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Budget 2008 Representations to HM Treasury

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Submitted on behalf of the following organisations:

EEF – the manufacturers’ organisation

Agricultural Engineers Associations
Association of Manufacturers of Power Generating Systems (AMPS)
Association for Instrumentation, Control, Automation and Laboratory Technology (GAMBICA)
British Chemical Engineering Contractors Association
British Electrotechnical and Allied Manufacturers’ Association
British Fluid Power Association
Catering Equipment Suppliers Association
Construction Equipment Association
Construction Products Association
Engineering Industries Association
Finance and Leasing Association
Gauge and Toolmakers Association
Heating and Ventilating Contractors’ Association
International Marine Contractors Association
Manufacturing Technologies Association
National Association of Steel Stockholders
Railways Industry Association
Society of Maritime Industries
Specialist Engineering Contractors’ Group

Summary

Twenty organisations representing manufacturing and its financing have combined with EEF to produce this submission.

Supporting continued growth in manufacturing

Manufacturing has made great strides in recent years but faces a more difficult environment in 2008. EEF's Business Trends Survey showed that on some indicators, manufacturing activity was at its strongest for ten years in 2007. The manufacturing sector entered 2008 feeling fairly confident about growth prospects in the near future. However, discussions with manufacturers indicate that they are becoming nervous about the outlook for the second half of 2008 and about how the credit crunch will affect a number of their key markets.

The evidence so far suggests that the direct impact on manufacturers of tighter lending conditions has been fairly limited and that investment intentions have held up. This reflects the fact that most manufacturers have been funding investment through their retained earnings rather than borrowing. However, we are yet to see the full effects of the credit crunch on bank lending while weaker growth prospects are likely to bear down on manufacturing investment. In addition, weaker domestic and export markets will make it harder to pass on cost increases and intensify the squeeze on profitability and the funds available for investment.

It is therefore vital that the government supports manufacturing's improved performance in more difficult conditions and avoids measures that would sap its resilience. In particular, the Budget needs to restore the damage done by the botched capital gains tax reforms by sending out a signal that the government understands the needs of business for a simple, predictive and competitive tax system. Our key priorities for the Budget in the short and medium term are:

- Despite the pressure on the public finances, the government must avoid the temptation to plug them with increases in business taxation. Increases that add to the cost of doing business or erode profitability are likely to have a negative impact on manufacturing activity and investment, at a time when export and domestic markets and companies are feeling more uncertain.
- The government also needs to develop a more consistent and coherent approach to tax reform. Currently, businesses priorities for the tax system – competitiveness, simplicity and predictability – are being presented to business as trade-offs. The government needs more effective consultation with manufacturers, linking any proposed changes to a clear strategy on business taxation.
- The tax authorities therefore need to develop a much closer relationship with business that avoids introducing unnecessary complexity into the tax code in the first place and finds the most effective way of reducing existing complexity. It should therefore commit to extensive consultation before making any major change to the tax code. This would help to avoid unforeseen consequences from tax changes, identify more effective alternative approaches, promote business understanding of what the government is seeking to achieve and help companies to prepare for the changes.
- The government should take steps to improve the relationship between small- and medium-sized businesses by extending Sir David Varney's recommendations: a risk-based approach to dealing with tax matters, speedy resolution of issues, and clarity through consultation on HMRC's dealings with SMEs.
- Looking to the medium-term, the government should cut the headline rate of corporation tax to 25 % which would put the UK in the top 10 in the OECD. It would not be fiscally responsible to make such a cut immediately, but we believe that funding such a cut through proceeds of economic growth should be a priority for the government. A reduction in the headline rate of corporation tax should not be financed by increases in other business taxes.

Principles-based approach to financial products

The consultation on a principles-based approach to financial products tax avoidance underscores EEF's concerns about the direction of tax policy. The government believes that a principles-based approach to avoidance is an attractive means of unclogging the tax system by avoiding the need for new complex anti-avoidance rules each year. Rather than offer simplification of the tax system, we believe the new approach could add to complexity and uncertainty, while hurting business' competitiveness abroad.

Principles-based anti-avoidance measures require a carefully designed and precise principle that applies to a tax base that is easy to both define and identify. Yet not only is the underlying principle poorly crafted, but given the global nature of business activity, disguised interest is a complicated tax base to define precisely.

While the intention of the new rules is to catch only the most contrived of actions, the proposed rules could mean innocent transactions are also scrutinised. This would generate increased uncertainty and lead to greater demand for clearances from HMRC. While this raises questions of HMRC's capacity and capability to make consistent decisions, we believe that this legislation would ultimately

place too much discretion over taxation with HMRC and transfer too much power from Parliament to the executive.

Neither does it seem that the government has given appropriate thought to the interaction of this legislation with other planned changes to the tax system, such as the ongoing foreign profits consultation. Neither does it seem the government has adequately thought through the negative consequences of these changes on the competitiveness of UK businesses abroad.

Given our concerns about the quality of the draft legislation and its consequences for competitiveness, we believe this legislation should be delayed for at least one year. The principles-based approach to financial products tax avoidance provides scope for simplifying the tax system. But these gains in simplification come at the cost of additional burdens and a significant loss in competitiveness for larger UK businesses.

Encouraging enterprise

Measured as the percentage of the population who are either a nascent entrepreneur or owner-manager of a new business, UK entrepreneurial activity dropped in 2006-07 relative to 2004-05 and is below 2002-03 levels as well. Given that the UK enjoyed economic conditions that were at least as favourable, if not more so, as many of its competitors, we believe that other factors contributed to the UK's relatively weak performance. We therefore need to look at whether the UK has the right policies in place to encourage new entrepreneurs and support the current batch of entrepreneurs.

Looking at the flow of entrepreneurs, the government needs to look at whether we have a sufficiently strong enterprise culture amongst young people in schools and higher education. One of the most effective ways to do this will be by making better use of the existing generation of successful entrepreneurs to inspire the next one. We need to make it easier for businesses to work with schools and the government must therefore deliver on its commitment to rationalise the large number of existing initiatives that bring schools and business together.

The government also needs to look at how to help the current stock of entrepreneurs become more effective. We set our proposals under three headings – regulation, access to finance and helping small firms grow.

Regulation – over the next twelve months the government must show business that it is making real progress. It can do this by introducing measures to reduce the regulatory burden that do not just show up as a reduction in costs on

the government's indicators, but are also seen by business as genuinely making life easier.

Access to finance – the opportunities available to small firms mean it is vital that firms are able to access finance at all stages of their growth. This requires a sophisticated approach to understanding small firms' finance issues and the relative roles played by the skills and capabilities of entrepreneurs, the availability of outside finance, business support and the taxation system. Key issues that need to be addressed include:

- Providing mentoring support to firms with new technologies or products to help them become investor-ready.
- Enhancing the role played by business angels, including matching them up more effectively with companies seeking investment.
- Business support (developing financial confidence and capability) should extend to all enterprise, from start-ups to growing SMEs.
- The Small Firms Loan Guarantee Scheme should be extended to cover all enterprise from start-ups to established businesses to help firms make the shift to intangible investments.
- Addressing shortcomings in the newly-introduced entrepreneur's relief for capital gains tax by removing the need to be an employee and reducing the 5% limit. It also needs to change the lifetime limit position to encourage serial entrepreneurs and long holdings.

Helping small firms grow – the government can also play an important role in helping firms with new technologies and products to expand by providing them with opportunities to develop markets in the public sector. We therefore welcomed the Sainsbury Review's recommendation to revamp the Small Business Research Initiative which allocates 2.5% of each government department's external spending on research to start-up and growing companies. However, this will require government departments to upgrade the skills and quality of public procurers.

EEF's report on public procurement and innovation suggested the best way to do this would be through using the Technology Strategy Board and the Office of Government Commerce to help train procurers within government departments in areas such as risk-management, commercial best practice, technical skills and how to recognise and understand long-term value.

Delivering the low-carbon economy

Addressing climate change is emerging as a priority issue around the world. Not least in the UK, where the government

aims to enshrine in law a target to reduce carbon dioxide emissions by at least 60% below their 1990 levels by 2050. Achieving such a target will require fundamental changes in how we generate and use energy right across society – in business, in transportation and in our homes.

Moving to a low-carbon economy provides UK industry with the opportunity to develop, make and sell low-carbon goods and services. UK industry has the manufacturing, skill and technology base to succeed in this new growth area. For example, the UK is well-placed in major areas of opportunity such as renewable energy, clean coal technology, advanced internal combustion engines, hybrid and electric vehicles, industrial automation and efficient domestic heating systems.

Despite these advantages, the UK will fail to realise the manufacturing opportunities presented by the transition to a low-carbon economy, unless both government and business are alert to what they need to do. Amongst the key areas for government to address are:

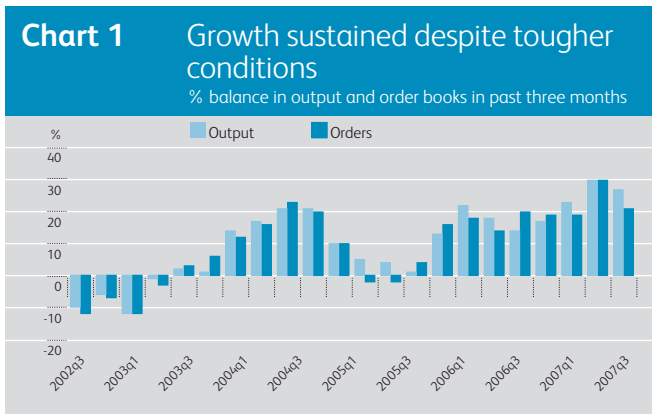
- giving greater priority to research and development;
- developing the next generation of scientists and engineers;
- providing targeted support for the wind energy supply chain;
- developing a long-term strategy and review support for marine renewables;
- establishing a specific support mechanism for carbon capture and storage;
- working with the European Commission to establish long-term and realistic carbon dioxide targets for road transport;
- reforming support for Micro Combined Heat and Power;
- introducing incentives for households to improve our housing stock;
- making low-carbon products more financially accessible, and;
- enabling consumers to make informed decisions.

1. Supporting continued growth in manufacturing

Manufacturing performance improves

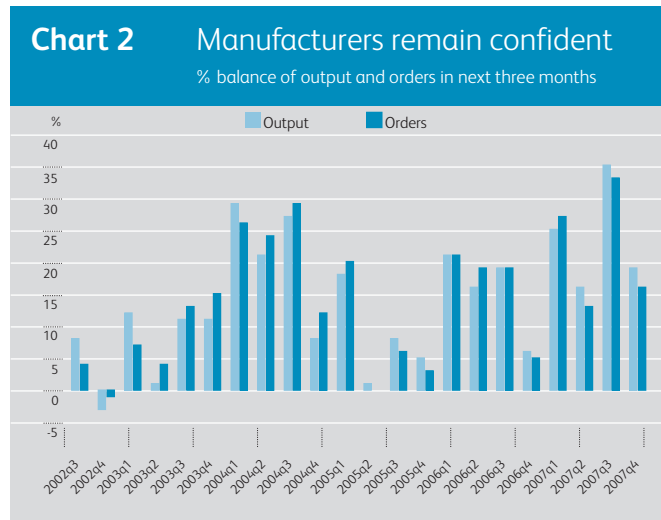
Manufacturing has made great strides in recent years but faces a more difficult environment in 2008. EEF's Business Trends Survey showed that on some indicators, manufacturing activity was at its strongest for ten years in 2007. These gains have been achieved by a combination of reduced costs, higher productivity (up by just under a quarter in the past five years) and an increased focus on the areas where manufacturing can best add value such as innovation, design, establishing niche markets and developing service offerings. At the same time, manufacturers have enjoyed the benefits of a strong UK and world economy.

The cumulative figures for 2007 show the best balances on output and new orders since 1995 and that it was consistently a strong year for manufacturing. Chart 1 shows that the fourth quarter results were only marginally less positive than in the rest of the year. The balance of companies reporting increased output fell slightly from 30% to 27%. While the drop in the new orders balance was a little larger, the figure of 21% was still the second best since the third quarter of 2004.



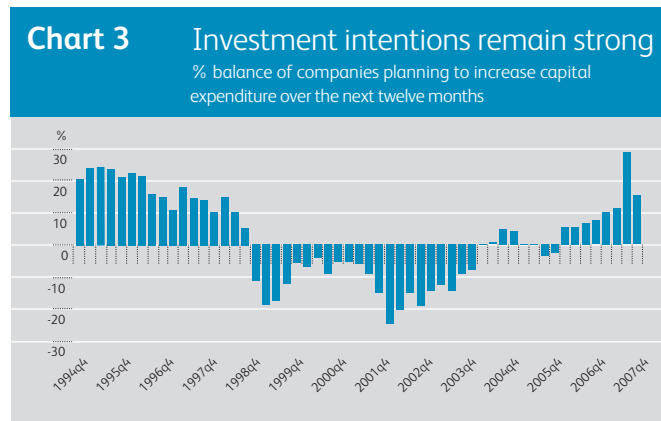
Source: EEF Business Trends Survey

Looking ahead, chart 2 shows that the manufacturing sector entered 2008 feeling fairly confident about growth prospects in the near future. Though confidence in the next three months weakened at the end of 2007, it remained above the levels seen in the first half of the year and above its long-term average. This reflects a combination of how much the competitiveness of manufacturing has improved and the fact that large parts of the world economy remain in good health. Indeed, while confidence about domestic orders has weakened, manufacturers remain upbeat about expanding sales abroad. However, discussions with firms indicate that they are becoming nervous about the outlook for the second half of 2008 and about how the credit crunch will affect a number of their key markets.



Source: EEF Business Trends Survey

Manufacturing confidence and the need to maintain the recent improvement in productivity is reflected in the continued strength of investment intentions. Chart 3 shows that the number of companies planning to expand capital expenditure in the next twelve months fell back a little in the last three months of 2007 but that it was well above its level over the rest of the decade. The third quarter figures had also been artificially high, reflecting the fact that companies were bringing forward their investment plans ahead of the reduction in the value of capital allowances from April this year.



Source: EEF Business Trends Survey

The evidence so far suggests that tighter lending conditions by banks following the turbulence in financial markets in 2007 have had little direct impact on most manufacturers. Less than 3% of companies reported a significant negative impact on the cost of credit while a further 27% experienced a moderate increase. In addition, only a fifth of firms reported any negative impact on investment plans or other

major expenditure. This reflects the fact that manufacturers have improved their balance sheets and are able to fund the majority of their desired investment from their own resources.

Maintaining gains will be tougher this year

The evidence we have presented does not mean that we can be complacent about the performance of manufacturing in 2008. While the direct impact on manufacturing of conditions in financial markets has so far been limited, firms have yet to feel the full effects of tighter lending conditions. In addition, its impact will be felt more widely through its effect on spending by consumers and businesses in the UK and by weakening export markets, particularly in the United States and also potentially in parts of the European Union and Central and Eastern Europe.

Weaker domestic and export markets will not only affect sales volumes, they will make it harder to pass on cost increases. The official data on producer prices and a range of business surveys shows that manufacturers are under pressure from the rising cost of oil, other forms of energy, metals and other raw materials. Though some surveys point to increases in the number of companies planning to raise prices, the reality is that far fewer of them are succeeding in doing so. Since the start of the decade, producer input prices have risen by 40% while output prices have increased by just 10%. Excluding food, drink, tobacco and petroleum, increases in producer prices have been stable at around 2.5% since the middle of 2006.

It is therefore vital that the government supports manufacturing in maintaining its improved performance in more difficult conditions and avoids measures that would sap its resilience. This submission focuses on what the government should do on tax and what it should avoid. In the rest of this section, we set out some key principles, drawn mainly from EEF's major survey of manufacturers on tax last year. In the following sections, we apply these principles to issues on which the government is currently consulting as well as how the government should seek to promote enterprise.

What manufacturers need from the tax system

Our starting point is that manufacturers need a tax system that is competitive with what is available in competitor countries, simple to work with and which provides the predictability that allows them to plan ahead. EEF's report on taxation, published at the end of 2007, 'Blurred vision – the need for a clear strategy on business taxation' suggests the need for improvement on all fronts. Amongst the key findings are that:

- Over half of manufacturers believe that their tax burden (total tax paid as a percentage of profits) had increased over the previous five years;
- Though the UK has a lower rate of corporation tax than the other G7 countries, it has fallen behind many of its other competitors in reducing it. Even with this April's reduction in the main rate of corporation tax to 28%, the UK still stands at 19th place within the European Union and 16th out of 29 in the OECD.
- Most firms are concerned over the rising complexity of the tax system and a third of them feel that the increase in complexity was significant. Almost 75% of firms attribute their perception of greater complexity either to the volume of new legislation or the frequency of changes.
- Almost half of those surveyed said that the number of personnel and time required to deal with tax matters had also risen.
- In contrast most firms claiming capital allowances and ECAs found the existing process straightforward or acceptable.
- Current environmental taxes are seen as unsuccessful at influencing behaviour, adding to complexity and reducing competitiveness.

Key principles and recommendations

The current tight state of public finances and the worsening outlook for economic growth severely limits the scope for immediate cuts in business taxation. Our main proposal for reducing the tax burden therefore focuses on what can be achieved in the medium-term. We also look at the key issue of the relationship of business with the tax authorities and some concerns related to areas on which HMRC is currently consulting.

Competitiveness

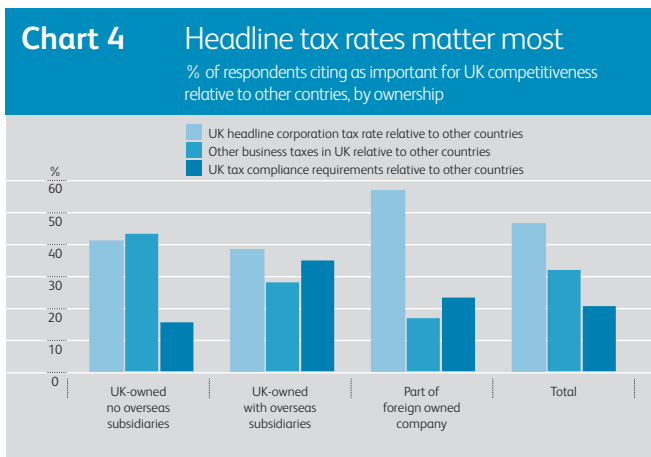
However, our starting point is the need to avoid further increases in business taxation. Our submission has already highlighted the deterioration in the UK's tax competitiveness. Though the announcement of entrepreneurs' relief on capital gains tax is helpful, business and investors still face an additional £700m tax bill as a result of the changes to capital gains tax announced in the pre-Budget. At the same time reductions in the value of capital allowances and an increase in the small companies' rate of corporation tax rate are combining to make the investment climate less friendly, particularly for smaller firms.

It is therefore vital that the government avoids further raids on business to shore up the public finances. Increases in taxation that add to the cost of doing business or erode profitability are likely to have a negative impact on manufacturing activity and investment at a time when

export and domestic markets and companies are feeling more uncertain. Attempting to improve the public finances through raising business taxes would, in our view, be counter-productive.

The government also needs to develop a more consistent and coherent approach to tax reform. This should be based more on effective consultation with manufacturers, with any proposed changes linked to a clear strategy on business taxation. Otherwise the government risks undermining the competitiveness of both large and small manufacturers at a time when the economic environment is becoming more difficult.

Looking to the medium-term, EEF’s tax survey showed a preference for cutting the main rate of corporation tax. Chart 4 shows that nearly half of companies (46 %) believed that reducing the UK headline corporation tax rate relative to other countries would have the greatest impact in improving competitiveness. This is well ahead of the three-in-ten firms that prioritised other business taxes.



Source: EEF Tax Survey 2007

We therefore recommend that the government cuts the headline rate of corporation tax to 25%. Table 1 shows that a 25% rate would put the UK in the top 10 in the OECD. However, it would not be fiscally responsible to make such a cut immediately. The most recent projections by HM Treasury show the current budget returning to a surplus of £3bn in 2009/10, followed by £9bn in 2010/11 and £14bn in 2011/12. Given recent trends in public borrowing and the worsening economic outlook, these projections look highly optimistic. There is therefore some uncertainty over when such a cut would be affordable. However, our central premise remains unchanged – that using the proceeds of economic growth to fund a cut in the corporation tax rate to 25% would be sensible and should be a priority for the government.

Table 1 A 25% tax rate would put UK in top ten

	Average statutory rate 2008	Rank of UK Headline Corporate Rate		
		30p	28p	25p
G-8	33.7	2nd	2nd	2nd
EU	23.6	21st	19th	14th
EU-15	27.6	10th	8th	3rd
OECD	26.7	20th	16th	10th

Source: OECD, Eurostat, Institute of Fiscal Studies

It is also important that any reduction in the headline rate of corporation tax is not financed by increases in other business taxes. In particular, there should be no further reductions in the value of capital allowances. The new Annual Investment Allowance covers only the first £50,000 of investment each year – a limited sum for many manufacturers, whose annual investments in new technology tend to be much larger than this. For these investors, the alignment of capital allowances with economic depreciation means that the tax system is effectively neutral with regard to investment. At a time when the economic climate has become more difficult, many manufacturers have lost an important support for investment. Government must not make any further reductions in the value of capital allowances.

It would also be welcome if the government removed the bias against leased investments in such schemes as the Annual Investment Allowances and Payable Enhanced Capital Allowances. The proposal to help loss-making firms through the latter is welcome, but could be tackled much more effectively if leased assets were included. In addition, the associations representing capital-intensive industries continue to be concerned about the pending abolition of industrial buildings allowances.

Simplicity and predictability

Firms’ perceptions that the tax system is becoming more complex are reflected in widespread calls for simplification. The structure of business and its activities has become significantly more complex in recent years, particularly in manufacturing. A growing number of manufacturers have bases in a range of locations across the globe, while foreign ownership of UK manufacturing has increased with EEF surveys showing between a third and two-fifths of members owned by non-UK companies. This creates pressures on the tax authorities to protect their revenues and has led to a raft of anti-avoidance measures.

Unless it is part of a tax-cutting programme, simplification also tends to create winners and losers. The potentially

damaging impact on the losers, and their public reaction to it, can therefore often make change difficult to achieve. The growing complexity of business activity also means that changes in taxation designed to achieve simplification fail to do so, or end up making the situation worse. The government also risks undermining its relationship with business when measures aimed at raising tax revenues, such as the recent changes to capital gains tax, are justified on the grounds of simplification.

The tax authorities therefore need to develop a much closer relationship with business that avoids introducing unnecessary complexity into the tax code in the first place and finds the most effective way of reducing existing complexity. Attempts to simplify the tax regime must also be based on a clear understanding of which areas of complexity concern business the most.

Significant changes to the tax code need to follow extensive discussion with business so that companies are able to understand the thinking behind any changes, prepare for them and highlight to the tax authorities any unintended consequences that are likely to result. In some cases, for example, business will regard a certain level of complexity as an acceptable price for the benefits associated with a particular tax incentive. In addition, if the measure has been in place for some time, business will have found ways to deal with its more complicated features and is unlikely to welcome any changes, particular if they are unexpected or add to their tax burden. Simplification without consultation will more likely than not lead to confusion.

The recent reforms to capital gains tax illustrate these points. It is fair to say that these changes to capital gains tax would have generated opposition from business and investors (leading to a rise in their tax burden), whatever process had been followed. However, much of the frustration resulted from the unexpected nature of the change and the failure to provide a convincing explanation for why it was needed. In addition, while the abolition of taper relief and its replacement with a single flat rate can be presented as a simpler system, the administrative savings to business from these changes are likely to be extremely limited.

KPMG's assessment of the administrative burdens of taxation put the cost to business at just £7m, most of which is spent on outside advisers when investors are considering make a disposal. EEF discussions with manufacturers and their advisers suggest that even in the simpler regime firms will continue to use outside advisers when investing in business assets and disposing of them. Any cost savings are therefore expected to be extremely limited.

Consultation would have raised concerns that the reduction in the non-business asset rate also provides significant incentives for tax avoidance. At 18%, non-business assets are set to be taxed at a lower rate than income, providing strong incentives for income to be re-categorised as capital for tax-avoidance purposes. This has already led HMRC to consult on new anti-avoidance measures targeted at income-shifting that are likely to add to complexity and place additional compliance burdens on business.

Where consultation with business has taken place – such as recent and detailed consultations on changes to foreign profits taxation and the capital allowances regime – firms have welcomed it. Overall, however, business continues to receive mixed signals from government on its willingness to engage with it in advance of significant tax changes. Indeed, the government's approach to anti-avoidance and CGT reforms illustrate how the lack of a strategic approach to tax reform is generating uncertainty, adding to complexity and undermining competitiveness.

As well as the need for more effective consultation as a matter of course before major tax changes, the government also needs to work on improving the links between the tax authorities and business. Sir David Varney's review of links with large firms has improved this group's relationship with the tax authorities though there is still some way to go. A similar approach needs to be taken to address the relationship with small and medium-sized businesses. The Administrative Burdens Advisory Board is taking steps to reduce the compliance burden of the tax system on business. In addition, the creation of 'Challenge Panels' to accelerate progress and increase accountability of senior HMRC staff with responsibility for this agenda is a much-needed move in the right direction.

However, small- and medium-sized companies have yet to feel the impact of the Advisory Board's work. In part, because it has not been up and running long, and secondly, culture change does not happen overnight. Nevertheless the momentum of the project must not be lost. We also recommend that HMRC increases the emphasis not just on administrative burdens, but on its links with small and medium-sized businesses more generally. This should extend Sir David Varney's recommendations: a risk-based approach to dealing with tax matters, speedy resolution of issues, and clarity through consultation on HMRC's dealings with SMEs.

2. Principles-based approach to financial products

In the next two sections of this submission, we look at how the tax system can encourage enterprise and in particular how it can help small and growing firms attract finance. However, we are concerned that efforts to make the UK a more attractive place for enterprise are not undermined by measures that make it more difficult to attract and retain major international manufacturers.

EEF research set out in table 2 shows that larger manufacturers are more likely to be developing strategies based around a greater focus on higher value activities but at the same time are more likely to be investing abroad to replace UK capacity. Related EEF research contained in its 2007 report *High Value – How UK manufacturing has changed*, also showed that many manufacturers are expecting to increase their focus on design and development and services but that foreign-owned firms were significantly less likely to see the UK as the primary location for these and other high value activities such as research, design and development, services and brands and marketing. The key issue is whether the UK can persuade international manufacturers to invest in higher value activities in the UK and retain existing ones.

Table 2 Larger firms more likely to focus on higher value activities and invest abroad

% of firms taking actions in response to competitive challenges by size of firm

Number of employees	Invest abroad to replace UK capacity	Increase focus on innovation	Develop service offerings
1-50	10	42	42
51-100	26	49	54
101-250	22	62	52
251-500	32	61	58
501+	54	100	77

Source: EEF Global Challenge Survey

EEF's research also showed that currently 85% of manufacturers see the UK as the prime location for production but that just over two thirds (68%) of them expect it to remain so in five years' time. The research also shows that larger firms (those with more than 250 employees) are also more likely than smaller ones to be planning to increase the proportion of production that takes place outside the UK and focus more on higher value added activities in this country. However, there is the danger that the movement of some production outside the UK will pull these other activities along with it.

The loss of larger firms, particularly if they were to move a large part of their research and development or other

innovative activities out of the UK, would have a significant impact on the UK's ability to develop a maintain a thriving base of small and growing manufacturing firms.

This is because at the most obvious level, smaller firms thrive on the orders from larger firms. Strong sales in the domestic market provide a platform for developing export markets. Larger firms also play an important role in working with suppliers in improving their working practices and in collaborating on innovation. They also provide critical mass in key areas such as skills and innovation through their demand for skills, training courses and collaboration partners in universities. This creates an infrastructure of provision which would not exist without them and from which smaller firms benefit.

It is therefore vital that the tax system remains attractive to larger international manufacturers, which is why we are concerned over the potentially negative implication of one taxation measure currently under consideration – the Principles Based Approach to Financial Products.

The consultation on a principles-based approach to financial products tax avoidance underscores EEF's general concerns about the direction of tax policy in the UK¹. The proposed legislation aims to simplify the government's approach to tackling tax avoidance. However, we believe that this will simply create uncertainty and damage the competitiveness of UK business.

EEF concerns with a principles-based approach

Recently a number of anti-avoidance tax measures have been poorly targeted and on occasion have themselves led to further changes. Moreover such measures often encourage tax planning around the specific and detailed technical rules. This tax planning simply leads to a further round of anti-avoidance measures, feeding a cycle that adds to complexity in the tax system. The government's new income shifting proposals as a response to the now infamous Arctic Systems case² are a key example of these problems.

The government believes that a shift from targeted rules to general principles could avoid this cycle. Two proposed principles are intended to provide business with a clear

¹ For more see, *Blurred vision – The need for a clear strategy on business taxation*, EEF, December 2007

² The Arctic Systems case arose as part of HMRC's attempts to tackle tax avoidance. HMRC decided to re-interpret the well-established law on how joint and family-owned businesses should be taxed. The husband-wife IT consultancy firm successfully fought an HMRC ruling that they avoided tax by paying the wife through dividends from their firm. After an HMRC tribunal and a High Court appeal went against the couple, the Court of appeal and the House of Lords found in favour of the family-owned business.

statement of what type of avoidance is being addressed and how the legislation intends to deal with it. This represents a major change to the UK tax system.

The first principle concerns ‘transfers of income’ and would prevent business selling an income stream simply to have it treated as a capital gain by the tax system. A simple example concerns a company planning to pay a dividend on which the recipient would be normally liable to income tax. However, the shareholder could convert that right to receive the dividend into an asset and sell it to another party for an amount similar to the dividend income without selling the shares themselves. In consequence, the income tax bill on the receipt of dividend income would be eliminated.

The second principle focuses on so-called ‘Disguised Interest’. This is described as interest income that is presented as other income such as capital gains or dividends, both of which are generally taxed at a lower rate. A very simple example of disguised interest is for one party to sell shares worth £100 to another party for £105 but to not require payment for one year. The government’s proposed principle would ensure that any interest income, no matter what form it takes, is taxed as such.

EEF has a number of specific concerns with the new principles-based approach:

- It is possible that the proposed rules could catch innocent transactions, increasing the administrative burdens on companies;
- We are uncertain that HMRC has the staff capacity to cope with the greater demand for clearances which this new approach will create;
- Much of the responsibility for approving clearances will be placed on individual HMRC staff. We are concerned that this will lead to inconsistent decisions, particularly when staff members change;
- Finally we are concerned that the potentially wide powers conferred on HMRC by a principles-based approach would transfer too much power from Parliament to the executive by avoiding the need for Parliamentary scrutiny through the Finance Bill.

We also have a broader concern with the new approach. For it to work, the government needs to set out a clear principle and apply it to an easily defined and identified tax base. We believe that the example of disguised interest proves how difficult this will be in practice.

Given the global nature of business activity, disguised interest is a complicated tax base to identify. This is demonstrated by the fact that HMRC have already had to redraft the legislation to include an explicit set of

exemptions within the legislation. Consequently, we believe that rather than offer simplification of the tax system, the new approach to disguised interest would add to complexity.

Concerns about competitiveness

The disguised-interest principle is also at odds with a new approach to the taxation of foreign-profits currently being examined by HMRC. This review has come partly in response to pressure from the business community for taxes on foreign dividends to be eased in order to improve the competitiveness of the UK tax system. The key elements of the proposed foreign profits legislation are:

- An exemption regime for foreign dividends paid to large and medium-sized UK-based businesses.
- Rules enabling the UK government to tax UK-based companies that seek to move profits abroad in order to take advantage of the new exemptions system. The proposed rules would allow the government to put limits on the ability of UK-based companies to move profits from the UK to companies based abroad (controlled companies) to avoid paying tax in the UK.

We are concerned that the principles-based approach is not compatible with the approach taken to the taxation of foreign-profits. This is because it would eat into the exemptions provided by the new approach to the taxation of foreign-profits.

Consider the basic case of a UK company that borrows in the UK to buy an overseas investment and receives dividend income on that investment. Currently, the UK provides double tax relief on this foreign income, with the company receiving a credit to ensure it is not taxed twice on it. The new approach on foreign profits is intended to simplify this tax relief, replacing the complicated system of credits with a relatively less complex set of exemptions.

This simplified example becomes more complicated once HMRC’s concerns over disguised interest are factored into the equation. Currently, UK-headquartered companies with overseas subsidiaries will take the opportunity to finance the foreign subsidiary by lending to it in a way that reduces its foreign tax liability. Lower foreign taxes are obviously beneficial for the UK company’s investment and it costs the UK Exchequer nothing since the cost is borne by the tax authority in the country of the overseas subsidiary. As this tax planning is done in a way that is compatible with the foreign country’s tax system, the cost is willingly borne by the other country.

However, under the principles-based approach, UK companies would face restrictions in managing their tax

affairs in this manner. This is because it would label these actions as tax avoidance, therefore making such tax efficient financing of overseas operations virtually impossible.

Other states, for example the US, Canada and Australia, accept tax-efficient financing of overseas subsidiaries. This is achieved either explicitly, as in the case of the US, or through the structure of the tax rules. Although direct comparisons of UK tax policy with that of our trading partners are often difficult, it is very clear that companies headquartered in other countries receive the benefit of this type of financing of overseas subsidiaries. The proposed legislation is therefore out of line with some of our major trading partners.

There also appears to be an inconsistency in the UK's policy to the financing of foreign subsidiaries. The effect of the disguised-interest principle would be to deny UK groups the benefits of tax-efficient financing of their overseas operations. Yet the UK currently allows foreign-based companies to finance their UK operations in this manner. Consequently, the disguised interest proposals would mean UK companies would face significantly higher costs when appraising investment opportunities, placing them at a commercial disadvantage to companies headquartered in other major developed nations.

EEF's discussions with manufacturers and tax advisers have raised significant concerns that the proposed rules could undermine the competitiveness of the UK's larger companies. The government therefore needs to allow significantly more time to work through the implications of its proposed approach.

Timing and consultation

We are also concerned that two major changes to the tax system (Foreign Profits and the Principles Based Approach to Financial Products) are being introduced on different timescales despite considerable overlap between them and without sufficient time for consultation within HMRC or with business. Although the recent redrafting of the Principles Based Approach to Financial Products has addressed some of the faults with the initial legislation, the consultation is still ongoing with further changes expected despite the Budget and the start date being imminent.

Moving from a rules-based tax system to a principles-based approach is a radical change of policy. This requires further consultation beyond the current rushed round, to explore with business whether it can achieve the policy objective without creating unacceptable uncertainty for the taxpayer or inappropriate tax treatment of 'innocent' transactions.

Given our concerns about the quality of the draft legislation

and its consequences for competitiveness, we believe this legislation should be delayed for at least one year and aligned with changes emanating from the new foreign profits rules.

Summary

The government's new approach to tax avoidance is born out of frustration at continued attempts by some taxpayers and advisers to plan around targeted anti-avoidance rules.

The new rules will undoubtedly have some success in eliminating tax avoidance, thus meeting the government's objectives of fairness and consistency in tax treatment and simplifying the tax code. Yet EEF believes that the new rules are being rushed through without the appropriate concerns for competitiveness or the uncertainty the approach would create.

EEF therefore suggests there is an urgent need for the government to develop a clearer strategy for business taxation against which tax policies and measures could be judged. Such an approach would have highlighted the problems with a principles-based approach to tax avoidance. It could also be forward looking, providing a framework for properly judging the effectiveness of potential future tax measures.

The lack of a clear strategy on business taxation is undermining progress made in improving business' relationship with tax authorities and, ultimately, hurting the competitiveness of UK business.

3. Encouraging enterprise

Overall framework needs more attention

Major changes taking place in the world economy are reshaping the rewards for fast-growing innovative companies and what they need to do attain them. At the same time developments in information and communications technology are speeding up the pace at which change occurs in markets and the ability of companies to react. This creates opportunities for companies able to identify new markets and react to changes in customer demands. Yet the greater intensity of competition means that companies need to invest in a wide range of areas including technology, design and skills if they are to compete effectively.

These factors increase the need for the UK to develop an enterprise policy that supports companies seeking to grow rapidly, and helps individuals creating new businesses to exploit new opportunities. We therefore welcome the fact that the government is looking at this issue again, with the publication of an Enterprise White Paper in March. We believe that the review is timely given that recent indicators suggest the UK is not making the same progress as its competitors.

Measured as the percentage of the population who are either a nascent entrepreneur or owner manager of a new business, UK entrepreneurial activity dropped in 2006-07 relative to 2004-05 and is below 2002-03 levels as well.³ This is disappointing given that the economic environment for entrepreneurs was particularly favourable over this period with economic growth strong and stable, house prices rising and the cost of credit low. In addition, many of the UK's competitors saw a rise in entrepreneurial activity over the same period. While both Germany and the US had relatively stable entrepreneurship rates from 2002-2007, Japan, Finland and the Netherlands all saw steady growth in entrepreneurial activity. Meanwhile, activity in China has increased by 50%, with Chinese entrepreneurs motivated more by opportunity and economic growth than by necessity.⁴

Given that the UK enjoyed economic conditions that were at least as favourable, if not more so, as many of its competitors, we believe that other factors contributed to the UK's relatively weak performance. We therefore need to look at whether the UK has the right policies in place to stimulate the flow of new entrepreneurs and to support the current stock of entrepreneurs.

³ Global Entrepreneurship Monitor 2007. Entrepreneurs are defined as the % of the population aged 18-64 who are either a nascent entrepreneur or owner manager of a new business.

⁴ GEM (2007).

⁵ Blanchflower (2007), *Entrepreneurship in the UK*, Max Planck Summer Institute on Entrepreneurship Research.

Flow of entrepreneurs

Much of this section is concerned with creating an environment that encourages existing entrepreneurs to continue creating investing in new businesses and helps their companies to grow and attract finance. However, we also need to look at whether we have a sufficiently strong enterprise culture amongst young people in schools and higher education. The government has made a significant investment in enterprise education that is starting to deliver improvements in attitudes towards enterprise. However, it needs to look at how to accelerate progress beyond its current levels. We believe that this will be best achieved by making better use of the existing generation of successful entrepreneurs to inspire the next one. In the US, the spread of an enterprise culture is indeed generational, where the children of the self-employed are 2-3 times more likely than others to become self-employed themselves.⁵

In the UK, a stronger entrepreneurial culture will come about through making it easier for businesses to work with schools, and the government must therefore deliver on its commitment to rationalise the large number of currently disconnected initiatives that bring schools and business together. However, it also needs to look beyond current approaches if it is to encourage significantly more young people to consider starting up their own business.

Existing entrepreneurs

The government also needs to look at how to help existing entrepreneurs become more effective. We set out our proposals under three headings – regulation, access to finance and helping small firms grow.

Regulatory issue

The regulatory burden has a large impact on starting up a business and the ability of existing firms to grow. Given that they lack the specialist staff employed by larger firms, new and small firms are disproportionately affected by regulation. It is therefore vital that unnecessarily complex regulations do not deter would-be entrepreneurs from starting up their own businesses, or eating into the management time that should be focused on improving and growing existing businesses.

Following the Arculus Review, the government has made a good start by setting out a plan to quantify the regulatory burden and reduce it. In the most recent Budget and Pre-Budget Review, the government made significant commitments to reducing the regulatory and administrative burden faced by business. In particular, we welcome the move towards a risk-based approach to regulation driven by

the Hampton Review and the more recent consultation on simplifying VAT rules and administration. However, over the next twelve months the government must show business that it is making real progress, with measures to reduce the regulatory burden that do not just show up as a reduction in costs on the government's indicators, but also genuinely make life easier for business.

Taxation is an important part of the regulatory burden. In the first section we commented on the fact that a majority of manufacturers felt that the tax system had become more complex over the past five years. At the same time we highlighted the benefits felt by larger firms from the measures introduced following the Varney Review, and the case for extending this to SMEs. The simplification measures announced in last year's pre-Budget were also welcome. However, it is vital that these measures to reduce the regulatory burden are not undermined by poor policy-making, with taxes reformed without adequate consultation or time to consider their consequences.

Access to finance

It is vital that firms are able to access finance at all stages of their growth. The competitive pressures they face suggest that a gap in funding can slow or halt growth, undermining a firm's viability. These pressures require a sophisticated approach to understanding small firms' finance issues and the relative roles played by the skills and capabilities of entrepreneurs, the availability of outside finance, business support and the taxation system.

Starting with skills, comparisons with the United States show that UK entrepreneurs are less likely than their US counterparts to have expectations of high growth within five years⁶ or to possess the breadth of skills needed to be successful. The access of a business to external finance depends primarily on its track record, management experience and potential for growth. Yet research conducted by Advantage West Midlands showed that many firms that have failed to access all the mainstream finance they needed, did in fact have a viable business and the capability to take on and sustain debt to support the growth of their business. This finding raises questions about the business-planning capabilities and financial awareness of UK entrepreneurs.

The evidence shows that, on average, UK entrepreneurs tend to be younger, less experienced and less likely to have qualifications such as MBAs than their US counterparts. Being relatively younger and less experienced, UK

entrepreneurs are less likely to have the skills or the financial stability to minimise the risks associated with entrepreneurship. In addition, the 2004 UK Survey of SME Finances found that a large majority of SMEs did not employ a qualified person to manage their finances. This left managers less competent and confident in dealing with financial issues such as applying for external finance as compared to other aspects of their business.

However the breadth of capabilities required to start up and grow a business extends beyond management and financial skills. Although business support schemes are developed on 'management' and 'investor readiness', we believe that the education system in the UK does not provide the range of skills necessary to successfully grow an enterprise.

The university system in the UK, for example, is more specialised than in North America, which tends to be more interdisciplinary and flexible. University students in the US, for example, are required to complete courses in a broad range of subjects, regardless of their specific degree. In addition, US universities and colleges allow students to supplement their primary degree with courses in specified secondary subjects. With a growing proportion of students choosing business as their secondary focus during university, US students may be more likely to have the breadth of skills necessary to be successful entrepreneurs.

Looking beyond the education system, the government can also help new or existing businesses (that developed a new technology, product or concept) to attract finance to help develop it. A key part of this will come about by helping these firms become investor-ready, i.e. they have got to the stage where they have a business plan that will convince potential investors to back them.

Scottish Enterprise has run a successful proof of concept scheme in Scotland that mentors firms to become investor-ready and provides access to finance to help them commercialise their new technologies and products. There are also a number of similar schemes in the rest of the UK but they tend to be smaller and fragmented. We therefore welcomed the Sainsbury Review's to introduce a national proof of concept scheme. It is important that the government now delivers on this recommendation.

Business angels also play an important role in providing outside expertise and finance to enterprise and we believe that this year's Budget should look to increase the impact of business angels. In particular, it should introduce measures that would improve the match up of companies and business angels. This should improve the understanding amongst companies of what business angels can do for them and what is available to assist them.

6 GEM (2007). The definition of 'high growth' is entrepreneurs who expect to create 20 or more jobs in five years' time.

Looking at this from the other end, government should explore measures, such as simplifying the Enterprise Investment Scheme, so that it encourages investment by both individual and networks of business angels. We also believe that it is important that business angels are not put off from making an investment because of a lack of understanding of the industry in which a business is operating.

This can be a problem for manufacturing, which has changed substantially in this decade and has moved up the value chain in a way that is not widely recognised. An EEF survey⁷ showed that small companies (those with less than 100 employees) were less likely than medium or large firms (those with over 100 employees) to believe that financial institutions understood their business or market. Indeed, in discussions with EEF, some venture capitalists suggested that ‘manufacturing’ businesses were likely to be at a disadvantage in attracting equity capital because private investors preferred to finance ‘technology’ firms.

At the same time, businesses need to become informed about the potential benefits provided by outside investors. For example, an EEF survey⁸ of investment performance showed that retained profits was the primary source of finance for over 80% of manufacturers. While this preference may be understandable, there are also a large number of alternative finance solutions available to companies – such as invoice, trade and payroll financing – that may be better suited to the firm’s needs. Using these alternative sources of finance could then free up cash to boost competitiveness through investment in intangibles.

Changes to the way in which enterprise is competing and financing its growth may require the government to revisit its support for enterprise. We welcome the attention by the Business Support Simplification Programme on financial awareness and capability, but the eligibility criteria for this support product is yet to be determined. We believe that business support in developing financial confidence and capability should extend to all enterprise, from start-ups to growing SMEs.

Likewise we believe that government finance schemes, such as the Small Firms Loan Guarantee (SFLG), may need to adapt as enterprises shift the focus of their investment from capital expenditure to more intangible forms of investment.

⁷ EEF (2007), *Strategies for success: How manufacturing is changing investment priorities*

⁸ Ibid.

⁹ Ibid.

¹⁰ Gompers and Lerner (1998), *What drives venture fundraising*, Brookings Papers on Economic Activity – Microeconomics.

¹¹ Poeterba (1989), ‘Venture capital and capital gains taxation’, In Lawrence Summers (ed.), *Tax Policy and the Economy*, MIT Press.

¹² Da Rin, Nicodano & Sembenelli (2004), *Public Policy and the Creation of Active Venture Capital Markets*, LSE.

As these investments are risky and complex to manage and to present to potential outside investors, small and growing firms could be less likely to receive external finance unless they are able to develop the required management and financial skills. Meanwhile, the pressures on profitability faced by smaller firms mean that they are less able to rely on internal finance.⁹ Consequently, small, yet established businesses investing in intangibles are likely to face similar constraints in accessing banking finance as start-ups and younger companies. The SFLG, therefore, should be extended to cover all enterprise from start-ups to established businesses to help firms make the shift to intangible investments.

Looking at taxation, a wide body of evidence shows that lower capital gains tax (CGT) has a significant impact on enterprise through its effect on the risk-reward balance. Not only does a lower CGT rate have a positive and significant impact on the provision of new venture capital funds,¹⁰ it also has positive effects on the supply of investment opportunities by providing workers with greater incentives to become entrepreneurs.¹¹ The result is that a reduction in CGT increases the share of both high-tech and early stage investments relative to total venture investments.¹²

In this respect, the recent concessions on CGT (and particularly the new entrepreneur’s relief), have only partly addressed the negative impact of the changes made to CGT in the pre-budget statement. For example, the requirement to be investing more than 5% of the company and to be a director of the company to qualify for the relief fails to provide any encouragement for arms-length investors. The government should therefore remove the need to be an employee to encourage business angels and reduce the 5% limit to encourage smaller business angels, start-up directors, director teams and individual employees. It also needs to change the lifetime limit position to encourage serial entrepreneurs and long holdings.

The lifetime cap on new Entrepreneurs’ Relief limits the benefits to business angels, venture capitalists and other private investors of the lower 10% effective rate. In addition to investing in small and growing businesses, these investors are also likely to be entrepreneurs themselves. The £1 million cumulative limit is likely to be too restrictive to significantly affect the balance between risk and reward for business investors and so would reduce incentives to invest in business. We believe that the government should regularly review the cap, with a view to increasing support for business angel investment in enterprise.

Helping small firms grow

The government can also play an important role in helping firms with new technologies and products to expand by

providing them with opportunities to develop markets in the public sector. In this respect, the United States has been particularly adept in using public procurement to foster the growth of innovative firms, with key roles played by its US Small Business Innovation and Research (SBIR) programme and by bodies such as the Defence Advanced Research Projects Agency (DARPA) which is responsible for the development of new technology for use by the military.

In the UK, government procurement has failed to punch its weight in terms of getting the most out of innovative businesses. The Sainsbury Review focused on how government support for enterprise and innovation could best be used to help the UK move into high-value goods, services and industries. One of EEF's priorities recommended by the Review was revamping the Small Business Research Initiative (SBRI) in the UK. Modelled on the US Small Business Innovation and Research (SBIR) programme, the UK's version is intended to serve as a publicly-funded venture capital scheme in which 2.5% of each government department's external spending on research is allocated to start-up and growing companies.

Analysis of the largest US programme¹³ showed that companies that won SBIR awards grew significantly faster in terms of employment and sales than a similar set of companies. While the UK government is committed to reforming the programme here in the UK, developing the SBRI in the UK would require government departments to upgrade the skills and quality of public procurers. EEF's report on public procurement and innovation suggested the best way to do this would be through using the Technology Strategy Board and the Office of Government Commerce to help train procurers within government departments. These would be in areas such as risk-management, commercial best practice, technical skills and how to recognise and understand long-term value.

We believe that these reforms would help reposition the focus of the UK SBRI to support innovative new technologies that address government departments' needs. These proposals would also strengthen the emphasis on commercialising business innovations and providing entrepreneurs with markets for their innovations.

¹³ Lerner (1996), "The government as venture capitalist: The long-run impact of the SBIR program."
NBER Working Paper No. W5753. NBER.

4. Delivering the low-carbon economy

Significant business associated with low-carbon economy

Governments around the world are getting serious about combating climate change. Targets for cutting carbon emissions and plans for achieving this are being prepared. The UK has one of the most ambitious targets, with the government aiming to reduce our carbon emissions by at least 60% below their 1990 level, by 2050.

To achieve this target, we will need to make fundamental changes in the type of energy we use and how we use it. Manufacturers will face a major challenge to make substantial improvements in their energy efficiency, requiring many of them to rethink their processes radically. Companies in some industries will also be concerned about the impact of potential environmental taxes and other measures on their competitiveness.

At the same time, climate change will create major opportunities for business to develop, make and sell low-carbon products and services. A recent EEF report, *Delivering the Low-carbon Economy* looked at three such markets in detail – low-carbon energy, motor vehicles and energy efficiency. The UK has significant strengths in all these areas and the potential to make major inroads in these markets. As one of the leading nations in taking action to combat climate change, the UK should also be well placed to take advantage of the opportunities associated with it.

Looking first at energy, the UK has significant potential to develop its offshore wind and marine (wave and tidal) renewable industries. The UK possesses the best wind energy resource in Europe. The potential size of the offshore market and specialist marine engineering capabilities should make the UK an attractive investment location, especially for next-generation turbines designed for offshore deployment. However, UK producers face significant challenges in breaking into well-established global supply chains. Similarly, the UK possesses the largest marine energy resource in Europe and has a range of transferable skills and capabilities stemming from the oil and gas, shipbuilding and power generation sectors.

The global market for clean coal technologies is likely to grow substantially, given that coal is used to generate 40% of the world's electricity and is forecast to remain the dominant fuel for power generation over the coming decades. The UK's strengths in the power, process engineering and offshore engineering industries, the offshore infrastructure stemming from the petroleum industry and an extensive carbon storage capacity also leave it well positioned to take advantage of these opportunities. Two sets of clean coal technologies have particular potential to reduce emissions

from coal-fired plant – advanced combustion technologies and carbon capture and storage – the removal, transport and storage of the carbon dioxide emissions from a coal plant.

Looking at road transport, a range of vehicle technologies and fuels exist which could lower its carbon footprint. Two major areas of opportunity for UK manufacturers are in internal combustion engines and hybrid and electric vehicles. The UK is well placed on engines, given that it accounts for between 25% and 30% of European production. We also possess a number of market-leading designers and developers of engines and engine-related technologies. However, the UK automotive engine industry faces a growing challenge from low cost countries which are beginning to play a significant role in the manufacture of vehicles and engines. UK industry also has significant expertise in a range of key technologies for hybrid cars such as control systems and electric drivetrains. However, in the short-term, lack of consumer demand and of a long-term carbon policy are likely to constrain the market for hybrid vehicles.

Business opportunities in energy efficiency are dominated by motor systems in industry and boilers in the home. Motor systems account for nearly 60% of energy consumption in business. There is considerable scope to increase their energy efficiency. Variable Speed Drives can reduce the electricity consumption of motor systems by up to 60%, by matching the speed of the motor to the requirements of the application. Rising energy prices and awareness of the financial benefits of greater energy efficiency are set to grow the market for Variable Speed Drives, and the UK has a number of companies either manufacturing them or offering design and integration services. However, to realise these opportunities, the industry needs to develop ways to communicate the financial benefits more effectively to the end user.

Domestic heating accounts for a quarter of total energy consumption in the UK. We are the largest gas boiler market in Europe and are major designers and manufacturers of boilers. In the near term, most opportunities will probably be in high-efficiency condensing boilers, which recover and recycle most of the wasted heat lost to the atmosphere from the flue of a conventional boiler. Building regulations require all new installations to be high-efficiency condensing boilers. However, boilers tend to be replaced only every 15-20 years at the end of their working life and incentives will be needed to accelerate the replacement cycle.

Realising the opportunities

Despite the advantages it possesses, the UK will fail to realise the opportunities presented by a low-carbon economy unless both business and government are alert to what they

need to do. In this submission, we focus on some key areas in which the government can support UK manufacturing in this area.

However, the ultimate responsibility for realising these opportunities rests with business. It needs to be creative in thinking about the opportunities that the low-carbon economy will present to develop new products, markets and services. It will also need to act quickly to link into the supply chains being formed to produce the new low-carbon products and establish a toehold in emerging global markets before their competitors.

Manufacturers also need to capitalise on their key role in delivering the low-carbon economy gives it the chance to improve their profile and image, particularly amongst those who would not normally consider a career in industry. More firms need to engage with schools to inspire teachers and students with what they are doing to deliver the low-carbon economy. They also have a major role to play in growing the market for low-carbon products by working with the government to educate consumers on how these products can cut their energy use, save them money and reduce carbon emissions.

Similarly, manufacturers, energy suppliers and the government need to work together to accelerate the uptake of products that will save consumers money in the long-term but which have large upfront costs. For example, a significant number of households could be persuaded to replace their existing boilers more quickly with much more efficient condensing boilers by a combination of a limited grant and the opportunity to spread the costs over a longer period by paying a small levy on their energy bills.

The government has a key role to play in supporting the development of low-carbon products and in removing the barriers that stand in their way. It needs to create and sustain a business environment which will encourage a low-carbon economy to emerge. In some cases, this will take the form of policies to encourage the development of low-carbon markets and in others measures to support UK industry in realising the opportunities that they present. In the remaining part of this section, we highlight some of the priorities for government.

- **Give greater priority to research and development.** Public funding for energy-related R&D in the UK is significantly lower than it is in any of the other major industrialised nations. The establishment of the Energy Technologies Institute is welcome, but the additional funding announced will still leave the UK behind its major competitors. Government must increase support for

energy-related R&D and should use a share of any EU ETS auction revenues to fund the increase. In addition, financial support should be refocused on technologies which offer the greatest long-term abatement potential and/or the most promising economic opportunities for the UK industry.

- **Develop the next generation of scientists and engineers.** Urgent action is needed to improve the supply of employees with high levels of skills in science, technology, engineering and mathematics (STEM) subjects. Lord Sainsbury's review of the government's policies on science and innovation contained a number of welcome measures to improve the quality of teaching of STEM subjects and ensure that young people get good quality information about the career options associated with studying them.

In response, government made a number of commitments. These included increasing the supply of well-qualified teachers in these subjects and investing in the continuing professional development of teachers and careers advisers to ensure that they are up to speed with what is happening in leading-edge manufacturing. In addition, a significant expansion in the number of science clubs has been promised. The government must deliver on these commitments by backing them with resources.

- **Provide targeted support for the wind energy supply chain.** The offshore wind market seems poised for significant growth and next-generation turbines (ideal for that environment) are under development. Whilst some UK companies are at the forefront of these developments, they have difficulty sourcing components locally. Government needs to provide targeted support to improve the capabilities of the UK supply chain.

The Supply Chain Groups Programme should be replicated for the wind industry. The programme successfully assisted the automotive and aerospace industries to improve their global competitiveness. Strengthening the UK supply chain would also make the UK a more attractive investment location for the major turbine manufacturers. Most of these companies are likely to be considering new production facilities in light of the tightening market for turbines worldwide and the UK needs to improve its record in attracting investment from them.

- **Develop a long-term strategy and review support for marine renewables.** The government needs to set out a strategic vision for marine renewables and review the appropriateness of existing support mechanisms. The existing mechanism used to encourage the development of renewable energy – the Renewables Obligation does

not provide the predictability regarding long-term support required by private sector investors in emerging technologies such as marine renewables. In this respect it does not compare well with the support provided in countries such as Germany, Denmark and Spain where feed-in tariffs, guaranteeing a premium price over a long time period, have been instrumental in establishing their wind industries.

The government therefore needs to look at the case for replacing the Renewables Obligation with a feed-in tariff for marine energy. It should also redeploy the support available through the Marine Renewables Development Fund to support R&D that would help developers reduce the cost of their devices.

- **Establish a specific support mechanism for carbon capture and storage.** The UK has the manufacturing base, technological know-how and offshore infrastructure to establish itself as a lead market for CCS. However, long-term policy support is required to complete the development and bring down the cost of the technology. The carbon price signal currently provided by the EU Emissions Trading Scheme (EU ETS) is insufficient as the price of carbon is highly volatile and the future of the scheme beyond 2012 is unclear.

Therefore, an additional and dedicated incentive is required for early projects which carry a 'first of a kind' risk and a disproportionately high infrastructure cost. This could take a number of forms, including: capital grants, tax credits, a feed-in tariff or guaranteed minimum carbon price. A share of the revenue raised from the auctioning of allowances in the power sector under EU ETS should be used to fund the support.

- **Long-term and realistic European carbon dioxide targets for road transport.** Significant, and potentially high-risk, investments are required to develop low-carbon vehicles. The product development cycle takes several years. Therefore, any policy to constrain carbon dioxide emissions from road transport must have a long time horizon and respect the product development cycles of manufacturers.

At the time of writing, the European Commission is considering the introduction of mandatory carbon dioxide targets for new cars, based on the average carbon dioxide emitted per kilometre travelled. The UK government must use its influence to ensure that any such policy has a long enough time horizon to drive the investment required and that the emission reduction targets set provide manufacturers with sufficient lead-time to develop new products in response.

- **Reform support for Micro Combined Heat and Power (CHP).** A number of micro-generation technologies exist. Micro CHP, which could be a direct replacement for gas boilers, is particularly promising for UK industry. The UK is the largest gas boiler market in Europe and has a number of major boiler manufacturers capable of developing and supplying micro CHP products. However, the comparatively high cost of micro CHP could act as major barriers to its uptake.

Government should explore options for encouraging the installation of micro CHP. These could include financial incentives to purchase micro CHP systems (e.g. a cash back scheme) and guaranteed payment for excess electricity generated (e.g. feed-in tariffs).

The Low-carbon Buildings Programme, the only significant support mechanism for micro CHP currently in place, is in urgent need of reform. Specifically, government should reconsider the requirement for those planning to install a micro CHP device to seek planning permission prior to applying for funding. It also needs to start investing in the skilled staff required to ensure that an appropriate number of installers of micro-generation products can be certified at reasonable cost.

- **Improve our housing stock.** Although in many cases the individual householder would benefit in the long term from making the investments necessary, people typically do not think in the long term, either because they do not intend to remain in their property for sufficiently long or because they have shorter-term spending priorities.

Government has introduced Energy Performance Certificates which will provide house purchasers with an authoritative assessment of the energy efficiency of the house they are looking to buy and the measures they could take to improve this. This needs to be backed with a fiscal incentive to encourage households to make this investment. For example, a refund on some of the stamp duty they pay (providing they invest within the first 12 months of moving house) – this would significantly influence their spending priorities in a way that support the government's programme to reduce carbon emissions in the UK.

- **Make low-carbon products more financially accessible.** Low-carbon products need to be made accessible to as wide a range of consumers as possible. Initially at least, low-carbon products will tend to be premium products – i.e. they will cost more than their conventional equivalents. Government needs to strengthen financial incentives for the uptake of those products which offer both significant abatement

potential and major opportunities for UK industry. Meanwhile, manufacturers will need to support low-carbon products with a range of financing options that will make them more affordable and broaden their appeal.

For example, incentives to accelerate the retrofitting of condensing boilers should be a major priority. Domestic heating is one of the major sources of energy consumption and carbon emissions in the UK. Condensing boilers are considerably more efficient than traditional boilers and the UK has a major condensing boiler industry. Market penetration of condensing boilers in the UK is above average and rising.

However, because boilers have a long lifespan and incentives for early replacement are limited, a large stock of inefficient boilers could remain for a considerable amount of time. Government should provide an attractive and tangible financial incentive, such as a meaningful cash-back scheme, in order to accelerate the retrofitting of condensing boilers in British homes. This could involve a partnership with energy suppliers to help households overcome the upfront costs associated with purchasing a condensing boiler.

- **Enable consumers to make informed decisions.** Consumers need simple and reliable means through which to compare both the carbon footprint and the energy consumption of different products. Government and industry need to work together to develop easily understood measures of the product's footprint. A number of carbon-labelling initiatives are already being developed in both the public and private sectors. These efforts need to be coordinated to ensure that messages to consumers are consistent and to avoid undermining the credibility of carbon labelling.



About us

EEF is a trusted partner to thousands of employers around Britain. We work on behalf of over 6000 companies, in manufacturing, engineering, technology and beyond. Together, they employ close to a million people. On any given day you'll find us helping our members tackle a whole range of employment challenges.

Our regional Associations bring us much closer to the businesses we support, whilst our offices in London and Brussels stay equally close to government – influencing the way policy is made and alerting our members to any changes in legislation that might affect them.

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