Engineering and Machinery Alliance

1 November 2007

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

Dear Chancellor

Re: The Pre-Budget Report
This is the first time that I have had the pleasure of writing to you in your new capacity as Chancellor of the Exchequer, so I hope that you will permit me to start by congratulating you on achieving this very high office of state, second only to that of the Prime Minister.

You have received many representations on the changes to Capital Gains Tax (CGT) and made it abundantly clear that you don't intend to reverse or change the policy of a single rate. We are pleased that you have agreed to introduce a tax-free threshold for retiring entrepreneurs selling their business.

1 Who we are
I am writing to you on behalf of the 1,300 mechanical engineering firms in the nine trade associations that make up our alliance, namely

- 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 they represent approximately 10 percent of the sector mostly SME firms with a total turnover of some £7 billion (circa 20 percent of sector) split pretty evenly between finished capital goods and components for capital goods. Typically 60-80percent of these firms' production is exported, directly or indirectly.

UK mechanical engineering sector turnover is some £35 billion, 74 percent (£26 billion) of it from exports. We run a positive trade balance of some £5 billion. Our customers are worldwide in industries such as food, aerospace, printing, paper, motor, medical, plastics and general engineering.

2 Cumulative impact analysis
I have waited to write to you on these matters until now, because I wanted to do so with the benefit of a PricewaterhouseCooper impact analysis examining the package of changes announced in the Spring, but for implementation in April 2008. This includes an increase in SMEs' Corporation Tax (CT) rates, an Annual Investment Allowance and the phased withdrawal of Industrial Buildings Allowance (IBAs).

I reasoned that if there were to be gains from that package then it would be more than churlish not to recognise the point when writing to you now to put on record the mechanical engineering sector's deep disappointment with the CGT changes.

Unfortunately the PwC analysis is pretty negative. It shows that the more a company invests (over £200,000 which in manufacturing is quite common even amongst SMEs) then the worse off the company will be compared to the pre-existing regime.

So combining those changes with the CGT increase will have the perverse effect of making it less attractive for firms to invest in manufacturing kit and more attractive for investors to put their money into additional homes or property particularly in the short term as there is nothing to offset the impact of inflation, which even at 2% a year eats away 25% of the original value in ten years.

3 Manufacturing investment

We have written about the state of UK manufacturing investment on previous occasions. Despite some improvements over the last two years, it is still considerably down on where it was in 1997. (On the basis of ABI figures, investment is 37% lower per company. According to United Nations data on robotics, UK manufacturing is only half as automated as manufacturing in the US, France, or Spain and is only a quarter of the level in Germany)

Our 2006 investment survey (see under publications at www.eama.info), covering R&D, training and IT as well as buildings and plant, showed four-fifths investing as much or more than a year before, with similar a proportion planning repeat levels in 2007. Importantly it also recorded one fifth of respondents investing at over 20 percent of sales. (These were all micro or small firms with a turnover of less than £5 million, but nonetheless with annual investment levels ranging up to £300,000 or more.)

Currently too many UK manufacturers prefer to take on cheap Eastern Block labour to reduce their costs of manufacture rather than investing in automation that will allow them to compete in world markets for the longer term. This is a very short term strategy that's increasing the demand for immigrant workers.

This reluctance to invest in automation is not solely a money issue. We need government support to both educate and encourage companies to invest in new technology, like the German's do.

We need to kick-start UK manufacturing investment in value adding technologies. That is the route to real, commercial competitiveness with the rapidly industrialising economies.

But the withdrawal of IBA and the increase in SMEs' CT rates from 19 to 22% will put a further drag on investment at a time when the pace could and should be picking up because firms have had a profitable couple of years.

4 Some alternatives

We therefore ask you to consider how the apparent aims of these changes (e.g. on CT to reduce the differential between incorporated and unincorporated businesses) can be mitigated so that they don't strike ethical businesses simply to catch a few tax-dodging individuals.

We suggest sweeteners as well as sticks such as allowing the increase in SMEs' CT rates to be offset against further investment or training.

Automation incentives

With regard to manufacturing more generally, we could see an incentive targeting automation (perhaps along the lines of the 100 percent allowances for energy-saving plant and water conservation machinery) as being of limited interest to the vast bulk of service firms but of considerable help in kick-starting serious investment and extra development in this area amongst UK manufacturers, particularly with a view to longer term competitiveness (and therefore with employment and tax implications) against the rapidly industrialising economies. If there are any anti-competitiveness considerations to be taken into account, there is evidence on how automation can help reduce the number of accidents at work.

As you know, the British Automation and Robot Association are part of our alliance and we would be pleased to talk to you in more detail about this (e.g. the UK is developing strengths in applying automation systems in food processing, medical leak testing, drug discovery and nuclear decommissioning).

Industrial Buildings Allowance (IBA)
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.

Exporting
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 for 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.

Different transitional arrangements should surely be introduced to encourage firms to grow their ability to service customers abroad directly, otherwise the jump from SME to large company tax status simply sinks on a tax structure consideration.

We are endeavouring to develop a good working relationship with your department as a useful source of contact with the grass roots views of SME mechanical engineering firms. We would be pleased to discuss these and other possible solutions, but would ask you please to ensure that it is with the considered aim of significantly improving the UK's investment environment for manufacturers.

With best regards

Yours sincerely

Graham Hayes

Graham Hayes
Chairman

cc Rt Hon Stephen Timms – Minister for Competitiveness BERR
Simon Edmonds – BERR
Brian Greenwood/Sandy Grom -- BERR
Neil Kidd/Katherine Green – HMT
Member associations