The manufacturers' organisation

# Submission for Spending Review – 2015/16 - 2019/20

The Spending Review needs both to consolidate Britain's public finances and to focus spending priorities towards promoting future economic growth. Investing in a stronger more productive economy is the best foundation for a healthy and sustainable Exchequer in the long term.

EEF members support the government's objectives of balancing the books, boosting trade, increasing the number of quality apprenticeships, investing in infrastructure, and reducing cost and regulatory overhead. A spending review that delivers on those objectives needs to do more than apply an across-the-board cut: it must prioritise and protect investment in innovation, export promotion, skills, and infrastructure – especially roads – in order to support businesses' own investments and build the foundations of future sustainable prosperity. However the approach is described, it should be anchored in partnership with business and add up to an industrial strategy.

For manufacturers, the Spending Review comes at a time when the global economic environment is uncertain, world trade growth is slowing, and the challenge to remain competitive is pressing. The review's outcomes must shore up firms' confidence to invest and hire, and must not add to the costs and challenges of doing business globally. Manufacturers hope that clear prioritisation of public spending, together with the forthcoming road map on business taxation, will provide certainty for businesses seeking to invest and grow in the UK over the medium-term. Spending cuts that undermine investment confidence, damage competitiveness, or reduce certainty would be at odds with the government's productivity ambitions.

The government has already announced a small number of fiscal proposals which are not welcome and will be developed in the Spending Review. Against an overall background of cuts to spending, the government is proposing to increase taxes on business through a training levy to fund spending on apprenticeships. This comes on top of a number of other new costs, including proposed tax changes for company pension funds and a levy on hiring much-needed staff from overseas. Whether the levy can, as the government hopes, create effective incentives that reward firms providing high-quality apprenticeships will depend on how it is designed and there is a lot of work to be done in partnership with businesses to get that right.

EEF does believe government can be cheaper, smarter and more effective and this submission contains a number of proposals for improving the efficiency of public spending.

**Recommendations:**

1. Policies relating to business should be brought more closely together in a single Business Department to save money and align policies more effectively.

2. Economic devolution to cities and counties should have business-led LEPs built into local governance so that the business voice is a key part of their accountability.

3. The government should maintain investment in innovation through Innovate UK and fund the Catapult centres so they can sustain the "one-third, one-third, one-third" target financing model.

4. The UK should look to achieve real terms increases in both science and innovation expenditure by the end of the Parliament.

5. Any reform of export support should preserve UKTI's outward-facing, customer service element which businesses are familiar with. Export support services should remain with UKTI. Other government departments can do much more to own export promotion activities in their areas.

6. Government funding to the British Business Bank (BBB) should be maintained.

7. Existing commitments to protect the competitiveness of Energy Intensive Industries should be honoured through the full compensation package for EU ETS, the Carbon Price Support and renewable levies.

8. The apprenticeship levy must be not be diverted into paying overhead or start-up costs, the policy objective that firms which train should receive more than they pay should be implemented at the level of individual firms as well as in aggregate, and employers should control the way levy money is spent though the voucher system.

9. Remedial English and Maths within vocational training is an unwanted cost of failure in schools; it should be funded from within the DfE schools budget, and not charged to employers or the adult skills budget.

10. There is no need for an apprenticeship levy on employers recruiting from overseas; this proposal was made before the general apprenticeship levy was announced and is now redundant and should be dropped.

11. Funding for both national and local roads should be protected, with no further diversion of money from roads into railways; the hypothecation of VED should fund both local roads and Highways England; and this protected funding should be anchored in a longer-term National Infrastructure Plan.

12. Local Growth Deals and the Single Local Growth Fund should continue as a competitive funding stream. The Regional Growth Fund can be discontinued.

## Economic and fiscal context

13. The Spending Review should both set a sustainable course for public finances, and implement the government's wider economic strategy by supporting productivity improvement, long-term investment, private sector growth and job creation.

14. The UK economy is on track for another year of solid growth, as labour market improvements have been sustained into 2015 and a pick-up in wage growth finally materialised. Yet the legacy of the financial crisis – now some seven years ago – has left a number of deep imprints. The repair job needed on public finances has been more challenging and taken longer than hoped, a hangover of compositional imbalances lingers, and the economy is suffering from comparatively weak productivity growth – both in terms of past performance and compared to that of our major competitors.

15. Moreover, the wider economic backdrop of this Spending Review is again one of uncertainty and turbulence in global markets. While the eurozone has navigated another Greek bailout package to hold the currency bloc together, more recent developments in China could pose more significant policy challenges in both emerging and developed economies. In a recent survey of manufacturers, almost half of respondents said they were concerned about the potential slowdown in China and were monitoring the impact on their businesses. Global trade is slowing, hitting exports. The government will want to continue demonstrating a degree of flexibility in hitting fiscal targets and monitor the impact of cuts on growth while global economic prospects look fragile. And it will be important that individual spending decisions should not damage businesses' confidence and willingness to continue investing and hiring.

### Addressing fiscal and economic challenges together

**Productivity on a strong growth trajectory**

16. Government has outlined the potential prize to the UK economy of raising our productivity performance. Manufacturers have a track record of relatively strong productivity growth and in the decade to the financial crisis the sector saw significant catch up and convergence with competitors.

17. In the post-war period, manufacturing productivity, as measured by output hour, has increased almost twice as fast as in the whole economy – 2.8% compared with 1.5%. The UK manufacturing sector is not unique in this respect. Across the developed world, before and after the recession, manufacturing has a better track record in improving productivity than the whole economy average.

18. Many of the key contributors to stronger productivity growth are evident in manufacturing:

    - A higher degree of export intensity exposes firms to competition, pushing them to be more productive and can be a spur to improve management capability. Manufacturers are more than twice as likely to be exporters than other sectors;

- Investment in innovation leads to the development of new products, processes and services and supports the exploitation of new technologies. Manufacturers' investment in R&D is six times higher than their output share of the economy;
- Investment in modern machinery and ICT improves efficiency and accelerates the diffusion of technology. Manufacturers' investment in machinery is three times higher than their output share of the economy; and
- Higher skills levels are associated with more productive sectors and firms. Between 2000 and 2013 the proportion of hours worked in manufacturing by employees with no qualifications has halved and the share worked by employees with a degree has increased by nearly 60%.

19. In a recent *EEF Innovation Monitor*[1], 95% of companies planned to make some form of investment in the next two years to improve productivity within their business. This ranged from almost four in five manufacturers planning investment in new technology and machinery, to 60% and 30% planning to increase spending on workforce and management skills respectively.

20. Yet sustaining these investments could become more challenging as recent evidence from the sector suggests that output growth has stalled and demand at home and from overseas has weakened in 2015q3. EEF's latest *Business Trends Survey* shows that all measures of output and orders have dipped into negative territory for the first time in almost six years. While investment and recruitment balances are still positive, there are mounting downside risks to this persisting if output and orders weaken further in the coming quarters.

21. The Spending Review should aim to mitigate the risks surrounding businesses' investment in productivity improvements, and it would be perverse for a pro-growth government to worsen them instead. The review's priorities should align with the private sector's ambitions. It can achieve this by reducing barriers to growth for manufacturers and supporting stronger expansion of this higher-productivity sector, and also by investing in areas of the business environment that enable growth across all sectors such as critical underpinning infrastructure. Retaining a collaborative approach to working with Industry partnerships should also reinforce the decisions taken in the Spending Review.

**The spending envelope**

22. The spending envelope implied by the July Budget statement has some clearly identified priorities – the need for further investment in key public services, and the UK's intention to maintain its international obligations such as overseas aid.

[1] EEF (2015) Investment Monitor: Investing in Productivity

23. Decisions to maintain some of the existing ring-fences to department spending into this Spending Review period have significant consequences for other department spending limits. The July Budget announced some re-profiling of spending reductions over this parliament, but estimates from the Institute for Fiscal Studies put the cuts to unprotected departments at 13% in real terms over the next three years.

24. As set out in our Budget submission, EEF would not support an across-the-board tariff cut for all unprotected departments. Instead, government should make investment in future growth, especially productivity improvement, a priority and protect it. Boosting future revenues though economic growth is the only sustainable way to consolidate the public finances.

25. Government has demonstrated its commitment to growth in its manifesto commitments – targets for apprenticeships starts, the value of UK exports, employment increases and reduced regulation, and more recently in the Productivity Plan, which sets ambitions on long-term investment, infrastructure and high-quality science and innovation. The Spending Review process is the next step in identifying how these should be delivered and what resources should be allocated to achieving them.

**Government structures and institutions**

26. The consequences of these decisions could be long-lasting, therefore it is right that the Spending Review considers appropriate delivery mechanisms, institutions and governance to deliver these outcomes.

27. The move towards greater devolution of responsibilities to English cities and regions is potentially a significant strategic shift in policy and governance and will require focus to ensure powers devolved are entrenched and put to the best use of local economies. A first priority is to put in place the right frameworks to ensure businesses start to trust and work with evolving institutions. For more significant devolution to be a welcome prospect, local areas need to develop the capacity and capability businesses feel are lacking.

28. Businesses have experienced false starts on devolution and are wary of engaging with another set of changes. Government is therefore right to make directly elected Mayors a condition for the devolution of far reaching powers, as this will serve to entrench Deals at the local level and allow visible leadership.

29. The business voice is a vital part of stronger and sustainable accountability. Within the last parliament, government established business-led Local Enterprise Partnerships (LEPs) to spearhead the identification of local barriers to growth and to identify the most appropriate policy levers to deliver long-term growth and productivity improvements. As Combined Authorities negotiate and put forward Devolution Deals, LEPs and the business voice must remain part of local frameworks to ensure this remains the focus.

30. As part of this Spending Review, government should:

    a. Ensure LEPs remain in place to continue to drive greater levels of collaboration between local authorities and ensure a focus at the local level on barriers to growth; and

    b. In areas that are moving towards a Combined Authority structure, including negotiating Devolution Deals, ensure business-led LEPs retain a strong role by re-establishing them, where appropriate, as business-led oversight and scrutiny committees as part of the emerging frameworks.

31. Other, more radical solutions should also be explored to reorganise the costs of government. Businesses want 'joined up government' to be more than an aspiration. Central government structures should be organised around solutions to economic or social challenges, rather than representing the interests of public service providers. There is a clear requirement for a government department focused on working with wealth creators to achieve this, given the need to address the challenge of poor productivity and sustain growth.

32. This amounts to a case for a business department that leads on what the business customer needs in international trade, on company and employment law, skills for employment – including all education provided to people who are old enough to be in the labour market – science and innovation, industrial energy policy, better regulation, and security of supply of economic resources. It could also, arguably, take on the vital business support functions of transport and digital infrastructure, and ensure housebuilding and development gets planning permission effectively.

33. Such a move could bring two potential benefits. Firstly, as such a department could be much leaner, it would waste less time and money in resolving battles over resources and priorities between conflicting silos. It could be effective with fewer senior staff, fewer policies, and a much clearer set of messages. Secondly, it would be cheaper because its business model would be to ensure business gets what it needs to grow.

34. Consideration of the costs and efficiency of central government should be a first step in improving productivity. However, its overall contribution to productivity growth will be small – certainly in the short-term – compared to the potential of other economic sectors.

35. Given this backdrop and manufacturers' efforts to invest, innovate and compete globally, the rest of our submission will set out the sector's priorities under four levers of future economic growth:

    - Enabling innovators and exporters to grow;
    - Creating the conditions for cost competitiveness;
    - Supporting a productive and adaptable workforce; and
    - Investing in resilient underpinning infrastructure.

## Enabling innovators and exporters to grow

36. Innovators and exporters provide a substantial part of the solution to the UK's productivity challenge. Companies which invest consistently in the development of new and improved products, processes and services are creating more value-added with fewer resource inputs, thus boosting both productivity and long-term growth. Such innovations can open the door to new domestic and foreign markets, contributing to the UK's aim of economic rebalancing.

37. UK manufacturers are prioritising both of these activities, which require resources and external expertise in order to get commercial results faster and more effectively. Government investment in enabling support services and infrastructure makes a big difference to outcomes, by facilitating important collaborations, joining up businesses with the research base and providing facilities that would be uneconomical for individual businesses to invest in. This support operates where the private sector alone would struggle to secure the same outcomes.

38. Also, some of these investments – particularly in science and innovation – are a key anchor for internationally mobile investments that deliver growth and good jobs economy-wide.

### Investing in science and innovation and backing industrial strategies

39. Creating, developing and commercialising new ideas and technologies provides a mechanism to boost productivity and exports in the short term and also creates longer-term growth opportunities for the UK economy.

40. Yet innovation is challenging for companies, and government support has an enabling role to play. Government science and innovation expenditure can crowd in private sector investment.[2] Direct support and schemes that encourage match-funding or collaboration are particularly effective at increasing both the level and effectiveness of innovation.

**Making the UK the best place to innovate**

41. The government's Productivity Plan notes that supporting collaboration – both within the UK and internationally – is a key way to boost innovation, improving the efficiency and supporting the quality of research. Collaboration should remain a key tenet of innovation policy. For manufacturers, collaboration – with their customers, the research base, or others – is a key way of overcoming the barriers to innovation, enabling them to make use of specialist expertise and facilities to which they would otherwise not have access. It is critical that these remain the underpinning principles for future investment in science and innovation over this Parliament.

[2] BIS (2014) Insights from International Benchmarking of the UK science and innovation system

**Manufacturers are already innovating, though returns can be uncertain**

42. Manufacturers are already investing heavily in innovation. EEF's latest Innovation Monitor survey shows that 94% of manufacturers engaged in innovation in the past three years, and over one third engaged in three or more types of innovation – for example product, process and service innovation - over the same period.[3] Such investment is delivering returns for manufacturers, but the returns can be highly uncertain.

43. This has a noticeable impact on success rates. Amongst all manufacturers looking to move into new export markets there was a 68% success rate but for those who said there were resources they would have liked to use but were unable to do so, the success rate was 45%.

**A breadth of government support helps companies overcome resource constraints**

44. The key resources manufacturers are unable to use – even though they would like to – are specialised expertise and equipment. Investing in these would often not make sense for one business by itself, such as high value testing equipment that they may only need to use for a small period of time, or expertise to address a specific problem. External finance and external factory floor space are lower priorities. If the government is to achieve its goal of the UK becoming the best place in Europe to innovate, therefore, support cannot just be about finance.

45. The table below shows that existing support provided by Innovate UK is well-aligned with these needs. The support is also working. Our Innovation Monitor 2015/16 showed that nearly all manufacturers who accessed support found it fully, or partially, met their requirements when innovating.

| | Funding/ cashflow | Access to expertise | Access to facilities | Building network | De-risking collaboration | % manufacturers using scheme |
|---|---|---|---|---|---|---|
| **Knowledge Transfer Partnerships** | * | ✓ | ✓ | | ✓ | 23% |
| **European Funding (e.g. H2020)** | ✓ | | | | ✓ | 15% |
| **Collaborative R&D** | ✓ | | | | ✓ | 13% |
| **Knowledge Transfer Networks** | | | | ✓ | | 12% |
| **Catapult centres** | | ✓ | ✓ | ✓ | ✓ | 6% |
| **Smart** (SMEs only) | ✓ | | | | | 6% |
| **Innovation Vouchers** (SMEs only) | ✓ | ✓ | ✓ | | ✓ | 3% |
| **SBRI** | ✓ | | | | | 3% |
| ***Source: EEF Innovation Monitor 2015/16*** | | | | | | |

[3] EEF/Vodafone Innovation Monitor 2015/16

46. Furthermore, our research shows that there is no demand for new schemes at this time. Of those EEF members who did not apply for support, one of the least cited reasons – at 9% - was that none of the support available was relevant to them. This compares with half who said that application processes were too long-winded, and 41% indicating they had insufficient knowledge of support. Critically, Innovate UK programmes are self-selecting in that they only support companies with the best ideas and the capability to turn them into a commercial reality rather than seeking to encourage firms to innovate. In the context of limited resources, we do not see encouraging companies to innovate as a role for government: it is implementation support that matters.

**Catapult centres are filling a gap in the innovation ecosystem**

47. As one of the flagship Innovate UK programmes, the Catapult centres are an important addition to innovation support, filling a gap in the innovation ecosystem. This is evident in high levels of business demand since their inception. The Hauser Review of the Catapult network noted the High Value Manufacturing (HVM) Catapult has experienced significant levels of industrial demand since its inception in 2011, considerably beyond the levels originally forecast. The HVM Catapult Annual Review for 2014-15 shows that it has already worked with 1514 companies, of which 41% were SMEs.

48. The Dowling Review[4] found that the centres are now a key part of the innovation ecosystem, stating that "while they are at a relatively early stage in their development… the results so far have been promising, with positive feedback about the establishment of the Catapults widespread".

**The Catapult centres need appropriate funding**

49. The Catapult centres will only continue to fill a gap if they have sufficient state funding to enable them to operate in the riskier mid-stage technology readiness level (TRL) projects, in other words, the 'valley of death'. If funding becomes too skewed towards the private sector, then research activity may become too focused on later-stage TRLs where there is less of a need for support from government.

50. International best practice points to a "one third, one third, one third" funding model, with income coming from core government funding, competitive funding and industry funding in roughly equal measure. For the HVM Catapult it has already moved very far from this point. Industry funding now accounts for about half of total funds, while core funding is less than one fifth. Government should work to the principle of funding Catapult centres on a "one-third, one-third, one-third" basis. This means additional funding to meet this aim is prioritised ahead of expanding the network too quickly.

51. We would also caution against trying to create a 'local network' of Catapults too quickly. The centres should focus on excellent, rather than local, provision. Our research shows that innovative companies – even SMEs – will often choose collaborative partners well beyond their local area, with expertise and opportunity more important factors than place.

[4] The Dowling Review of Business-University Research Collaboration (2015)

**A successful Industrial Strategy approach needs strong rationale and a robust review process**

52. Support provided by Innovate UK enables the bottom-up development of new ideas – regardless of sector or technology area – through mechanisms including support for collaboration, provision of finance, equipment and expertise. Yet there are some large social and economic challenges – such as environmental issues and demographic change – where the UK should take a leadership role. This requires sustained and strategic investment.

53. Industry can be part of the solution to these challenges, but the size of the challenges means that addressing them will require the kind of coordinated action that can only occur in collaboration with government. This is something which an Industrial Strategy approach – however labelled - can deliver through coordinating investment, building a critical mass around new and existing technologies, and encouraging collaboration.

54. At the very least this requires a dialogue to be maintained between industry and government, but government should also look to make investments where necessary, within a clear framework for doing so. This could be achieved – as the Dowling Review suggests – by prioritising investment in sectors, conditional on a commensurate increase in R&D investment by business.[5] An alternative measure might be an increase in an industry's productivity levels.

55. For industry this provides certainty that – where improvements are being made – government's investment will continue. At the same time, it gives government an assurance that its investments are delivering value for money and enables an exit strategy if partnerships are no longer working.

56. This could be extended to other areas of the innovation support landscape. For example, although the Catapult centres are relatively new – and we would caution against piling on too many requirements initially – the Hauser Review recommends that Innovate UK and the Catapults should work together to develop more sophisticated KPIs that sit within Catapults' Grant Funding Agreements, to incentivise impact and engagement with industry whilst still ensuring that Catapults work ahead of the market.[6]

57. If Catapults continue to meet their KPIs, then their funding should be assured but this will also give an early indication if individual centres are starting to fail.

**Funding for science and innovation should be maintained. There should be a commitment to real terms increases by the end of the parliament and certainty about the trajectory of spending.**

58. In order to deliver long-term productivity growth and address major socio-economic challenges, both science and innovation require long-term investment and certainty of funding. The alternative – a feast and famine approach – can be highly damaging. "Feast" periods can lead to frustrating implementation delays and poorly prioritised spending whilst "famine" periods can erode the skills and infrastructure necessary for successful innovation.

[5] Dowling Review of Business-University Research Collaborations (July 2015)
[6] Hermann Hauser (2014) Review of the Catapult Network

59. This is clearly the case for Innovate UK, which – due to the long term nature of innovation funding – must commit many of its funds in advance. A cut to funding, even further down the line, would limit the extent to which it can provide support to companies straight away. Data from Innovate UK's annual report shows that at the end of the financial year 31 March 2015 Innovate UK had £767m worth of commitments payable within one year and a further £1693m payable within 2-5 years. This compares with an annual budget of £615.9m in 2014/15.

60. As we have shown in previous sections, firms have a need for schemes that help de-risk innovation and enable them to make use of expertise and facilities that they would not be able to access by themselves. Cuts to existing support levels would immediately reduce what Innovate UK could fund, causing frustrating delays and rejections in receiving funding.

61. This, and uncertainty around which schemes are available, will reduce uptake of support over the longer-term, further reducing potential innovation outputs. Indeed, our Innovation Monitor survey showed that 23% of EEF members who did not use innovation support said the reason was because support schemes changed too frequently for them to understand them.

## Enabling exporters

62. One of the most persistent challenges facing the UK economy has been the poor performance of our exports. Weakness in our major markets – particularly in Europe – has played a major part in this. The picture is not all bad, and manufacturers have had some success in expanding into new markets around the globe, but finding fresh export destinations and building a sustainable export business overseas is one of the most challenging things manufacturers can do.

63. Government can help businesses achieve export success: promoting the UK overseas, helping businesses overcome obstacles such as trade barriers, a lack of knowledge about opportunities and differences in business practices. Ministers have embodied their commitment to back exports in its target for UK exports to reach £1 trillion a year by 2020. The recent creation of an Export Taskforce also highlights the government's commitment and is an important step towards ensuring all government departments are pulling in the same direction to support and encourage exporting.

64. The government's Productivity Plan highlights two key areas where government must play a role: supporting diversification of export markets, and – linked to this – supporting trade agreements beyond the EU. Both of these are valuable:

    a. Enabling exporters to move into new markets should promote more sustainable economic growth; and

    b. Free Trade Agreements can be central to increasing trade opportunities, often leading to lower tariffs and barriers to trade, such as product standardisation and customs procedures, and can significantly open up trade between signatory countries. 82% of EEF members said it was very or quite important that the UK government got action on increased access to non-EU markets through Free Trade Agreements within the EU.

65. Recent policy announcements such as the £20m of additional support to increase UKTI's regional network of International Trade Advisors announced in 2014 and additional funding for UKTI activities in China were well directed:

    - International Trade Advisers: The role of UKTI's International Trade Advisers is highly valued by manufacturers. In particular, feedback from our members highlights the importance of the relationships they build with their UKTI advisors, who can be key to the support, help and advice they receive; and

    - Trade missions: trade missions from the Prime Minister and other senior ministers play an important role in promoting the UK's brand and capabilities overseas.

66. As a whole economy issue, having the whole of government behind the exporting agenda is a positive move; having the support that is needed across departments is important, especially where barriers to exporting fall out of the remit of UKTI. The export target has focused minds and is helpful in generating dedicated efforts to reaching it.

**Support should be broad**

67. There are a number of challenges facing exporters and a number of different types of companies that might require support: export support should not be one-size-fits all. A range of schemes is necessary to reflect the myriad of exporting strategies and levels of experience.

68. While emerging and high-growth markets offer important opportunities for UK exports, ultimately, an exposure to a range of markets is most likely to deliver a resilient export performance.

69. Whilst considering the export journey that manufacturers go through, we see the key export support areas for funding as:

- Tailored advice and guidance from local International Trade Advisors;
- In-depth market knowledge and commercial contacts from overseas trade teams in embassies, high commissions and consulates around the world; and
- Support given to companies to secure large export projects through the High Value Opportunities programme.

**Exporting is challenging enough – support should be simple and certain**

70. Stability in accessing support is important, especially where companies see it is already working. EEF research on innovation support schemes shows that if a range of support schemes are maintained on a stable footing this can boost both awareness and uptake, thus helping companies achieve successful outcomes faster than they would have in the absence of it.

71. Many companies report that their relationship with their local UKTI International Advisor is often key to the support, help and advice they receive. The service level of support that companies expect will need to be maintained, especially with the background dialogue of the importance of the exports to economic and productivity growth.

72. It may be the case that UKTI can be structured in a more efficient and streamlined manner behind the scenes, but EEF members do not demand change to the outward-facing, customer service element. Any changes should be clearly and simply communicated to users so as to uphold the high levels of trust in the service.

73. A distinction could be drawn between export support, and promotion, activities. Export support services should remain with UKTI, to ensure continuity of service and customer satisfaction. Export promotion activities – for example, those promoting capabilities and expertise in different sectors – could sit within other government departments.

74. UKTI must therefore have the funding to be able to support UK businesses to the best of its ability. A predictable and stable support environment for exporting needs to be matched with a predictable and stable funding stream. This will allow UKTI certainty to put in place plans and strategies for the long-term, and provide businesses with reliable and consistent support.

**Support should enable manufacturers to build their business overseas**

75. To sustainably grow the UK's exports in new markets it is not enough for companies to export there once, they must be able to build their business and sales. Export finance can be particularly valuable for manufacturers looking to sell into new markets, playing a role in de-risking transactions, but this help cannot be one-off. UKEF's focus should be expanded beyond supporting individual transactions to provide more campaign-based support that enables companies to grow their businesses in a sustainable way in new markets for the long-term.

## Competitive finance for investment

76. Innovation, export growth and investments in new technology place significant financing demands on manufacturers. A large proportion of this will be met from internal resources, but companies also need access to external finance on reasonable terms and to have the support of financiers which understand their business.

77. Government funding to the British Business Bank (BBB) should be maintained in the next Spending Review period. The UK's financial sector continues to exhibit a lack of competition between finance providers and products – with 80-85% of business current account market share held by the four largest banks[7] – limiting the supply of finance to viable SMEs and hence the growth potential of the UK economy.

78. The SME Finance Monitor[8] shows that despite improving market conditions over the past two years, the level of SMEs using external finance has consistently decreased – from 50% in Q1 2012 to 36% in Q1 2015 – while the number of permanent non-borrowers[9] has increased significantly – from 30% in Q1 2012 to 48% in Q1 2015. The Bank of England's Credit Conditions Review for 2015q2 also shows that net lending to SMEs has been declining for most of the post-crisis period with only tentative signs of a pickup in 2015.

79. The BBB's objectives therefore remain pertinent to the current state of credit conditions in the UK. The BBB plays an important role in fostering competition in financial markets and should receive adequate funding to continue to increase and diversify the supply of finance to SMEs.

80. Given the focus the government has placed on improving the UK's export performance, adequate funding should also be administered so the BBB can develop additional export finance products, as well as working with UKEF on improving their product mix and promotional activities.

[7] Competition and Markets Authority (CMA), 'Retail Banking Investigation: Updates Issues Statement', 21 May 2015
[8] BDRC Continental SME Finance Monitor available at http://bdrc-continental.com/products/sme-finance-monitor/
[9] Permanent non-borrowers are businesses that are not using external finance and show no inclination to do so

**Regional growth fund**

81. In contrast, the Regional Growth Fund has run its course and government should rule out committing additional funding to its continuation. The Regional Growth Fund was a successful scheme for the targeting of support necessary after the economic downturn, helping to support investment and job creation. Focus in the future should be on programmes which enable businesses to increase their levels of export or which help manufacturers help themselves to innovate more effectively.

## The defence sector

82. The Chancellor has announced that the government intends to meet the NATO target of spending 2 per cent of GDP on defence. Within that total, £160 billion is due to be spent on defence equipment over the ten years to 2024. Decisions taken as part of the Strategic Defence and Security Review (SDSR) will shape the impact that expenditure has on the security of the nation, and on industry.

83. Manufacturers have two interests in the outcome of those decisions. As exporters, they need a safe and stable international environment, and it is UK defence and security policy which contributes to that most effectively. Yet it is also the case that the defence of the realm is an enterprise in which industry, especially manufacturers, plays a direct part. More than half the competencies needed to deliver the whole force concept expressed in the government's Future Force 2020 strategy are to be found in the private sector. Industry sustains the UK's capability to project force globally – whether through the industrial capacity needed to deliver the Trident Successor programme, or the shore support teams that the Queen Elizabeth class carriers will need for overseas deployments, or through firms' commitments to reservists. In the modern world, industry is part of the order of battle.

84. The SDSR needs to start from a credible National Security Strategy based on an up-to-date threat assessment. It must recognise that the global security environment has changed significantly since the previous Review in 2010, and describes the actual risks and tasks the UK's armed forces are likely to face. The SDSR should follow from that analysis and be grounded in a credible account of the UK's capability and risks. Welcome as the headline commitment to defence spending is, the resource envelope should not be the starting point for the SDSR if that leads us simply to spend more on a strategy that has been overtaken by new threats.

85. The new strategy should be holistic, in several ways. At the most obvious level, it should recognise the trade-offs involved in decisions about new platforms. Off-the-shelf purchases, for example, may represent very bad value for money if the opportunity costs of failing to integrate new platforms with existing UK technologies and capacities are taken into account.

86. The Review should also take as its starting point a view of national defence as an overall enterprise, and result in a strategy for that enterprise. MoD, as the ultimate customer, needs to develop a much better understanding of the value chains involved in its decisions, and in particular recognise where lower-tier suppliers, many of them SMEs, represent unique UK industrial capabilities that are the engine of future innovation and productivity growth. There is a case for explicitly recognising, and even mandating, UK content through the supply chain. This should not be made the responsibility of prime contractors alone, and requires a step up in MoD's own capacity to understand industry. The governance of its procurement decisions should be improved, and the emphasis of the Defence Growth Partnership should widen.

## Creating the conditions for cost competitiveness

87. Manufacturers in the UK win new business and grow because they compete on quality, service and through the collaborative relationships they build with their customers and supply chain.

88. The cost base in the UK still matters. The UK will not secure vital investment and good jobs if we are a more expensive place to do business than our competitors. Industry cannot shoulder a disproportionate share of any costs or new revenues needed to repair the public finances as our export intensive sectors will be placed at a global disadvantage and our economy will pay the price in the long-run.

89. The government has committed itself to reduce industry's cost base through deregulation, and the £10 billion target for regulatory reductions is welcome. However, the government has also proposed fiscal policy changes, for example on the taxation of pensions, and the proposal for new payroll levies to fund training (discussed below), which will increase business costs and are not.

### Energy intensive industries compensation package

90. It is widely accepted that the costs of energy and climate change policy in the UK are placing our energy intensive industries (EIIs) at a serious competitive disadvantage. Action has been taken to address the concerns of industry, for example, with the introduction of compensation payments for the EU ETS in 2013, the Carbon Price Support in 2014 and a commitment to commence payments in relation to renewable levies later this year and next. Having recognised the importance of the issue and the very real threats these policy costs pose to industry, it is imperative that government stands by its commitments and ensures provision is made for the introduction of the full package as part of the Spending Review.

91. In the absence of any compensation measures it is estimated that the 2015 costs of climate change policy in electricity bills would be in the region of £600 million a year to EIIs, or a cost of £30/MWh. The introduction of compensation for the EU ETS and the carbon price floor has reduced this cost down to £22/MWh but this still means EIIs in the UK are exposed to far higher costs than elsewhere and face a total cost of £430 million this year. Analysis carried out for BIS provided the following estimates of policy costs experienced by EIIs elsewhere in the EU:

| Country | Estimated policy cost (£/MWh) for EIIs in 2015 |
|---|---|
| **Denmark** | £12 |
| **France** | £6 |
| **Germany** | £13 |
| **Italy** | £16 |

***Source: ICF International, An international comparison of energy and climate change policies impacting energy intensive industries in selected countries – final report, July 2012***

92. The package of compensation and exemption measures promised over the course of the last parliament would place UK industry on level playing field with its EU counterparts. If the package was in place today it would have reduced costs from £30/MWh to £7/MWh. Instead, with compensation only available for a small proportion of the policy costs, energy intensive companies continued to be exposed to upwards of 70% of them.

93. At the 2014 and 2015 Budgets, the Chancellor committed to the introduction of compensation measures with regards to the costs of the Renewables Obligation and the small scale Feed-in Tariffs. Yet there are growing concerns over the length of time it has taken to obtain State aid clearance as well as the security of the budget for the whole compensation package out to 2020. It is imperative that the Spending Review announcement allays these worries and confirms the budget for the package.

94. EEF recognises the significant budget required for such a package of measures and that it may prove increasingly hard to maintain in the years ahead. We will work with government to arrive at a long-term solution to the problem that reduces public expenditure and would welcome further discussions on the issue.

## Business energy efficiency tax review

95. As part of this dialogue, we welcome the announcement of this energy taxation review at the July Budget. Businesses have called for simplification of the landscape for some time and this is an opportunity that should be embraced by all sectors of the business community. If consensus can be achieved in the coming months and the correct reforms put in place, the review affords us the opportunity to significantly reduce administrative burdens for both business and government and provide a more effective means of driving investments in energy efficiency.

96. Whilst it is understood that the consultation period for the energy taxation review will extend well beyond the Spending Review time frame and that final decisions will not be made until next year's Budget, it is also understood that very high level decisions, or points of principle, will have an impact on the Spending Review. One such point of principle is that energy taxation, which damages business competitiveness, should be kept to a minimum. We would like to see confirmation from government that the energy taxation review will reduce the costs of energy taxation over the course of this parliament to levels below those that would have been expected in the absence of the review.

## Supporting a productive and adaptable workforce

97. Manufacturers support the government's ambitions to create more high quality apprenticeships, such as those in manufacturing. Government's three million target will be challenging. Manufacturers are nevertheless willing to play their part and support the creation of a great number of new quality apprenticeships with government support.

98. Manufacturers rely on apprenticeships to acquire the skills they need to maintain and grow their businesses. Over seven in ten EEF members offer apprenticeships to bring new skills into their business. Plans to recruit apprentices continue, with two-thirds planning to recruit a manufacturing and engineering apprentice in the next 12 months, and 38% planning to recruit an apprentice outside of manufacturing and engineering.[10]

99. The number of manufacturing and engineering apprenticeships has seen steady growth over the past 10 years, bucking trends of peaks and troughs seen in other sectors. In fact, manufacturing and engineering apprenticeships represented 15% of all apprenticeship starts in 2013/14, which is more than the sector's share in the economy.

100. Manufacturers strongly support the government's desire to ensure that all new apprenticeships are of high quality. Delivering quality apprenticeships must remain the government's priority, above quantity. Manufacturers see quality as defined by outcomes – likely to be influenced by the length of the apprenticeship, level of qualification attained and career prospects (long-term employment, opportunities for career progression, salary levels) which result from the successful completion of the apprenticeship.

101. Over a third (36%) of manufacturers say they (the employer) funds their apprenticeship programmes entirely themselves. Anecdotally, these companies indicate they do so as they cannot find the quality training provision needed locally and therefore bring their training in-house and do not currently access public funding. The majority (60%) use a combination of employer and public funding.[11] The majority of manufacturers are currently willing and able to invest in apprenticeships, if this investment is in turn supported by government.

[10] EEF Higher Education Survey 2012-14
[11] EEF Skills Survey 2012

## The proposed apprenticeship levy

102. At the 2015 Summer Budget the Chancellor announced the introduction of a new levy on large employers to fund three million new, high quality apprenticeships. The subsequent Budget briefing stated that the "levy will raise money to fund increases in apprenticeships… and will be entirely funded by the contributors and not government." This left open the question of how the government would continue to support apprenticeships in larger employers. Since then, although a consultation had been published, there has been little detail announced on how the new levy will operate. It is unclear who the levy will capture (the definition of large employers), how it will be collated and distributed (the channel, the amount of the levy and the funding mechanism), how much employers will be required to pay and how much they will get back. The Budget did confirm, however, that "the money will be directly controlled by employers" and importantly "firms that offer apprenticeships can get more back than they put in." The government must deliver on these, and other key principles, in order for manufacturers to support any new levy system.

103. It is important to recognise that the levy is a new tax, intended to finance a proposed increase in government spending to deliver the manifesto policy. It will increase businesses' costs – and, as explained below, potentially will do so by more than the levy amount. For this to be accepted by firms and successfully implemented in a way that actually delivers the manifesto target for apprentice numbers, it is indispensable that the government should work very closely with firms to understand the practical, financial, and behavioural effects of its proposals. EEF will be responding in detail to the levy consultation later.

**Firms that offer apprenticeships can get more back than they put in**

104. The government initially stated that firms offering apprenticeships will be able to get more money back than they pay in levy. However, the recent consultation does not reflect this commitment at firm level, but only in aggregate. At the same time, the qualification for being able to receive more back than an employer pays in is hedged in terms that only employers who demonstrate a commitment to apprenticeship training will benefit in this way. It is not obvious what this means.

105. Anecdotal evidence from EEF members to date has suggested that if a levy of 0.5% of payroll is imposed on some larger firms, then those companies will need to increase their apprentice intake by 200% or more to receive their contributions back again. Given that employers bear around 75% of all apprenticeship costs, this would mean a requirement to spend £3 to recover £1. The policy objective to offer firms that train more back from the levy than they pay is not delivered if firms are in fact required to make significant further investments in order to recoup their levy outlay.

106. If manufacturers need to significantly increase their apprentice intake in order to recoup their levy payment, this may also have negative consequences on the number of apprentices offered permanent employment upon completion.

**The money will be directly controlled by employers**

107. For the employer to become the customer – able to buy the training provision they need – the money must be directly controlled by the employer. Only then will we create the demand-led system needed by manufacturers. The government should press ahead with the proposed digital voucher model. This should be the payment mechanism for all firms engaging with the apprenticeship system regardless of size or whether they pay the levy. The voucher model must not set the price of training and providers should only be able to draw down the remaining funds if the employer has been provided with the training they need.

**All levy funding must go on apprenticeships, not overheads**

108. All levy set-up and running costs, and infrastructure, must be funded by government, and every pound of levy money must be spent on training. Government must continue to invest in capital funding to ensure that colleges and providers have the capacity to deliver a greater number of high quality apprenticeships.

**Basic English and maths is paid for by government**

109. Employers continue to prioritise numeracy and literacy skills when recruiting apprentices; indeed 75% of manufacturers say these are a priority when recruiting apprentices. Level 2 English and maths are vital for all learners, regardless of age, and are needed to progress not only in apprenticeships, but to other forms of training or employment. However, around 40% of pupils do not achieve grades A* to C in English and maths by the time they are 16. This puts pressure on both the further education sector and employers, who then incur needless cost playing a remedial role with this cohort of young people to support them in undertaking an apprenticeship or employment.

110. It is unsurprising that BIS currently allocates a significant proportion of the Adult Skills Budget to training for Level 2 English and maths, but that is only paying what should be avoidable cost of failure in schools. This funding could be used elsewhere if schools performed better in helping young people achieve a basic level of numeracy and literacy prior to leaving secondary education. Therefore, the Department for Education should be responsible for funding for all Level 2 English and maths provision regardless of the age of the learner; this would locate the financial incentive for school performance improvement in the right place. The responsibility must not fall onto the FE sector or the employer.

**A levy on employers who recruit from outside of Europe is not needed**

111. As part of its Review of Tier 2 (Highly Skilled Migrants), the government has asked the Migration Advisory Committee (MAC) to explore the government's proposal to introduce another levy (also known as a skills surcharge) on employers that recruit employees from outside of Europe. In the government's commission to the MAC, it states that the levy will be 'used to fund UK apprenticeships.' However, since the start of the commission, the wider apprenticeship levy has been announced. If the UK-wide apprenticeship levy will fund apprenticeships, we see no need for an additional levy on employers that recruit from overseas.

**Certainty and stability of funding – between now and 2017**

112. The new apprenticeship levy is set to be introduced in 2017. However, there has been no detail on how the government will fund apprenticeships between now and the proposed introduction date (2017). Our survey data found that currently two-thirds of manufacturers plan to recruit an engineering apprentice in the next 12 months. Manufacturers must have clarity that government will commit public funding to apprenticeship training for all apprentice starts before 2017. Without this co-investment from government, it is highly likely that the number of employers offering apprenticeships will fall considerably.

## Investing in resilient, underpinning infrastructure

113. Infrastructure is central to productivity and is the bedrock of the economy. Beyond supporting economic activity to take place, it enables and boosts the productivity of people and capital. Infrastructure also delivers the spare capacity required for future unconstrained growth. An export intensive economy needs good quality and robust transport infrastructure including airports, ports and roads. An economy focussed on developing a productive and adaptable workforce needs a comprehensive transport network and advanced broadband and communications infrastructure.

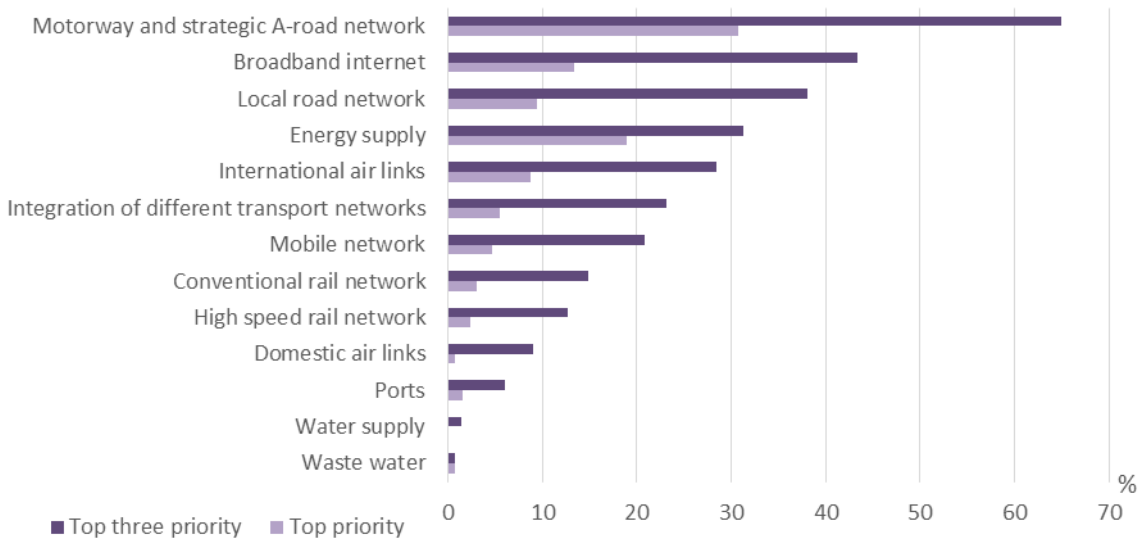
114. Reliable and resilient underpinning infrastructure enables the most productive use of people and capital resources and reduces transaction costs. Infrastructure also delivers reciprocal productivity benefits across sectors, for example, maximising the use, and with it the productivity, of airports through well connected rail access.

115. Within the realm of transport, the government is still the majority provider of investment and funding and therefore as a client of the infrastructure supply chain has a central role to play in supporting the sector to drive up levels of productivity and supporting investment in capital and skills through certainty on funding.

116. Manufacturers place a high stock in infrastructure availability and quality placing it fourth on the list of factors determining where they will locate their next global investment according to EEF's Invest for Growth survey.

**Roads are the priority for manufacturing investment**

***% of manufacturers saying each infrastructure network is a priority for investment***




***Source: EEF Business Environment Survey 2014***

117. From sending and receiving goods, maintaining customer and supplier relationships and accessing talent, infrastructure is a key determinant of manufacturing growth with good infrastructure boosting the productivity of inputs to the manufacturing process.

118. Manufacturers are clear on what is needed placing investment in the road network at the top of their list across all infrastructure networks, followed by digital communication, energy and international air links.

## Guarantee announced funding to sustain productivity growth

119. As part of this Spending Review, government must adopt an approach which recognises that infrastructure is never a case of 'job done'. There are some positive steps that can be taken to continue to deliver infrastructure to support productivity while also minimising the risks of asset failure and the economic consequences thereof.

**Guarantee the funding for Highways England to 2020/21**

120. Recent project challenges in the rail industry as part of Control Period 5, including the pausing of major rail electrification schemes, has highlighted the fragile nature of the UK infrastructure supply chain.

121. Delayed or postponed projects undermine confidence and with it investment in the skills and capital required. As the government notes in the productivity plan "the road network has suffered from a lack of investment by successive governments." As a result, the infrastructure supply chain will need all the certainty it can get to enable it to make the investments needed as part of the first Road Investment Strategy and beyond.

122. The government should guarantee the funding for Highways England to 2020/21 and rule out a switch of funding from roads capital to rail, including HS2, over the lifetime of this parliament.

**Guarantee the funding for local roads maintenance of £5.8bn to 2020/21**

123. Roads managed by local authorities are the UK's largest infrastructure asset by value and support businesses in non-urban areas, such as manufacturers, to access markets and recruit skilled talent. Despite this importance, the condition of the network has continued to decline with the funding backlog for the network increasing from £9.8bn in 2012 to currently stand at £12.16bn according to local authorities (or £8.6bn according to the Department for Transport).

124. Manufacturers also highlight the significant deterioration in the local road network compared to other infrastructure sectors over the two years to October 2014. Asked to rate the change in quality over two years to October 2014, 38% of manufacturers said the local road network became worse with just 6% saying it got better. This is the weakest balance for any area of infrastructure, with the second worst being the strategic road network (SRN).

125. This situation was compounded historically by a stop start funding cycle based on annual budget allocations, additionally two thirds of spending on maintaining England's non-strategic road network comes from local authorities themselves.

126. The government has set out a £5.8bn capital funding package over six years to 2020/21 which will give local authorities the certainty to start long-term planning for maintenance and achieve more value for spend. This capital funding must be protected as part of the Spending Review.

## Future funding

**Non-SRN principal roads**

127. As part of the July Budget, the government announced a Roads Fund for the management and upgrade of England's strategic road network (SRN). In the first year of operation, 2020/21, revenues from Vehicle Excise Duty is forecast to total £5.4bn in England. The Road Investment Strategy for that year allocates £4.1bn to the SRN, leaving a surplus of over £1bn in non-earmarked funds.

128. The SRN represents 3% of England's road network and 33% of total traffic volumes. Investment in the network is important and the government is right to put it on a sustainable footing. As we have outlined before, the local road network is also a crucial asset and one that is deteriorating. Many motorists paying into the Roads Fund will not recognise the distinction between strategic roads and local roads, particularly as 84% of all A-roads are managed as local roads.

| **Primary Route Network (Major road network)** | | **Local road network** |
|---|---|---|
| ***Strategic road network***<br>All motorways and around 16% of A-roads | ***Non-SRN principal roads***<br>84% of A-roads and some B-roads | ***Non-principal roads***<br>B, C, U |
| Length: 4,300 miles (around 3% of the total) | Length: 17,400 miles (around 9% of the total) | Length: 165,000 miles (around 88%) |
| Traffic volume: 33% | Traffic volume: 33% | Traffic volume: 34% |
| Managed by Highways England | Managed by around 150 local highway authorities | |

129. EEF recommends that the Roads Fund should be expanded in scope to cover non-SRN principal roads. Alongside this, a common standard should be developed for the management and maintenance of these roads to ensure the best use of public funds.

130. This expansion of scope would deliver the same level of certainty to local authorities as Highways England will enjoy and with it boost business productivity through the provision of a more reliable and resilient road network.

131. As part of this, the role of the Office of Road and Rail and Transport Focus should be expanded to cover non-SRN principal roads to ensure the productive use of scarce roads funding by local authorities, delivering value for money benefits similar to Highways England.

## Devolution

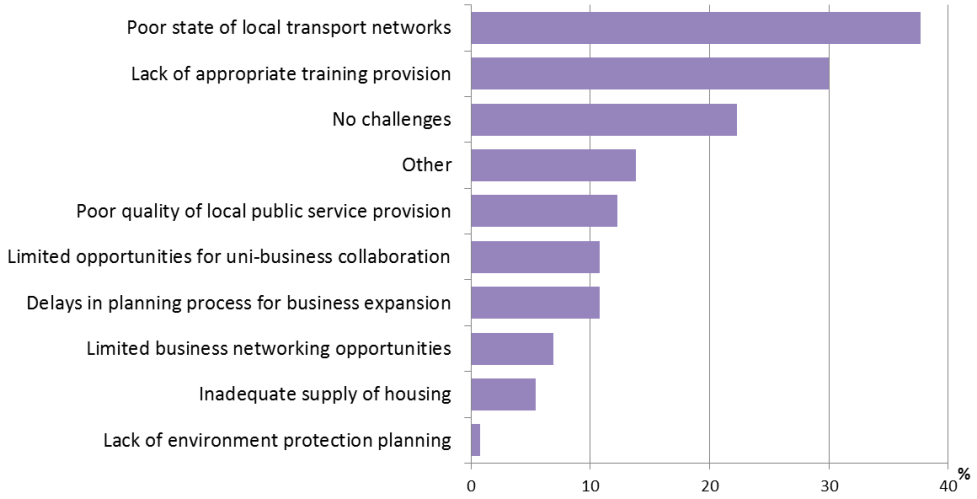
### Local Growth Deals

132. Devolving power, responsibility and money to local areas in England and away from central government can help to achieve better-balanced growth. Devolution could help to embed the core foundations for growth through local leadership, the tailoring of national programmes to local needs and ensuring faster and more responsive action to issues.

133. EEF believes Local Growth Deals and the Single Local Growth Fund must continue as a competitive funding stream. The Single Local Growth Fund offers the opportunity for local areas which are not yet geared up to take on significant devolution of powers, to better prepare their capacity and capability to deliver.

**Transport is the main challenge that needs to be addressed in the local business environment**

***% manufacturers citing factor as a top-two business challenge in their local area***




***Source: EEF Business Environment Survey 2014***

134. Nothing underpins a robust business environment better than the availability of reliable and resilient infrastructure, particularly transport. It is therefore unsurprising that manufacturers believe this should be the initial focus of regional devolution, our previous surveys have shown this to be the main challenge in local business environments.

135. Transport is an economic enabler not just in terms of allowing people to get the jobs they want and businesses to access wider talent pools, but also in terms of enabling future support for devolution from the business community through tangible improvements in local transport networks.

136. With £5bn left to allocate as part of the Single Local Growth Fund in the remainder of this parliament, the government should allocate this as capital funding to allow more investment in the quality and connectivity of regional transport – the bedrock of the local business environment.

**Devolution Deals**

137. The government should ensure devolution deals with Combined Authorities have a central focus on transport and other infrastructure including devolving elements of rail, the regulation of buses and other public transport. Deals should also allow Combined Authorities to develop as integrated transport authorities taking on London-style powers.

## Long-term strategy on infrastructure

**Evolve the National Infrastructure Plan**

138. Infrastructure development is never a case of 'job done' with existing infrastructure assets such as roads, airports or digital networks needing to be continuously repaired, renewed or upgraded. Occasionally, new infrastructure is needed to meet emerging challenges or to support economic activity.

139. Building on progress made with evolving the National Infrastructure Plan, the government should publish a 15-20 year review of the infrastructure challenges we will need to address and the cost of not tackling them.

## About EEF

EEF, the manufacturers' organisation, is the representative voice of UK manufacturing, with offices in London, Brussels, every English region and Wales.

Collectively we represent 20,000 companies of all sizes, from start-ups to multinationals, across engineering, manufacturing, technology and the wider industrial sector. We directly represent over 5,000 businesses who are members of EEF. Everything we do – from providing essential business support and training to championing manufacturing industry in the UK and the EU – is designed to help British manufacturers compete, innovate and grow.

From HR and employment law, health and safety to environmental and productivity improvement, our advice, expertise and influence enables businesses to remain safe, compliant and future-focused. More information at www.eef.org.uk

**FOR FURTHER INFORMATION CONTACT:**
**Mr Paul Raynes**
**Policy Director**
**020 7654 1541 (direct dial)**
**praynes@eef.org.uk**

**Follow us online:**

**Blogs: EEF Economics Blog: www.eef.org.uk/blog/**
**Twitter: @EEF_economists**
**LinkedIn: http://www.linkedin.com/company/eef**