23 February 2006

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

Dear Chancellor

**Re: EAMA 2006 Budget Submission**

**Introduction.** The Engineering and Machinery Alliance (EAMA) groups seven organisations* representing over 1,000 SME manufacturers with a turnover of some £3 billion split pretty evenly between finished capital goods and components for capital goods. Substantially more than half of sales are to customers overseas.

Our membership is representative of the mechanical engineering sector, where 13,000 firms with an average turnover of some £2.5 million exported £25.4 billion in 2005 and ran a positive trade balance for the UK of some £4 billion. Last year's export sales were 6.7% up on the previous year. However, the sector and our members remain much concerned by UK manufacturing's poor investment performance.

**UK manufacturing's investment performance**. According to ONS's Annual Business Inquiry, UK manufacturing has cut net capital expenditure by 42% as a sector since 1997. Investment per company has only fallen fractionally less according to the same source (37%).

**ANNUAL BUSINESS INQUIRY – DECEMBER 2005**
**Manufacturing**

| | | | Computations | | |
|---|---|---|---|---|---|
| **Year** | Number of enterprises thousands | Total net capital expenditure sector £ million | Change 1997-2004 | Total net capital expenditure per company £ | Change 1997-2004 |
| **1997** | 169.7 | 20,314 | | 120,000 | |
| **2004** | 154.9 | 11,745 | -- 42% | 76,000 | -- 37% |

Mechanical engineering has recorded an even more dramatic slump – 54% for the sector and – 48% per company over the same period.

**ANNUAL BUSINESS INQUIRY – DECEMBER 2005**
**Manufacture of Machinery and equipment not classified elsewhere**

| | | | Computations | | |
|---|---|---|---|---|---|
| **Year** | Number of enterprises thousands | Total net capital expenditure sector £ million | Change 1997-2004 | Total net capital expenditure per company £ | Change 1997-2004 |
| **1997** | 14.4 | 1,109 | | 77,000 | |
| **2004** | 12.9 | 514 | -- 54% | 40,000 | -- 48% |

For general comparative purposes, since it is often claimed that UK and US manufacturing are following similar paths you may be aware that US manufacturing investment over the same period has fallen by around 24% for the sector as a whole and an average of 22% per company according to US Census Bureau Annual Survey of Manufacturers.

**US CENSUS BUREAU ANNUAL SURVEY OF MANUFACTURES**
**All Manufacturing Establishments**

| | | | Computations | | |
|---|---|---|---|---|---|
| **Year** | Establishments thousands | Total capital expenditure sector $ million | Change 1997-2004 | Total net capital expenditure per company $ | Change 1997-2004 |
| **1997** | 362.8 | 151,511 | | 418,000 | |
| **2004** | 350.7** | 115,113 | -- 24% | 328,000 | -- 22% |

**Note**: **Number of companies according to latest available data is from 2002 census (if number of companies was smaller, decline per company would have in fact been smaller)

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When we wrote to you in the autumn ahead of your pre-Budget statement, we described some of our members' suggestions on how to make some specific regulations easier to deal with. We have taken these forward through the Cabinet Office's portal and at a meeting on February 1 with members of your SME Taxation and Enterprise teams.

This latter was a useful exchange between your officials and our member associations and some of their member companies. I very much hope that this will be repeated on a more regular basis.

When we wrote to you at this time last year, we focused on investment and exporting. Given the preceding data, the thrust of which I think is common ground between us, you will not be surprised to find us arguing for the same priorities. And as already mentioned we are engaged in the regulatory simplification process.

The unpalatable facts are that since then, UK manufacturing investment has continued to bump along, reducing our home market. And as you know, this has coincided with a Treasury directed policy switch reducing support for UK export activity, when it is even more important for our members.

**Encouraging investment to sustain longer term performance**. Exporting and investment flourish where businesses can be confident about the medium and longer term outlook and treatment. We are therefore pleased that you have decided to reinstate 50% capital allowances for SMEs. It is important that this level should be maintained for the longer term, so that companies can plan successfully.

We hope that this change will be well publicised and are well placed to help in this.

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 you are 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.

We believe that it follows that capital allowances can be used to directly promote investment in productive capacity, since HMRC are already used to classifying different allowances, e.g. enhanced capital allowances for energy conservation equipment, water conservation equipment and low emission cars.

Granting 100% allowances would have two benefits:

- Boost productivity of industries buying the equipment
- Increase the cash turnover of the engineering sector, which generally increases prosperity and employment opportunities.

We now ask 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.

**Other 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.

***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.

The reasons for this action are:

1. Employers Liability Insurance (ELI), which is mandatory, tends to be more expensive for manufacturing companies than for others;
2. According to the Association of British Insurers (ABI) ELI has been increasing 10-15% per annum, but according to an EEF survey many manufacturers faced increases of up to 30% (i.e. well above inflation);
3. Manufacturing companies activities require cover that other firms don't need to consider to the same degree (e.g. engineering cover for mechanical and electrical breakdown);
4. It is inappropriate for the Exchequer to exacerbate the inflationary impact of increased premiums through IPT (manufacturers margins are still typically 10% or lower);
5. Ease of implementation, no primary legislation required.

***Corporation Tax (CT)***. We understand (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. This measure aims to promote growth of small businesses through better targeting of tax incentives and by simplifying the corporation tax structure to minimise compliance costs and allow firms to focus on growing their business."

However, the current system discourages SME companies from setting up operations in export markets:

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 £1.5m.
3. This £1.5m 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 £1.5m 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 hobbles a UK SME from growing its international capability in areas such as servicing machinery, which is an increasingly important and competitive part of the higher value added export sale.

***Training.*** Lack of skills and the costs involved in bringing on additional skills in an existing employee or taking on an unskilled person and then preparing them for a productive future are difficult decisions in any company, but particularly for SME manufacturers.

Companies take these issues into account as part of the decision about whether or not to invest in new, more complex machinery that will increase the firm's value-added to its customers.

Equipping the unemployed for a useful future while paying the minimum wage makes it too expensive for many SMEs to remain competitive while taking people on and training/educating them at the same time. The typical SME needs a productive employee from day one. And in essence the same applies when a new machine is installed, the firm needs it to be earning its keep as quickly as possible to be competitive.

We believe that a simple training credit against NI or enhanced tax relief for the company would encourage firms to invest in training and encourage them to undertake the necessary training in a planned and timely way. Training doesn't come cheap.

**Regulatory simplification**. We are fully committed to regulatory simplification and to helping in any way we can. Our report last year contained over 20 different instances, where some form of simplification would be helpful. Amongst its conclusions were the following:

1. Companies believe that Government can begin to turn things round if it drafts new regulations jointly with business (38%), simplifies the forms it sends out (22%) and cuts the number of regulators (19%).
2. For example, when Government considers extending family friendly policies it could consider at the same time SMEs' requirements for skilled workers as cover for a mother or father looking after their child. Such legislation can have a massive impact on smaller companies.
3. Here we suggested that Government work with business to look at retiree tax incentives to foster 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. 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.

**Grants.** We are now completing a study on our members' use of grants as a microcosm for the mechanical engineering sector.

Some relevant preliminary results:

- Grants clearly affect investment behaviour. Three-quarters of successful firms say that they would not have proceeded without the grant.
- As an SME manufacturer, a firm is more likely to be successful in applying for a grant in the West Midlands and less likely to succeed in the East of England and the South East.
- Whereas R&D (25%) and training (20%) account for most applications followed by exporting and machinery (both 14%), applications for exporting (67%), training (64%), R&D (61%) and IT (50%) grants seem to have an evens or better chance of success.

This seems to indicate that targeted measures to increase investment and training would produce useful dividends for the economy if driven from a national perspective .

Yours sincerely

Graham Hayes
Chairman

cc Rt Hon Alun Michael – Minister for Industry, DTI
Gerry Miles/Demos Demosthenous – DTI
Will Straw/Goran Mandic – HMT
Member associations

*British Automation and Robot Association (BARA), British Paper Machinery Suppliers Association (BPMSA), 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)