amongst young people, teachers, their parents and guardians, giving the vocational stream status closer to that of the academic route.

Short term measures
Selective Finance for Investment (SFI)
Awareness of Selective Finance for Investment, which helps firms making capital investments, is very low. In part this is because it's only available in certain geographical areas and also because grant levels vary under the scheme too.

However, we have learned that all English RDAs with the exceptions of the South East (SEEDA) and Yorkshire (YF) are now offering grants under SFI of up to 15% for companies in all post codes. We therefore recommend that

- This availability should be extended for a 24 month period to SEEDA and YF and all the nations so that all UK companies have equal access to it.
- The scheme should be checked to ensure that it is user friendly and then given a much higher profile nationally for most cost efficient promotion.

Cash flow and the Small Firms Loan Guarantee Scheme

The Small Firms Loan Guarantee Scheme (SFLG) is designed to help companies with capital expansion plans guaranteeing 75% of the sum involved which is provided through the scheme mainly by the high street banks.

Current trading issues are focused on revenue availability.

In normal times a customer placing an order for a machine will be expected to pay a deposit of approx 40% with the order. This helps finance manufacture. However, in these uncertain times, the customer is increasingly asking the supplier to provide a guarantee that they will either receive the machine or their money back. If the supplier goes to their bank the bank will more than likely provide the financial guarantee but deduct the sum from their overdraft facility, so in cash flow terms the supplier is no better off for having the deposit from the customer.

This practice, of banks providing a guarantee on behalf of a supplier, is well established in Germany and France. Under normal circumstances they are provided without difficulty.

Many UK manufacturing SMEs involved in exporting to Europe even in normal times report facing a request for a guarantee, especially if it is one of the first times they have dealt with that customer. Typically they find UK banks only prepared to do so if they reduce the overdraft facility by the same amount. Generally the sums involved are small (£20-80,000) for a period of one to three months.

Currently there is so much uncertainty, banks and customers are all hanging on to cash for as long as they can. We offer the following embryonic suggestion to help firms trade through the current downturn which is increasingly expected to last for 18 months to two years.

- To loosen up the ‘frozen cash’ we suggest that the SFLG be adapted to provide a guarantee against the deposit paid by the customer for the relatively short period required to build the machinery. This will help good businesses trade through the downturn by ensuring that they have access to most of their cash. (There would have to be a fee involved, but by backing the scheme, Government would help keep this to a reasonable minimum)

Yours sincerely

Martin Walder
Chairman

cc Rt Hon Peter Mandelson – Secretary of State -- BERR
Ian Pearson – Business Minister -- BERR
Baroness Vadera – Minister for Competitiveness -- BERR
Simon Edmonds/Brian Greenwood/Sandy Grom -- BERR
Katherine Green/James Miller/Garry Siveyer – HMT
Member associations