INVEST FOR GROWTH

Encouraging more globally focused companies to expand in the UK

eef The manufacturers' organisation

INTRODUCTION

The UK's journey back to economic recovery has been a slow and challenging one. Along the road, all signs have pointed to higher levels of private sector investment as a means of reaching our destination of better balanced growth.

More investment will help make up the growth shortfalls in other parts of our economy.

More investment will ensure the UK is growing the capacity of important sectors – particularly manufacturing – to produce the goods and services the rest of the world wants to buy.

And more investment will determine prosperity and living standards across our economy by driving productivity forward.

Manufacturing has a positive story to tell about its plans to invest and grow. Manufacturers' strategic priorities point to a sharp focus on bringing new products and services to new customers in new geographical markets and sectors. And these strategies have been matched both with an increase in investment in modern machinery over the past three years and plans to increase capital expenditure further in the coming three years.

However, the reality of the recovery in business investment levels raises questions about whether enough progress is being made to grow business investment and overcome the roadblocks companies face in implementing their investment plans.

There is a lot of ground to be made up. Not just from the sharp decline in investment seen during the recession, but also the historically lower levels of investment – in the economy and manufacturing – relative to our industrialised competitors. Our report highlights underlying concerns amongst companies themselves that they may be losing ground to competitors and the growing gap they see between what they need to invest and current levels of investment.

Moreover, for those companies that have upped their investment levels, the UK may not have been their destination of choice. Today's businesses are global – neither investment nor production is constrained by geographic borders and manufacturers are looking to new markets and locations to help them achieve growth. Taken together with the stability and competitiveness of the business environment, companies will be sizing up the pros and cons of investing in different locations.

Bringing these issues into the spotlight is the fact that business investment across our economy in 2012 was some £15 billion lower than forecasters were expecting just two years previously.

Demand certainty, finance, parent company approval, confidence about the returns an investment will generate, access to markets, location of suppliers, the motivation of the company itself and a more tempting skills base, tax and regulatory environment somewhere else, are all in the mix for future investment decisions.

Manufacturers must be ambitious, but our survey clearly highlights what they need from government to have the confidence and certainty to commit to their investments in new capacity and the latest technologies in the UK. These investments do not align with the political cycle and they generate jobs and returns beyond the fiscal forecast horizon.

A long-term, modern industrial strategy that sets out the commitment to support more globally focused companies choosing to invest in the UK and a government throwing its efforts behind the right policies on tax, skills, energy and finance to make that happen must become the foundation for a stronger, investment-led recovery.

This report sets out how manufacturers can play their role in rebalancing our economy, the challenges they need to overcome to achieve this and the choices policy makers face in supporting the critical investment decisions that will ensure we have a global, productive and dynamic manufacturing base for the future.

THE UK INVESTMENT CHALLENGE

As the UK emerged from the recession, a consensus formed that the economy needed a new model of growth, one with a more sustainable balance between consumption and production. This better balanced growth needed to be underpinned to a greater extent by innovation, trade and investment.

The disappointing news for our economy is that the recovery in investment that has long been predicted by forecasters has consistently been delayed. Economic conditions have continued to dampen firms' appetite to invest for much longer than anticipated. Some companies have struggled to finance their investment plans and others have sought to execute their investment plans in markets outside the UK.

Investments in new plant and machinery, innovation and people are both a key driver of productivity and a crucial part of a more balanced economy. There is now widespread agreement that a globally competitive manufacturing sector is a critical component of a better balanced economy. We need to build the same consensus on how the UK harnesses the strategic ambitions of our globally focused and innovative companies to ensure that new investment is not further delayed and the UK is the location of choice for manufacturers – of all sizes and across all sectors of industry.

The challenge now is to dismantle any roadblocks to growing investment and provide the long-term certainty that manufacturers need to invest and grow. In this section we look at the size of the challenge facing manufacturing and policy makers.

The starting point for investment-driven growth

Manufacturers must invest to grow and stay competitive in dynamic global markets. Investing in capital equipment and developing new products and processes, as well as intangible areas such as skills, marketing, and branding raises the productivity of capital and labour, keeps manufacturers at the forefront of changing customer demands and makes products more marketable. Investment also helps companies maintain their competitive advantage by allowing them to maintain the quality of their products, reduce costs and take advantage of the latest technology that can ensure their continuing success in global markets.

More sustainable growth over the long-term requires more companies choosing to invest in the UK and, more of those companies upping their level of investment. While the UK is by no means in a unique position in this respect, our starting point suggests that the challenges facing it are greater than in other countries.

UK manufacturing has seen some significant ups and downs in recent decades (see *Three Decades of UK Manufacturing* on page four) and with this, some large fluctuations in investment patterns. Business investment across the sector hit a turning point around 1998, when it peaked at £21 billion and since then it has been falling.

In the years leading up to the 2008/09 recession, manufacturing investment did show some signs of returning to growth, reaching a pre-recession peak of almost £14 billion in 2008. By 2011, manufacturing investment had fallen to £12 billion - 45% below the 1998 peak and 12% below the pre-recession peak.

The benefits of investing in new technology

A company producing metal products made a significant speculative investment in a new robot a number of years ago. The company purchased the equipment as they saw it as a potential opportunity for further exploration into how it could be used in the production process. The technology enabled the company to produce some of their products more cost effectively with reduced quality issues and expand their product offering. The company now has nine robots which are integral to the company's production of key product offerings.

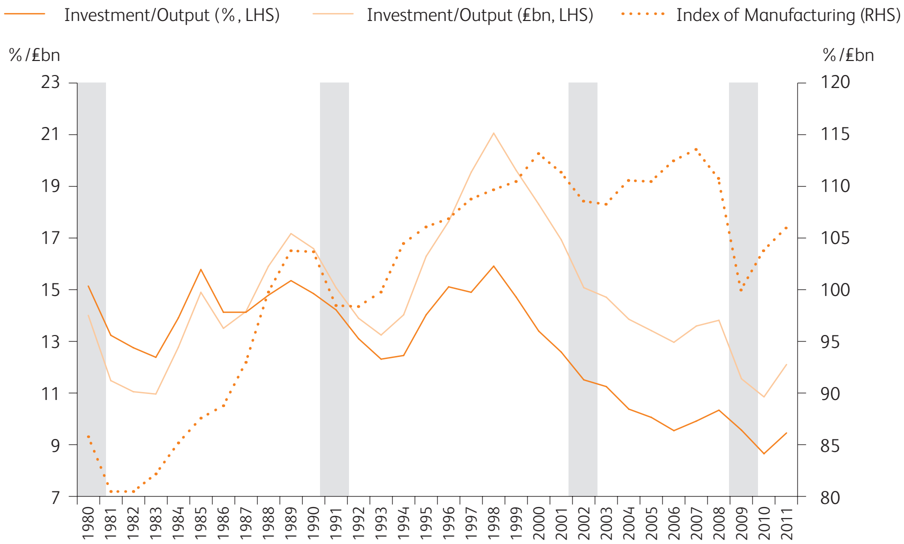
Three decades of UK manufacturing

During the last three decades, manufacturing has weathered four recessions, has adapted to a more global operating environment and has faced considerable pressure from emerging economies. Chart 1 shows the many ups and downs of manufacturing output and investment over the years (recessions indicated by grey bars). Up until the late 90s investment broadly tracked output before the trends de-coupled and investment started falling while output broadly stabilised.

In the 1980s, with the rise of globalisation, manufacturers had to adapt to increasing competition, particularly a substantial rise in imported products. Productivity also increased substantially with technological advancements.

CHART 1 THE MANUFACTURING SECTOR HAS FACED MANY CHALLENGES

MANUFACTURING INVESTMENT AS % OF MANUFACTURING OUTPUT, MANUFACTURING INVESTMENT (£BN), GREY BARS = MANUFACTURING RECESSIONS, INDEX OF MANUFACTURING 2009=100



Source: National Statistics

During the 1990s the UK was faced with another global recession and some fluctuations in the exchange rate with a large depreciation early in the decade, followed by a sharp rise from 1997.

The 2000s bought another round of challenges, particularly relating to the substantial rise in trade from low-cost producers in China and other emerging nations. China joined the World Trade Organisation in 2001 and the European Union increased to 27 countries, taking in several low wage economies.

Since the recession ended in 2009, manufacturers are once again seeking to maintain their positions in the global market. Firms have had to rethink how their supply chains are organised, in some cases bringing production back from low-cost countries to take advantage of the higher quality that can be achieved in the UK and in other cases making the move overseas to be closer to potential suppliers and customers.

Investment declining over time

Manufacturers of all sizes have similarly seen a decline in their investment over time. Manufacturing capital expenditure was just over 8% of Gross Value Added (GVA) in 2010, more than five percentage points lower than 1999. This trend in investment intensity has been seen across firms of all sizes as shown in chart 2.

The decline also saw the UK falling further behind other countries in terms of investment. At its peak in 1998 UK manufacturers invested approximately 14% of manufacturing GVA, similar to Germany, France and the US. Yet manufacturing investment intensity did not start to decline in these countries until the early 2000s and the fall was not as large. By 2008, our investment intensity was some four or more percentage points lower than these countries.

There is no easy answer to why UK manufacturing investment has behaved in this way. It has been driven by a combination of factors, some of which have emerged since the financial crisis and others are longer-standing.

- ***Investing overseas:*** Manufacturers investment intentions have remained strong since the end of the financial crisis suggesting manufacturers have been planning investment. The mismatch between intentions and actual investment suggests that some of it is happening elsewhere.

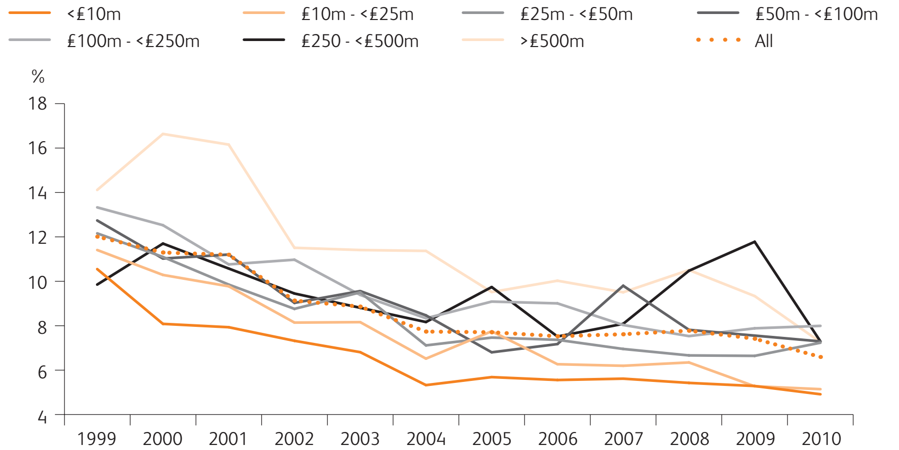
- ***Lack of finance:*** The availability, cost and terms and conditions of external finance have been tightening since the financial crisis and many manufacturers, particularly smaller ones, struggle to access what they need.

- ***Policy instability:*** For many years, companies have not had sufficient certainty about government policy that affects key aspects of the business environment, such as tax and regulation. This lack of stability means returns have been less certain and therefore investment has been less likely to go ahead, or for it to be in the UK. This also has an important influence on investment decisions in foreign-owned companies in which UK managers have to make the case to the parent company to continue to invest in the UK.

- ***Reluctance to spend cash reserves:*** With a very uncertain economic outlook, some companies – particularly larger ones – are holding onto their cash or are waiting for the right investment opportunities to emerge.

CHART 2 INVESTMENT INTENSITY LOWER FOR FIRMS OF ALL SIZES

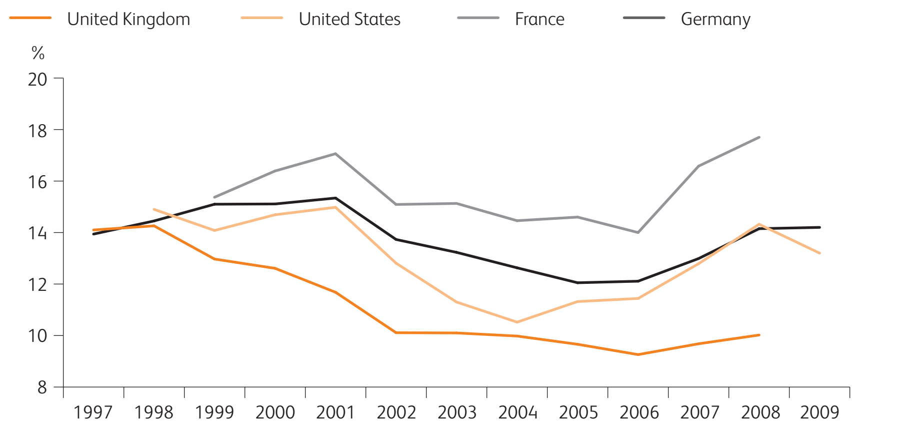
% NET CAPITAL EXPENDITURE / GVA BY COMPANY TURNOVER (£M)



Source: Annual Business Survey, ONS

CHART 3 MANUFACTURING INVESTMENT FALLS SHORT OF COMPETITORS

GROSS FIXED CAPITAL FORMATION IN MANUFACTURING AS % OF MANUFACTURING GDP



Source: OECD

- ***UK investment culture:*** Anecdotal evidence suggests the UK has a culture of getting the most out of existing capital equipment and delaying investment for as long as possible. Where manufacturers in other countries invest in new technology earlier, UK manufacturers are good at focusing on cutting costs and getting as much value as possible out of their current assets.

- ***Other constraining factors:*** A number of other factors are also capping companies' ability to invest including other draws on cash, lack of the right skills, production costs including energy, and other restrictions in the business environment such as the tax burden and regulation.

Investment recovery underway

The past few years are not likely to have improved the UK's investment position relative to other countries. Business investment across almost all countries suffered during the recession as global demand collapsed and financing became more difficult. But UK investment was amongst the hardest hit during the recession, with only the US experiencing a similar contraction.

In some respects the story on manufacturing investment is a positive one as growth has come back faster than in previous recessions. However, the pick-up in overall business investment has still been slower than in the US, Germany, France and Canada – some of the UK's key competitors.

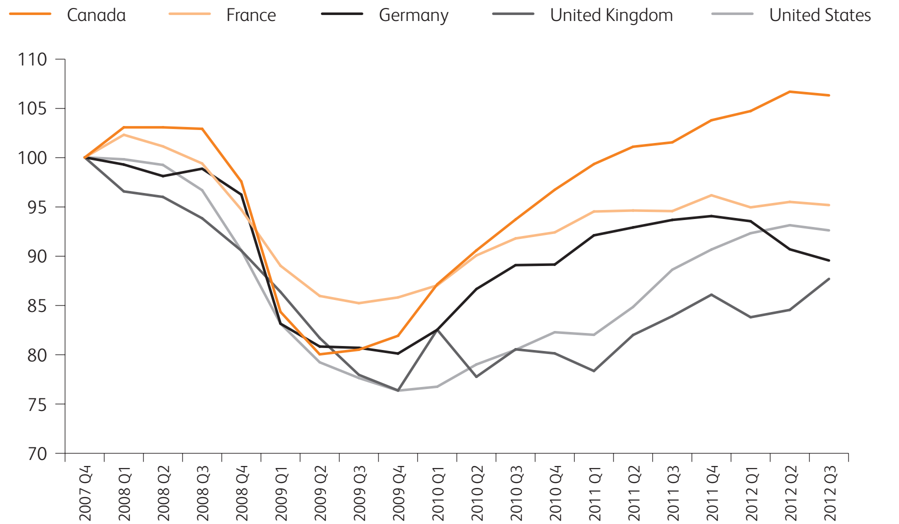
Where do we go from here?

We cannot afford to stand still. The investment landscape is constantly changing; the price of investment goods has been coming down over time, embedded technology has been increasing, and re-investment rates have been accelerating with the pace of technological change and increasing competition.

Looking forward, the Office of Budget Responsibility (OBR) is forecasting growth in business investment of 4.9% in 2013, 8% in 2014 and over 10% per annum in 2015 and 2016. However, achieving this sustained level of investment growth will require changes on a number of fronts.

Manufacturers – large and small, UK and foreign-owned – need a great deal more certainty about the economic ambitions that the UK should be aiming for as part of a

CHART 4 UK INVESTMENT HIT HARDER THAN MOST
WORLD BUSINESS INVESTMENT, 2007Q4 = 100



Source: Oxford Economics

modern industrial strategy[1]. One of these ambitions must be to increase the number of more globally focused companies choosing to invest and expand in the UK. And we will know we are making progress towards this ambition when we see:

- The proportion of companies exporting more than 25% of their turnover increasing, and
- A higher proportion of turnover across the economy being accounted for by mid-sized businesses (businesses with a turnover of £25 to £500 million).

The rest of this report looks at recent and future manufacturing investment, the factors that influence those trends and the barriers to increasing investment that are strongly affecting UK companies.

[1]EEF, The Route to Growth: An industrial strategy for a stronger, better balanced economy, http://www.eef.org.uk/NR/rdonlyres/779379BD-3DC6-49D0-99AA-34D90921E602/21515/RoutetoGrowth1.pdf

AIMS, INVESTMENT AND OUTCOMES

In the last section, we commented on the challenges that manufacturers in the UK have had to overcome. Our latest survey shows that they continue to respond and are putting in place strategies to remain globally focused, specialised, quality-driven, customer-focused and successful. While there are clear objectives in place, our survey raised the question as to whether investment will be sufficient to deliver them fully.

Succeeding in a challenging environment

Before looking at recent investment trends, it is important to first look at what companies are seeking to achieve. Manufacturers are continually taking a strategic view of their offering, for example, tailoring products and services for different markets, looking for opportunities to take capabilities into new sectors and supply chains, and continuous improvement in manufacturing processes.

Manufacturers are planning a wide range of strategic actions planned for the coming year (chart 5) including breaking into a new sector or market, whether with a product or a service, as well as developing new products, services and processes.

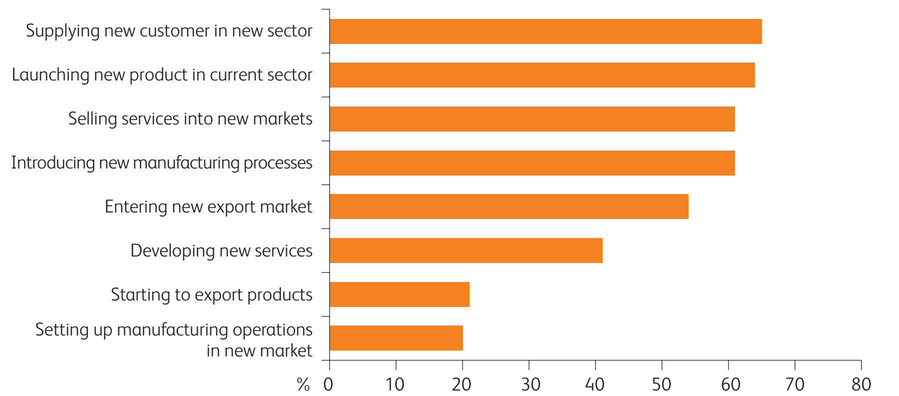
As well as the core business of 'making things', services continue to be an important part of manufacturers' businesses across all sizes of company, providing an additional revenue stream and the capability to help create long-lasting relationships with customers.

Previous EEF research[2] has found that manufacturers currently are more likely to focus on service provision in domestic or near export markets, giving UK manufacturers the opportunity to extend and expand this activity into markets further afield.

Nearly seven in ten companies plan to use their expertise to break into new sectors over the next 12 months. Many large Original Equipment Manufacturers (OEMs) and companies near the top of the supply chain have expressed their desire to expand their supply base and move away from single sourcing or increase locally sourced content to minimise the impact from any potential future supply disruptions. This has opened up opportunities for companies to tap into new sectors. The dampened growth outlook in some industries has also caused companies to search for growth opportunities outside of their core sectors.

Achieving these kinds of strategic aims is important if we are to see better balanced growth in the economy. As an export and investment intensive sector, manufacturers are well placed to deliver the kind of growth that the UK needs. Manufacturers' ambitions of launching new products and entering new export markets are key to building a strong, growing economy.

CHART 5 MANUFACTURERS HAVE STRATEGIC PLANS
% OF COMPANIES PLANNING ACTION IN NEXT 12 MONTHS



Source: EEF/GfK NOP Investment Survey

[2] EEF, *Manufacturing Advantage: changing the ground rules of global competition*, 2008, http://www.eef.org.uk/NR/rdonlyres/D34C2BA7-9125-417E-A8EC-DE39BE1FB1D3/16808/Manufacturing_Advantage_Changing_the_ground_rules_.pdf

Driving investment

Closely linked to manufacturers' strategic priorities are the factors they report influencing their decision to invest in new capital equipment. Encouragingly, the top three reasons are all related to doing something new or better – improving production, adopting new technology and manufacturing new products. These drivers are ahead of the on-going need to replace existing capacity as plant and machinery reach the end of their useful life. Even when companies face constraints on investment budgets, there will be an on-going need to replace or upgrade existing equipment.

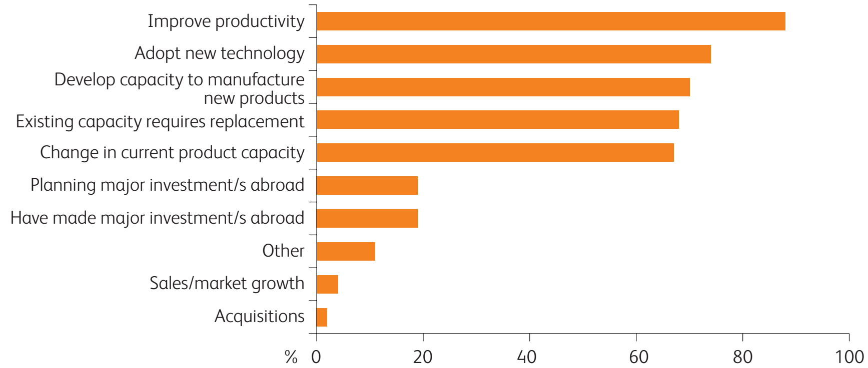
"Every year, manufacturers must be more efficient than the last."

– Electronics manufacturer

Looking behind the headline figures shows that large companies are more likely to identify developing capacity to manufacture new products as the biggest driver of investment, whereas a larger proportion of small and medium sized companies identified productivity improvements as the biggest driver.

CHART 6 PRODUCTIVITY IMPROVEMENTS AND NEW TECHNOLOGY TOP REASONS FOR INVESTING

% OF COMPANIES CITING DRIVER



Source: EEF/Gfk NOP Investment Survey

Reasons for investing

One manufacturer supplying into the automotive industry categorises its investment into three areas:

– Investment to replace or improve current capital/plant and machinery;
– New equipment needed to fulfil a specific new order;
– Investment to extend the company's manufacturing capacity in other areas.

An example of investment to extend the company's manufacturing capacity in other areas is its strategy on turned parts. The firm buys approximately £1m worth of turned parts per year. It concluded that a £150k investment in new machinery to turn the parts in house and could produce around half of the required parts per year if worked on a double shift. The payback for this would be two years.

The company has bought one of these machines so far and is planning on buying another with the aim of producing about half of the products they need. Restricting their own production to half of what they need allows flexibility and some leeway if demand drops.

The current investment picture

Making new investment is critical to manufacturers achieving their objectives. As we have already discussed, the downturn severely curtailed the ability of companies to do this. However, half of companies in our survey report increasing their investment on capital equipment in the past three years, a reasonably consistent picture across all sizes of company (chart 7) and just over a tenth report decreasing investment.

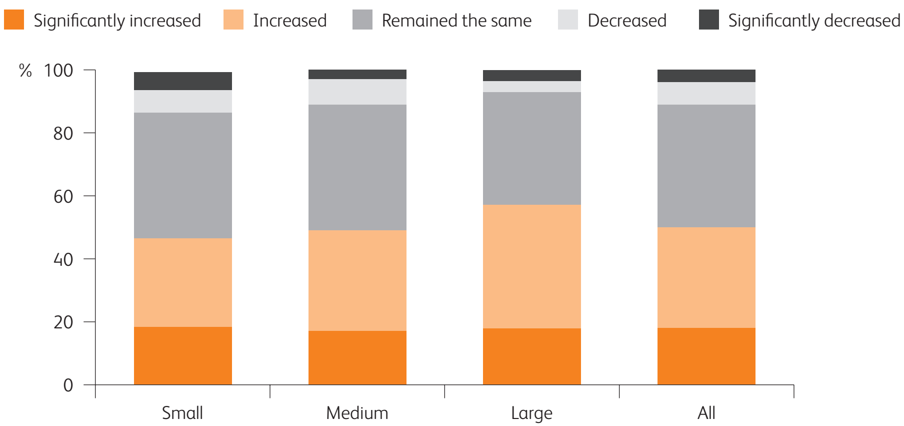
Our survey data are supported by official statistics which shows manufacturing investment grew by around 15% since late 2009, and business investment in manufacturing had increased in five out of the six quarters preceding the third quarter of 2012. However, it must be noted that a small number of large companies account for the lion's share of this investment.

Our results also show some variation in the intensity of investment. Just over half of companies invested between 1% and 5% of their turnover in capital equipment in the past three years, with a further fifth investing between 6% and 10%. Official statistics put the average figure historically in manufacturing at 2-3% of turnover.

Companies investing over 10% of their turnover, around 15% of our sample,

CHART 7 MANUFACTURERS REPORT POSITIVE INVESTMENT ACTION

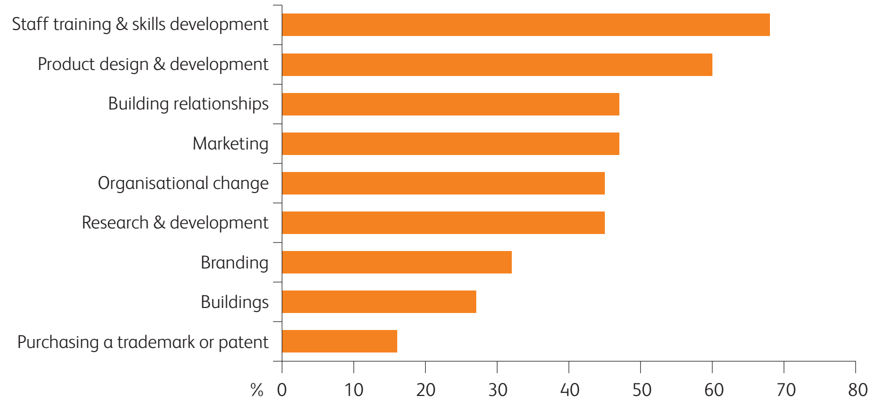
% OF COMPANIES REPORTING TREND IN INVESTMENT IN PAST THREE YEARS BY COMPANY SIZE



Source: EEF/GfK NOP Investment Survey

CHART 8 SIGNIFICANT INVESTMENT NOT JUST IN CAPITAL EQUIPMENT

% OF COMPANIES MAKING A SIGNIFICANT INVESTMENT IN AREA IN PAST THREE YEARS



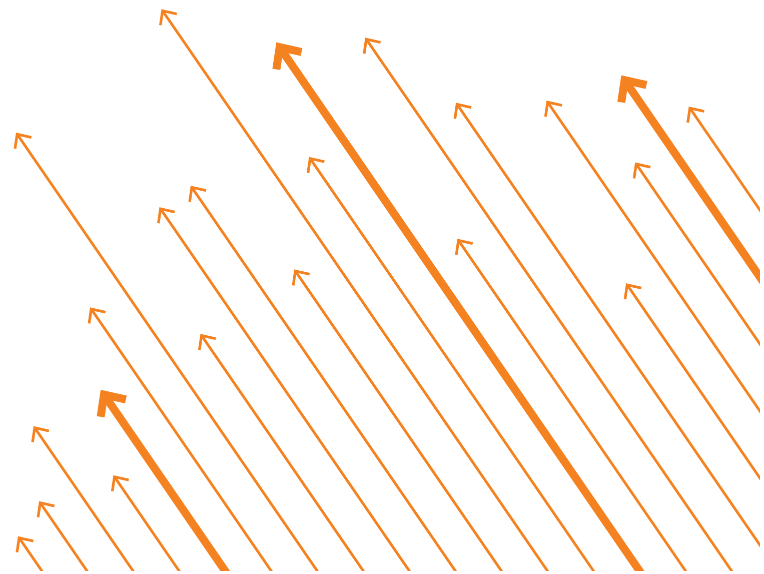
Source: EEF/GfK NOP Investment Survey

are most likely to be aiming to achieve multiple business objectives; at least three of those shown in chart 6. Indeed, 55% of companies hoping to achieve three or more strategic aims in the next 12 months report increasing investment in the past three years, compared with a third of companies planning just one or two actions. This strongly indicates that more ambitious growth strategies support proportionally higher levels of investment.

Looking ahead, manufacturers are also, on balance, planning to increase investment in capital equipment over the next three years; 45% of companies expect investment to increase with one in ten planning to scale it back. This pattern is again consistent across all sizes of company but firms in the transport and machinery sectors are most upbeat about future investment plans.

Investment not just in capital

Whilst capital equipment is important, investment in more intangible areas is also a critical part of the competitiveness equation. For example, a trained, skilled, and flexible labour force able to react to changes in demand is vital, as is investment in new product design and development.



In order to bring a new product to market, it is highly likely that a company must invest in most or all of the areas in chart 8 in order to achieve it. Indeed, the larger the number of strategic aims companies are hoping to achieve in the coming year, the larger the number of intangible areas where a significant investment has been made (chart 9).

Investment brings reward

This strategic nature of manufacturers' plans holds companies in good stead for growth. Investment in capital equipment allows companies to achieve their strategic aims and to make products more efficiently, to extend their offering, bring previously outsourced work in-house, produce for a range of specifications, and reduce waste and cost. This allows companies to have a more competitive offering in the global marketplace, leading to an increase in sales and profitability. Overall, nearly three-quarters of firms report an increase in productivity over the past three years and just over half report improved profitability, an uplift of nearly 10% from 2009. However, there are considerable differences between firms that had raised the level of investment in the past three years, where a balance of nearly half of them had seen increased profitability in the same timeframe, compared with a balance of just 7% of companies who had decreased investment.

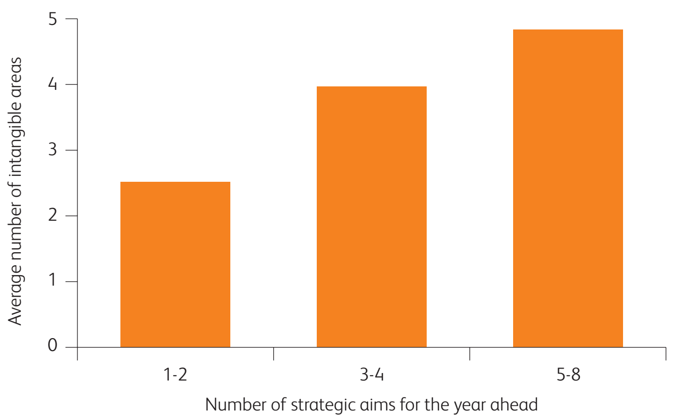
Increased profitability then puts the company in a better cashflow position, allowing companies to further invest in the capital equipment needed for their business. Of those companies who had seen profits increase in the past three years, a balance of 42% expected investment to increase in the next three years, compared with a balance of 21% who had seen profits fall.

Recent trends and future plans are also shaped by the extent to which firms were able to shake off the effects of recession and how aggressively they plan to go after new markets and customers. Our research shows that over the past three years many manufacturers were making important incremental investments. However, the minority of firms that are committing a relatively larger share of their turnover are likely to be investing at the forefront of technology – seeking to take a big step ahead of the pack, not just to stay with it.

But the query still remains as to whether this is enough. Pre-recession, the UK's investment levels were already behind our key competitors. While manufacturers have the strategies in

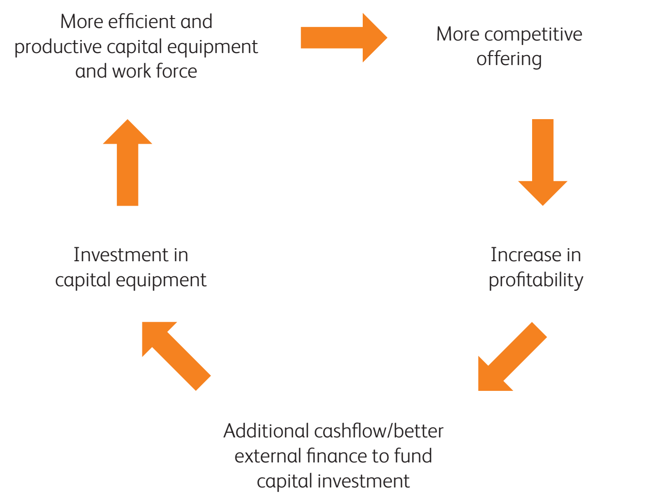
CHART 9 INTANGIBLE INVESTMENT ALSO NEEDED TO ACHIEVE STRATEGIC AIMS

AVERAGE NUMBER OF INTANGIBLE AREAS COMPANIES HAVE SIGNIFICANTLY INVESTED IN IN PAST THREE YEARS BY NUMBER OF STRATEGIC AIMS FOR THE YEAR AHEAD



Source: EEF/Gfk NOP Investment Survey

VIRTUOUS CIRCLE: INCREASED INVESTMENT LEADS TO INCREASED PROFITABILITY LEADS TO FURTHER INVESTMENT…



place to compete, there are questions as to whether, for enough of them, their investment plans match ambitions and whether those plans will enable catch up with competitors. Ultimately, we need to be investing enough to grow a critical mass of world-leading manufacturers supporting deep, sophisticated supply chains.

Manufacturers in our survey are not complacent about investment trends across the industry. There are mixed views on where current investment levels leave the UK relative to competitors. While on balance manufacturers feel they are not being left behind, a significant minority of firms (a fifth) believe they are currently lagging behind their peers internationally. This view holds even for companies that have recently been investing a relatively higher proportion of turnover and for those that have raised their capital expenditure plans in recent years.

In addition, nearly a third of companies in our survey said the gap between what they want to invest and what they actually invest is growing. And it is not just those companies who say they have decreased investment who feel this is the case, although those firms who have decreased investment are even more likely to say they agree. This view is also not confined to smaller companies – a similar proportion across all sizes of firms take the same view.

Manufacturers are focused on growth and the investment their company needs to achieve it. Despite this, we still see underlying concerns about how UK business investment trends will evolve. In addition to understanding why some firms are unable to realise their investment and what can be done about it, which we will return to, we also need to acknowledge the fact that some manufacturers are choosing to invest, though not in the UK.

of manufacturers who **increased** their investment in the past three years said there is a gap between what they want to invest and what they actually invest

of manufacturers who **decreased** their investment in the past three years said there is a gap between what they want to invest and what they actually invest

LOCATION PUSH AND PULL FACTORS

Investment decisions are more than choosing what to invest in and how much, manufacturers must also decide where to do it. Today's businesses are global – neither investment nor production is constrained by geographic borders and, as outlined earlier, manufacturers are looking to new markets and locations to help them achieve their strategic objectives. These factors, together with aspects of the business environment across various economies, mean companies will be sizing up the relative pros and cons of investing in different locations. As many economies like the UK are trying to build a more balanced model of growth post-financial crisis, competition for high-value investment in manufacturing is becoming more aggressive.

Globally, over US$660 billion of manufacturing investment was made across borders in 2011[3] and the UK has traditionally been a significant investment partner and destination for Foreign Direct Investment (FDI). In 2012 the UK maintained its position as the leading European destination for inward FDI showing that the UK is an attractive place to invest[4]. Investment across borders is a two-way street though, and UK companies also engage in high levels of overseas investment. Overall UK companies are net investors overseas as they hold more investment stock in other countries than foreign companies hold in the UK[5].

A wide range of factors influence investment location decisions

Of the manufacturers we surveyed, over two-fifths have some production overseas, up from one-third in 2009. Our survey also showed that decisions on where to locate investment can be finely balanced and will be influenced by a range of factors relating to the business environment and what the business is trying to achieve. These factors, which act to both push and pull investment away from, and indeed towards, the UK, highlight the need to make the UK a favourable place in which to invest relative to other countries on multiple fronts.

Range of factors impact decision to invest overseas

A precision engineering company recently confirmed the development of a production facility in South America. The decision to invest overseas was influenced by a range of factors, including

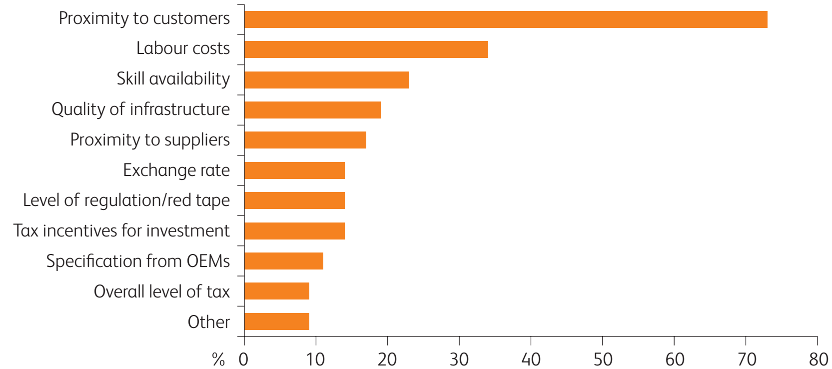
– Proximity to the North American market;
– Accessibility of processes and services necessary for the manufacture of the company's products;
– Commitment of the state government to support the company's business needs, such as skills;
– The stable policy settings associated with the Industrial Park in which the investment will be located.

[3] UNCTAD, *World Investment Report 2012, Towards a New Generation of Investment Policies*, www.unctad-docs.org/files/UNCTAD-WIR2012-Full-en.pdf
[4] Ernst and Young, *Staying ahead of the game, 2012 UK Attractiveness Survey*, www.ey.com/Publication/vwLUAssets/2012_UK_Attractiveness_Survey/$FILE/EY_2012_UK_Attractiveness_Survey%20.pdf
[5] UNCTAD, *World Investment Report 2012: Towards a New Generation of Investment Policies*, 2012, www.unctad-docs.org/files/UNCTAD-WIR2012-Full-en.pdf

Chart 10 shows that decisions on investment location take into account ease of market access, supply chain location, costs, taxes and regulation, as well as the availability of necessary skills.

CHART 10 PUSH AND PULL FACTORS INFLUENCE INVESTMENT LOCATION DECISIONS

% RESPONDENTS CITING TOP THREE MOST IMPORTANT FACTORS WHEN DECIDING WHERE TO INVEST



Source: EEF/GfK NOP Investment Survey

Access to market is the most important factor when choosing where to invest. Over two thirds of survey respondents said proximity to customers was one of the most important factors when deciding on investment location. Specific factors will vary depending on the market, but transport and logistics costs; prevalence of trade barriers and the advantage of geographical proximity in order to collaborate with customers on design and development are all factors in the mix. In addition, some investment decisions will be pulled towards particular locations in response to requests from OEMs; 10% of our survey respondents said their investment decisions were impacted by their key customers. By placing requirements on suppliers, particularly small ones, large customers can safeguard their supply chains to ensure consistency and quality of inputs or components.

Costs are another factor taken into consideration when investing. However, as wage increases are accelerating in emerging markets, we have seen a marked shift in the relative importance of labour costs in investment decisions. A decade ago, almost three-quarters of companies cited labour costs as a major driver for overseas investments[6]. Today just over one third of manufacturers surveyed identified labour costs as one of the three most important factors for investment decisions. Cost is particularly important for production with a high labour component – one manufacturer told us that if labour is more than 15% of the cost of a product then it is better to make it abroad. Other factors also impact the overall cost of production; in the US, for example, energy costs are expected to reduce dramatically in the coming years as a result of shale gas production, which will make the US a more attractive investment location for energy intensive industries.

Access to the right skill sets was the third most important factor when deciding where to invest, with 23% indicating it was among the most important. Skills are particularly important for manufacturing of high-value goods and services with knowledge being a key input into the design and production process. Getting maximum value from new investments in technology and modern machinery requires a sufficient pool of skilled people to operate and maintain it. In addition manufacturers across the world are looking for education and training systems to match the pace of technological change so that the skills base remains current.

Access to suppliers is also a significant factor with 17% of companies raising it as important when choosing where to invest. Manufacturers report collaborating up and down the supply chain on business critical areas such as product development, forward planning and service offerings. In many cases, the importance of investment and collaboration flowing down from large companies and OEMs to those further down the supply chain can be critical in prompting further investment and confidence. Maintaining the resilience of supply chains is critical to remaining competitive and delivering on customer expectations.

Push and Pull – the UK

In many respects the UK is an attractive proposition for potential investors, with its stable institutional and political settings as well as a flexible employment system and an accessible skilled labour force[7].

However, the importance governments around the world place on attracting and retaining investment means that the comparative advantage of locating in any one country never stands still. This makes it critical to place a continuous focus on how the UK is perceived as a place to invest. However, our survey indicates that UK-based manufacturers continue to have some underlying concerns about some aspects of the UK business environment. The issues that manufacturers expressed the most concern about with respect to decisions on capital investment in the UK were the burden of regulation; the availability of skilled employees and the tax system.

[6]EEF, *Where now for Manufacturing?,2004,* www.eef.org.uk/NR/rdonlyres/D6F1960E-5232-4ED0-B16F-A07E4E73E73B/2755/461.pdf

[7]Ernst and Young, *Staying ahead of the game, 2012 UK Attractiveness Survey*, www.ey.com/Publication/vwLUAssets/2012_UK_Attractiveness_Survey/$FILE/EY_2012_UK_Attractiveness_Survey%20.pdf

Regulation regularly tops the league table of business concerns. This can be the source of additional cost and bureaucracy in almost every part of a business's operations – from health and safety to pensions. The UK is not, however, unique in this respect. In the US lobby groups point to the annual $1.7 trillion burden on businesses from regulation[8]. The government is having some success in stemming the flow of new regulation through its One In One Out and now One In Two Out policy but relatively few businesses have felt its effects yet.

Skills shortages within industry have been a longstanding problem. According to a recent EEF survey[9], only 22% of firms reported having no recruitment problems, highlighting the widespread difficulty faced by many in accessing the skills necessary for growth. While 15% of companies surveyed were particularly negative about the UK's relative skills position, we are not alone in dealing with a shrinking pipeline of young people with STEM skills and an ageing workforce. For example, a recent comment from the German Chambers of Commerce noted that "every third company they surveyed said that they saw the skills shortage as one of the biggest risks to the development of their business over the next 12 months"[10].

Tax treatment of capital investment, essentially the UK's capital allowances regime, was also rated as less supportive of business investment than comparable regimes in other countries. This view was more strongly held by small and medium sized companies which are less likely to have benefited from the reductions in the headline rate of corporation tax, but have been impacted by previous reductions to the main rate of capital allowances. However, we should bear in mind that this survey was conducted before the Autumn Statement and the temporary increase in the annual investment allowance might have improved this rating.

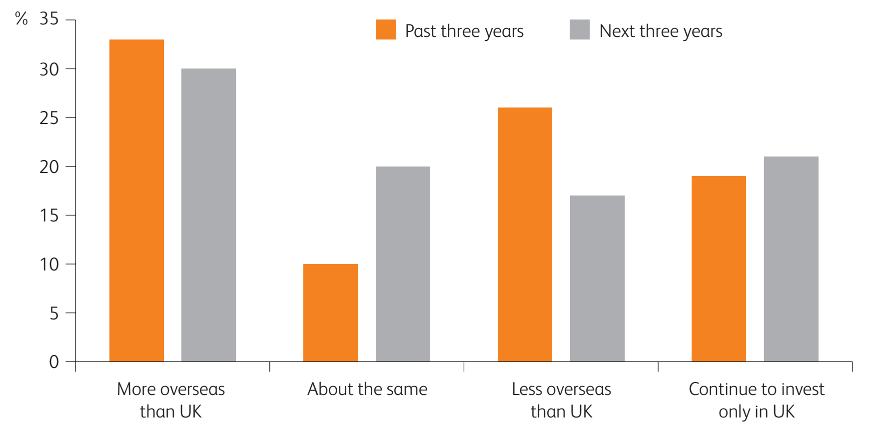
Investment intentions in the UK vs Rest of the World

With an increasing proportion of manufacturers with overseas production and positive investment intentions for the future, we asked companies about the balance of investment in the UK compared to overseas.

Chart 11 shows an overall shift in preference towards more overseas investment in the next three years compared to the last three years. Of those manufacturers with some of their production located overseas:

CHART 11 COMPANIES INVESTING MORE OVERSEAS THAN IN THE UK

% OF COMPANIES WITH PRODUCTION OVERSEAS STATING CAPITAL INVESTMENT LOCATION BALANCE



Source: EEF/GfK NOP Investment Survey

- Around 80% had made some investment overseas in the past three years and a similar proportion is planning overseas investment in the next three years.
- One third said they invested more overseas than in the UK in the past three years and this is expected to slightly decrease in the next three years, with 30% planning to invest relatively more overseas in the next three years.
- Looking to the UK's investment position in the next three years, fewer companies are planning to invest more in the UK than overseas compared to the past three years. And the proportion of companies investing only in the UK will remain approximately the same at 20%.

[8]National Association of Manufacturers, *A Manufacturing Renaissance*, www.nam.org/~/media/AF4039988F9241C09218152A709CD06D.ashx
[9]EEF, *Skills for growth: a more productive and flexible labour force*, www.eef.org.uk/NR/rdonlyres/ABA79301-3521-4B89-99E9-8BA966DAF569/21779/skillsforgrowth.pdf
[10]Global Post, 25 June 2012, www.globalpost.com/dispatch/news/regions/europe/germany/120622/germany-economy-labor

Investment overseas is not restricted to companies with operations abroad; some companies with no production outside the UK are also looking at overseas investment opportunities. Some 15% are looking to invest overseas in the next three years for the first time. Of these companies, almost half are planning to invest more overseas than in the UK which is not surprising as a first foreign investment is likely to be a significant undertaking.

Importantly our survey does not reveal any significant differences in perceptions of the UK business environment or the importance of pull factors between those investing more in the UK and those choosing to commit more investment outside the UK.

When it comes to investment location decisions, there are some things that can be influenced by government and others that are more difficult for government to change. Focusing on creating a favourable business environment and building positive perceptions will be important in attracting and retaining investment in the UK.

Attracting foreign investment

As well as making the UK a more attractive investment location for UK-based firms, increasing the number of foreign-owned firms investing in the UK is another route towards rebalancing. With a highly global manufacturing sector, the UK also needs to be actively competing for investment from large international companies. Foreign-owned companies are a very important source of investment and make a key contribution to the resilience of UK manufacturing sectors and supply chains.

– *Foreign-owned companies are more likely to be large and, therefore, will invest more:*
  Thirty per cent of foreign companies have more than 250 employees compared to only 16% of UK companies. Earlier we noted that large companies are responsible for the lion's share of UK business investment.
– *Foreign companies tend to take a longer term approach to planning capital investment:*
  Large companies take a longer term approach to planning new investments in capital equipment and R&D, which can demonstrate a lasting commitment to operations in a particular country.

With more investment and a more planned approach to capital expenditure, foreign-owned companies can be an important player in the development of important supply chains. The automotive industry provides a good example of how attracting foreign investment can strengthen and develop a sector.

The benefits of foreign ownership – the automotive industry

Foreign ownership has long been a feature of automotive companies based in the UK – in the early 1950s Ford and GM had a share of nearly a third of the British automotive market.

The volume car manufacturers producing in the UK are all foreign-owned, but have chosen to produce in the UK because of high productivity levels, access to a skilled workforce and availability of high quality suppliers.

2012 saw numerous and considerable investment announcements from these OEMs, despite a weak and uncertain European outlook, further boosting the UK automotive industry as a whole and providing opportunities and confidence for supply chains.

The opportunity in the UK market for the automotive supply chain is set to increase from £11bn in 2012 to £21.5bn in 2016 – many of these suppliers taking advantage of this demand will be smaller, UK-owned manufacturers.

ROADBLOCKS TO INVESTMENT

We now turn to some of the specific barriers that manufacturers face when making investment plans and implementing decisions.

Companies come up against a variety of hurdles which prevent planned investment going ahead – some of these are created by policy makers, some reflect shifts in the demand environment and some are internal to the company.

EEF's Business Trends survey has highlighted how demand uncertainty has impacted manufacturers' businesses over the past 18 months. For a number of manufacturing sectors the prospects for order books weakened through 2012 and visibility of the future orders pipeline was reduced – we have seen total new order volume balances drop from 21% in 2011Q1 to 3% in 2012Q4. Indeed, in separate research on manufacturers' plans, views and prospects for 2013[11], a global economic downturn was cited as the biggest risk to growth this year by two-thirds of survey respondents. In this survey, demand uncertainty was identified as a top three reason for rejecting investment by half of companies, and was given as the biggest reason by a quarter of companies.

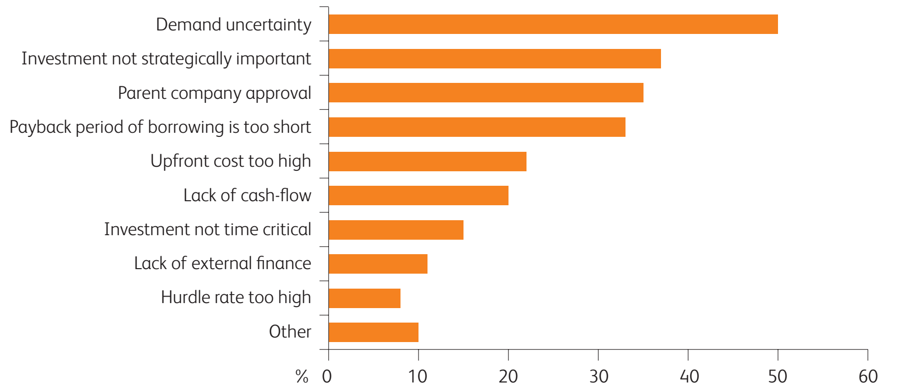
In effect, much investment will not be cancelled by the uncertain economic outlook or short-term shifts in prospects, but merely postponed until confidence returns and companies feel more positive that orders will be forthcoming. But the longer that investment is postponed by companies in the UK, whilst firms in other markets continue to invest, the less competitive the sector becomes and the bigger the gap that will appear.

In numerous cases, there will be a range of investment options that have been put forward and management must choose which are the most important to go ahead. Over half of companies cited that an investment not being strategically important or not time critical as a reason for cancelled investment.

Subsidiaries often rely on both approval and finance from their parent company and must meet certain conditions or criteria in order for investment funding to be approved. The attractiveness of the UK as somewhere to place investment also comes into play when decisions about the level and agreement to whether expenditure will go ahead are being made by a parent company, whether UK or foreign-owned.

CHART 12 CURRENT ECONOMIC OUTLOOK MOST CITED REASON FOR CANCELLED INVESTMENT

% OF COMPANIES



Source: EEF/GfK NOP Investment Survey

Finance environment is constraining cash

The finance environment is another important enabler of investment but for many companies it is also a constraint. Investment decisions can come down to whether or not there are sufficient internal funds available for investment and the cost and availability of finance from banks and other providers.

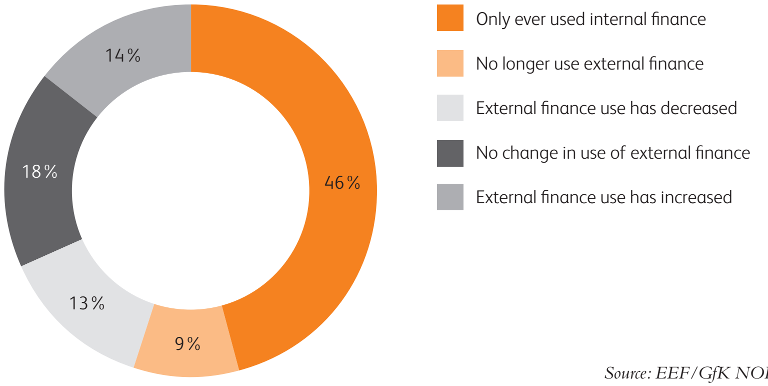
Looking first at internal sources of funds; a fifth of firms say that a lack of cashflow is the reason for investment not taking place and a similar proportion cite the upfront cost of capital equipment as a barrier to implementing new purchases of plant and machinery. This is a particular issue for small and medium-sized companies. EEF's Business Trends survey data shows that investment intentions and cashflow balances are closely linked (chart 14) and when cashflow balances fall, so do investment intentions. However, these constraints are also closely related to the external finance environment – an issue we will return to later.

The financial crisis has also changed the approach taken by some companies to cash management. There has been a lot of discussion amongst policy makers about large (or even excessive) cash holdings amongst businesses with estimates putting the corporate surplus at over £700 billion. In March 2011 the Office for Budget Responsibility (OBR) forecast '*strong business investment growth*' across the economy in the coming five years as a result of '*the corporate sector running a large financial surplus*'. Later in 2011, the OBR revised the outlook for investment citing uncertainty about official statistics on cash available to non-financial corporations.

Our survey shows a divided sector on this issue with 43% of companies saying that they had increased the amount of cash they are holding on their balance sheet due to the financial crisis and uncertainty in the business environment. But the same proportion said that this was not happening within their business.

CHART 13 USE OF INTERNAL FINANCE FOR INVESTMENT IS HIGH

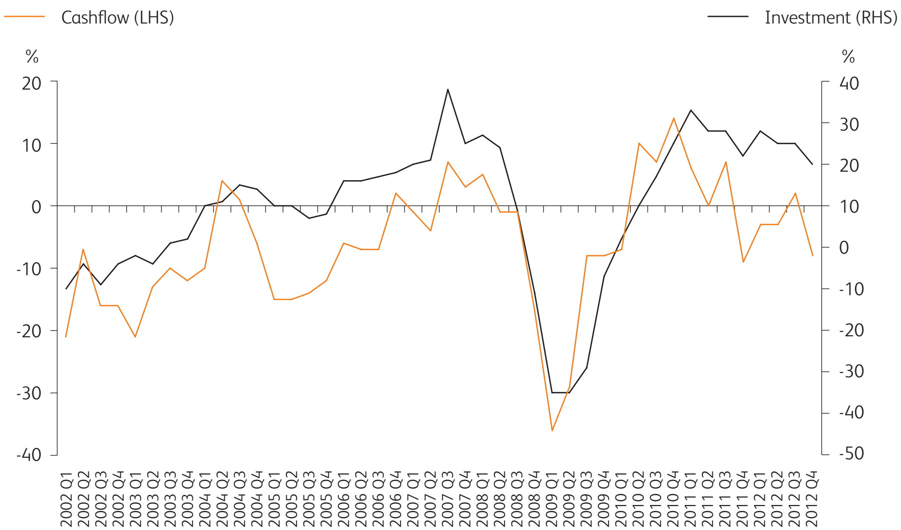
% OF COMPANIES REPORTING USE OF TYPE OF FINANCE FOR INVESTMENT



Source: EEF/GfK NOP Investment Survey

CHART 14 CASHFLOW BALANCES AND INVESTMENT INTENTIONS TRACK ONE ANOTHER

% BALANCE OF COMPANIES REPORTING INVESTMENT INTENTIONS AND CASHFLOW BALANCE



Source: EEF Business Trends survey

[11] EEF, *Executive Survey 2013*
www.eef.org.uk/NR/rdonlyres/EA2448C5-993A-4643-9AD4-8EA7904ED2BF/21979/EEFExecutiveSurveyJanuary2013report.pdf

There could be several reasons for increasing cash reserves, for example companies wanting to strengthen their balance sheets in order to get ready for the refinancing of debt or due to the external finance environment. Firms may also be holding off investing until business conditions improve or the right opportunities present themselves.

However, it should also be noted that a large proportion of this cash holding increase is not held in the UK and much of the balance is held by very large companies. Smaller companies are more likely to be struggling to access the cash that is necessary for investment.

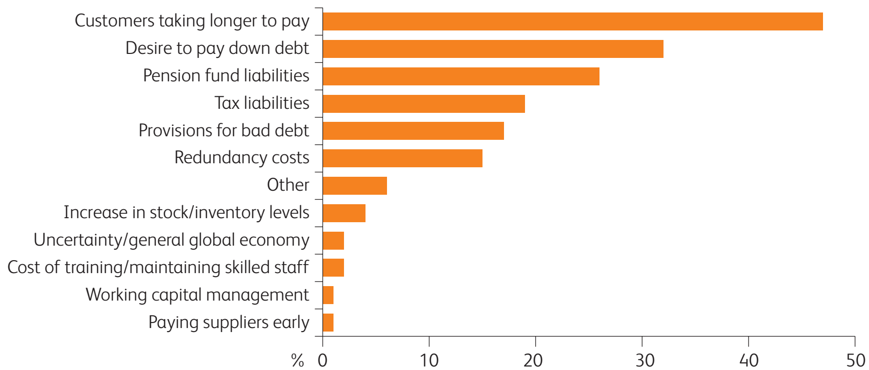
The conclusion would therefore appear to be that some, large corporates may well be in a position to take forward new investment plans, but this is by no means universally the case and nor is it guaranteed that those will take place in the UK.

Pull of cash away from investment

With long and complex manufacturing supply chains it is unsurprising that when companies act to preserve cashflow, this has knock-on effects on other companies. Just under half of surveyed companies said that customers taking longer to pay – topping the list of draws on cash – was an issue affecting the money available for investment. This was slightly more of an issue for small companies than large, but two-fifths of large companies still saw this as a concern.

CHART 15 OTHER DRAWS ON CASH PULL AVAILABLE FUNDS AWAY FROM INVESTMENT

% OF COMPANIES CITING AREAS AS REQUIRING SIGNIFICANT CASH THAT WOULD OTHERWISE BE USED FOR CAPITAL INVESTMENT



Source: EEF/GfK NOP Investment Survey

For a third of companies, there is a desire to pay down debt despite current low interest rates; a similar proportion across all sizes of company. Previous experience with banks during the financial crisis, when many companies saw renegotiation or removal of their lending facilities at short notice, has tainted manufacturers' appetite for exposure in this area. Many firms may also be aware that facilities arranged before the crisis with good terms may be coming to an end and are, therefore, cautious about what will be the offering for them when they need to renegotiate.

There are many areas which also constrain cash over which companies have very little sway, including both tax and pension liabilities. The latter is a particular problem for large companies, with nearly two-fifths saying this was a significant draw on cash compared with just over a fifth of small companies.

The very nature of manufacturing means there is a lot of uncertainty in the business environment. Our survey suggests that manufacturers are able to overcome some of the barriers they face but that others continue to hold them back. If they continue to be a constraint, this will pose a risk to an investment-led recovery.

In the next section we discuss the role of the government in removing or minimising the challenges manufacturers face when investing.

The legacy of final salary pension schemes

More than one quarter of companies said their pension scheme liabilities significantly limit their capital investment.

The UK is unusual when compared to most other EU member states, with the highest number of final salary pension schemes. Within the UK, manufacturing is the hardest hit sector with a proportionally higher number of these schemes[12].

The provision of occupational pension schemes has become increasingly costly for employers since 2007, creating instability for businesses, particularly those with Defined Benefit (DB) schemes. Monetary policy has compounded the issue in recent years through its impact on bond yields which has seen the cost of DB schemes increase since the financial crisis and as a knock-on effect, add to the contributions which employers are required to make to the Pension Protection Fund.

Pensions fund liabilities having a real impact on manufacturers

One manufacturer explained that over the last couple of years the company has had to put approximately £1.2 million cash into their pension deficit – approximately half of the company's profit before tax. They put as much money into the pension deficit as they spend on capital investment, and this is cash they would otherwise have used for investment.

Another manufacturer told us that the changes to the pension scheme in 2002 increased the time spent managing the scheme by the Finance Director from 12 to around 30 days per year.

[12] National Association of Pension Funds, *NAPF Annual Survey 2012*, http://www.napf.co.uk/Membership/Annual%20Survey.aspx

GOVERNMENT'S ROLE IN PROMOTING INVESTMENT

The government's choices and policy decisions have a real impact on manufacturers' investment decisions. The UK is not alone in seeking to attract and retain investment. Many countries are facing the challenge of rebalancing their economies and boosting investment which means there is significant international competition for a finite pool of investment. This section considers how the government can create a climate that supports investment and address the uncertainty that can weigh down on investment plans.

Our starting point is the priorities for reform identified by manufacturers in our survey.

An Industrial Strategy would have the biggest impact on investment in the UK

Government has a lead role in setting the destination for our economy with a clear vision of the priorities for better balanced growth. Manufacturers need confidence that key aspects of the business environment will not change substantially between a decision on investment being formulated and it delivering a return to the business further out. Establishing a long-term strategy for manufacturing was therefore identified as the single biggest change that would bring clarity and certainty and have a positive impact on investment plans.

Manufacturers plan their expenditure in order to ensure success in achieving their strategic aims. A third of companies say they plan a year ahead for expenditure on capital equipment and 40% say they plan 2-3 years ahead. Only around a tenth of companies say they do not plan with smaller companies more likely to have shorter planning horizons or not plan at all.

of manufacturers said a long-term strategy for manufacturing would have the biggest positive impact on investment in the UK.

said a long-term strategy for manufacturing was among the top three changes that would positively impact investment in the UK.

Planning is not limited to capital expenditure, R&D budgets are also thought out well in advance. While a greater proportion of companies say they do not plan for R&D expenditure (28%), the average planning period for this type of investment is just under two years. Size variations can be seen with a third of large companies planning four to five years ahead compared with just 9% of small companies.

While investment expenditure is generally planned well in advance, the decision on whether to go ahead with an investment or not takes into consideration factors that influence the viability of an investment over a much longer time period. When management boards make their decisions they look at the project's potential profits including expected sales, predicted future movements in input prices and, importantly, how government policy settings and legislation impact on their business costs. In the current environment, anecdotal evidence suggests that many boards require investments to generate a three to four year payback period. Greater uncertainty over any costs makes it more difficult for investments to meet required payback periods.

The government can provide greater certainty over costs and legislation

Constant changes to the policy environment undermine the certainty which manufacturers and other businesses crave when making investment decisions. The fact that the investment cycle, which spans from the inception and subsequent purchase of an investment through to resale or retirement of the asset, rarely matches the political cycle means the uncertainty that comes with new political terms and changing policy positions can spill over into business decisions. Different types of investment have different cycles: plant and equipment asset replacement cycles are becoming shorter as machinery is becoming obsolete at an increasing pace due to rapid development of new process and technology and constantly changing consumer demand. At the other end of the spectrum, the investment cycle for specialised technology, such as low carbon technology, can span decades.

For both these types of investment, the provision of greater stability over time for variable costs can be a big incentive for a company to invest. Clear long-term signals relating to the policy environment can often make a difference, firstly, to whether or not an investment decision goes ahead by giving greater certainty over the payback period and, secondly, whether that investment is ultimately made in the UK as they lower the risks associated with investment. Where there are limited differences between investment options, the existence of certainty within the policy environment can be the deciding factor and can, at times, tip the balance of an investment decision.

An industrial strategy needs to be based on a wide range of policies that matter for business

The route to better balanced growth needs to be informed by businesses' priorities. An overarching industrial strategy needs to focus on getting the policies that affect investment incentives right for the broadest possible base of businesses. We asked manufacturers to identify what they thought these priorities should be by asking them what changes to the policy framework would have the biggest impact on their investment in the UK.

Each of the policy areas outlined in this section is an important enabler of investment which, if we do not do right, could restrict business investment activity.

Certainty providing the right environment for investment

The managing director of the UK division of a large international organisation told us that frequent changes to policies, such as skills, tax and innovation support, reduce trust in the UK business environment. This in turn leads UK businesses to invest with more of a short-term focus. Businesses have little confidence that changes to policies in the UK, such as the churn in tax legislation over much of the past decade, will remain in place for long.

This was contrasted with a more consistent and long-term approach taken to the same policy areas in other parts of Europe that stretch over decades. While the approaches taken by other countries may not necessarily be the most efficient, over time they have proved to be more effective in providing a stable investment environment as they are widely known, understood and trusted.

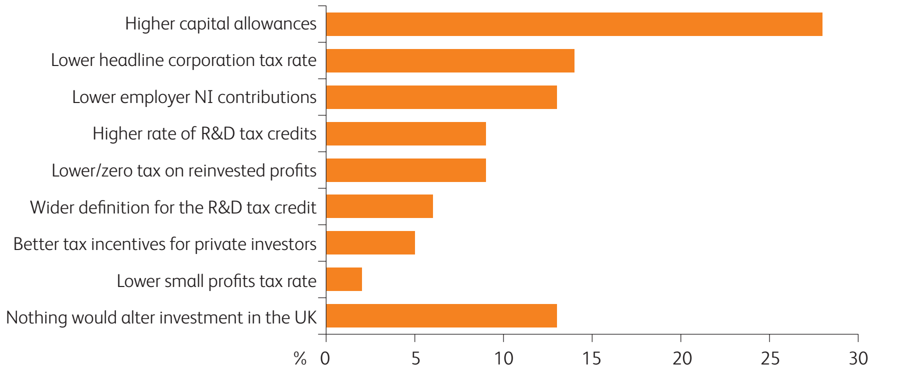
THE ROLE OF THE TAX SYSTEM

The tax system impacts decisions on both how much a company invests as well as where it chooses to make an investment. With manufacturers competing in very global markets, the competitiveness of the UK tax environment is an important part of ensuring the payoff and benefits from investing and doing so in the UK are worthwhile.

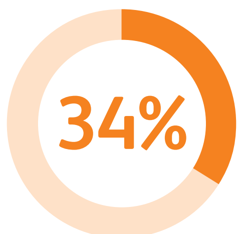
Chart 16 shows that the government has a very wide range of tax policy levers which impact the level of investment in the UK. Out of all tax system changes, increasing the rate of capital allowances was identified by 28% of companies as the reform that would have the biggest positive impact on investment in the UK. This was particularly important for small and medium sized firms. Other tax settings are also important with lowering the headline corporation tax rate and reducing employer National Insurance contributions being identified by 14% and 13% of respondents respectively as having the most significant impact on investment in the UK.

CHART 16 A WIDE RANGE OF TAX POLICY LEVERS TO IMPACT INVESTMENT

% RESPONDENTS THAT IDENTIFY CHANGE AS LIKELY TO HAVE BIGGEST IMPACT ON UK INVESTMENT



Source: EEF/GfK NOP Investment Survey



of manufacturers said a change to the tax system would have the biggest positive impact on investment in the UK.

said a change to the tax system was among the top three changes that would positively impact investment in the UK.

The recent reductions to the headline corporation tax rates and the increase in the Annual Investment Allowance are moves in the right direction and will have an impact on the level of investment in the UK.

> *"The increase in capital allowance will make a big difference to us and will definitely influence our [investment decisions]."*
>
> – Metal Products Manufacturer

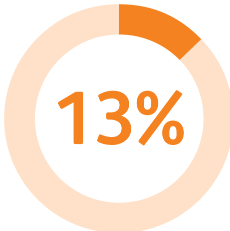
Yet internationally the tax environment continues to change as countries seek to improve the efficiency of their tax system over time and the UK needs to ensure it remains competitive and predictable in the long-term.

THE EXTERNAL FINANCE ENVIRONMENT

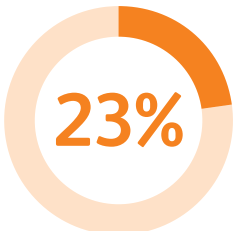
The financial crisis has changed the external finance landscape, making it more difficult for firms, especially SMEs, to access the finance they need at the right cost and with the right terms and conditions. This problem is having an impact on investment – over a third of companies report they have viable investment going unfunded because of difficult credit conditions associated with external finance. As shown in chart 17, this problem is more acute for smaller companies who rely primarily on banks for their external finance.

We see the main problem as a lack of competition in the SME banking sector. While some action has been taken to improve finance conditions – namely through the Funding for Lending Scheme – there is more that could be done to reverse the trends that have been holding businesses, particularly SMEs, back from using external finance.

The problems facing the SME banking sector are structural and the financial crisis has only exacerbated long running issues. Sustainable solutions will need to deliver results over the long-term and need to begin with addressing the underlying problem of a lack of competition in SME banking in the UK.



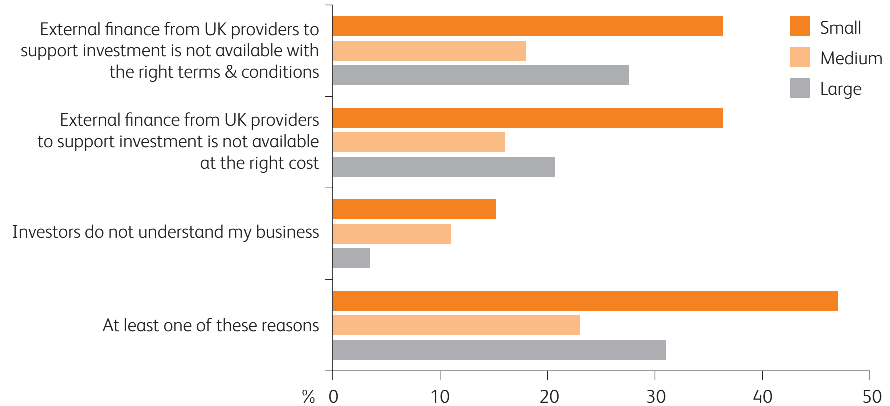
of manufacturers said an improvement in credit conditions would have the biggest positive impact on investment in the UK.



said an improvement in credit conditions was among the top three changes that would positively impact investment in the UK.

CHART 17 REASONS WHY VIABLE INVESTMENT IS GOING UNFUNDED

% OF COMPANIES AGREEING WITH STATEMENT

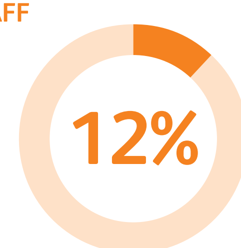


Source: EEF/GfK NOP Investment Survey

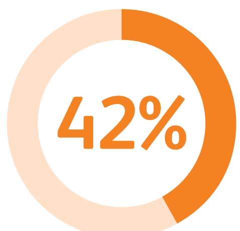
ACCESSING SUITABLY QUALIFIED STAFF

UK manufacturers' skills needs are increasing as they focus on innovation and developing new markets. In a global market it is crucial for businesses to be flexible and respond quickly to changing customer demand. However, UK companies are facing some significant challenges:

- Four in five manufacturers report having problems with recruitment
- Problems include both candidates' lack of technical skills and experience, and a lack of applicants.



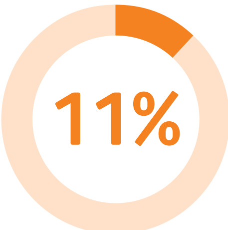
of manufacturers said increased availability of qualified staff would have the biggest positive impact on investment in the UK.



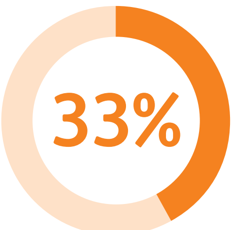
said increased availability of suitably qualified staff was among the top three changes that would positively impact investment in the UK.

The government has an important role to play in ensuring the economy has, and will continue to have, the right mix and supply of skills to support a growing and rebalanced economy. The absence of the right skills and the policy settings to ensure the economy retains those skills will make the profitability of investment in the UK more risky and increase the risk of it going elsewhere.

COMPETITIVE ENERGY COSTS



of manufacturers said competitive energy costs would have the biggest positive impact on investment in the UK.



said competitive energy costs were among the top three changes that would positively impact investment in the UK.

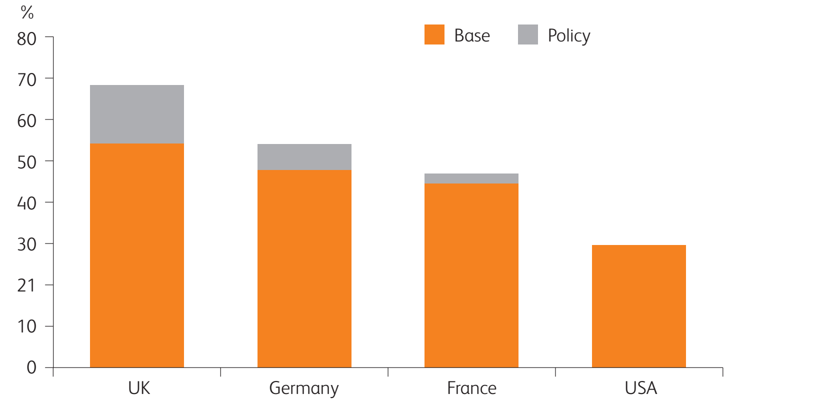
Globally, all manufacturers and businesses must bear the costs of energy but energy prices vary across countries. While countries generally face a consistent price of oil, other energy prices as well as government policy leads to very divergent overall energy costs and the UK does not come out well.

– UK prices have been higher than EU average prices for six of the last nine years.
– UK Energy Intensive Industries pay significantly more for electricity than key competitors: 130% more than the US, 45% more than France and 26% more than Germany.
– Government policy has a greater impact on prices in the UK than elsewhere.

Significantly higher prices make it difficult for UK manufacturers to compete effectively and make the UK a less profitable location for investment relative to other locations. Current prices are not the only concern and long-term policy commitments can place significant pressure on prices for the foreseeable future. UK government has indicated that current green policies will add 22% to today's prices, 34% to prices by 2020 and 45% by 2030.

CHART 18 UK GOVERNMENT POLICY HAS A HIGHER IMPACT ON ENERGY PRICES

ELECTRICITY PRICES IN £/MWH FOR ENERGY INTENSIVE INDUSTRIES IN 2011

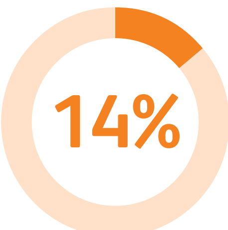


Source: Department for Business Innovation and Skills

There is a trade-off between achieving environmental aims and keeping energy prices competitive. The government needs to ensure the right balance is struck between the two and that investment is not being eroded to the extent that UK businesses are no longer able to compete in the global market.

SUPPORT TO COMMERCIALISE TECHNOLOGY

of manufacturers said more support to commercialise technology would have the biggest positive impact on investment in the UK.



said more support to commercialise technology was among the top three changes that would positively impact investment in the UK.

Innovation is an important part of growth of individual companies as well as the economy as a whole. The UK, however, does not innovate as successfully as other countries despite many individual companies, especially manufacturers, being highly innovative. Part of this is to do with the fact that UK businesses as a whole tend to invest less in R&D as a proportion of output than businesses in many other competitor nations – in 2010 UK business spent 1.1% of GDP on R&D, less than Germany and France who spent 1.9% and 1.4% respectively.

The balance of government support for innovation is weighted towards early-stage research rather than mid- to late-stage research. This means the UK struggles with converting basic research into commercial products and services that can make a profit. UK companies, and SMEs in particular, also face issues accessing the facilities and financing they need to support innovation.

The government could do a range of things to support the research process and help companies bring more products and services to market. Boosting funding for mid- to late-stage research, providing more focused support for SMEs and addressing finance limitations for innovation are some of the ways in which the government can increase investment in innovation.

Our survey clearly highlights that there is no one single action or lever that policy makers can deploy that will deliver the shift in business investment our economy needs. Manufacturers – small through large, with different strategies, serving markets across the world – inevitably place varying degrees of importance on varying aspects of the business environment when it comes to their next investment. Government can provide greater certainty about its overall economic priorities and focus future reforms on the horizontal policies that will support the widest group of manufacturers.

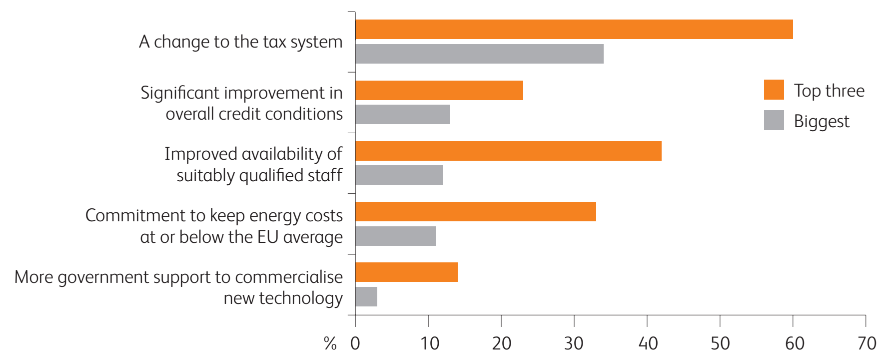
POLICIES TO BOOST INVESTMENT

This report has outlined a very wide range of factors that impact on manufacturers' investment decisions. Some of these factors are not easily changed including, for example, the economic uncertainty that is plaguing the global economy and how the geographical balance of growth is shifting. But the government does have a clear role and businesses have outlined what they consider the priority policy areas for reform to impact investment levels in the UK.

The table opposite outlines how these various policy areas can, with the right conditions, support investment by lowering the cost of production, increasing cash flow, ensuring the availability of inputs into investment (i.e. finance) and production (i.e. skills and staff), and facilitation of the process of getting products to market can make the UK a more attractive place to invest.

CHART 19 THE GOVERNMENT HAS MANY POLICY LEVERS TO IMPACT INVESTMENT

% OF RESPONDENTS INDICATING CHANGE WOULD HAVE A POSITIVE IMPACT ON INVESTMENT



Source: EEF/GfK NOP Investment Survey

Policy area	How policy influences investment
The tax system	Taxes in general reduce cash flow. Other policies administered through the tax system encourage certain behaviour, such as capital investment (through capital allowances) and R&D expenditure (the R&D tax credit).
Credit conditions	Tight credit conditions, which companies are subject to at the moment, make it difficult to get the right amount of finance needed for investment at the right cost.
Qualified staff	Lack of a pipeline of skills necessary to make investment productive, particularly when skills are available elsewhere, can increase the risk of investment being unprofitable.
Energy costs	The cost of energy is a significant cost of production for some types of companies, particularly energy intensive industries such as the steel industry. High costs make it more difficult for investments to reach hurdle rates and achieve the required payback periods.
Support to commercialise technology	There is more government support available for early stage research and companies often find it difficult to get the finance or support necessary to turn ideas and research into profitable and marketable products.

The specific policy recommendations outlined below should be priorities for government action. Each policy priority will support and boost investment in the UK, helping the UK achieve its ambitions and creating a more balanced economy.

1. ***Get the overall strategy right***
   As a first step, the government must set out a modern industrial strategy that sends a clear signal to businesses and encompasses the above key policy areas. This should not only drive all parts of central government to supporting the overarching aim of better balanced growth and influence outcomes at the forthcoming Spending Review, but it will also provide a clear framework for local areas, which will take on increased responsibilities for identifying and delivering local growth priorities.

2. ***Minimise uncertainty around future policy changes***
   Policy changes stemming from the European Union add to the instability in the business environment. Minimising this uncertainty needs to be a priority and the UK needs to provide a strong voice in Europe. The government must boost efforts to shape the future direction and focus of EU institutions to ensure they are committed to improving competitiveness, and build a coalition of Member States to make a stronger commitment to deregulation.

3. ***Further reforms of capital allowances***
   The increase to the Annual Investment Allowance will make a difference to manufacturers investment decisions. However, the increase is temporary and supporting greater investment in the UK in the medium-term will require more policy stability and a focus on significant improving the international competitiveness of the UK's capital allowance regime. We recommend consulting on reform of the capital allowance system so it better matches economic depreciation.

4. ***Increase competition in the SME banking sector***
   Measurable improvement needs to be made in banking, particularly SME banking, to lower the constraints access to finance places on investment. The government should kick-start efforts to increase competition in SME banking with a short review of actions to improve the competitive landscape, including how to lower barriers to new entrants and the case for an incentive for firms to switch banks.

5. ***Getting growth capital to the supply chain***
   Proximity to supply chain capacity is an important factor in manufacturers' investment decisions. If SMEs are unable to access the patient capital they need to tool up and meet new contracts, the UK may lose out on opportunities to anchor large companies, with high investment potential, on its shores. The government must work with the banks and industry bodies to develop more innovative thinking to get the finance mix right.

6. ***Developing a responsive and well-resourced skills system***
   Government has stated that investment in higher level apprenticeships (i.e. advanced and higher apprenticeships) is a priority for our future competitiveness. However, these require a significant investment of time and money by business. It should therefore reform its funding structure to ensure that resources are targeted at this area, providing greater support for employers who provide longer apprenticeships and greater opportunities for higher levels of attainment. Government has started to rebalance the skills funding model to allow employers greater freedom and flexibility in choosing the training which they need to provide to build their future workforces. Employer ownership needs to be accelerated and widened to allow employers of all sizes these opportunities.

7. ***A balanced energy policy***
   Investing in the next generation of low carbon energy must not hamper manufacturers with costs not faced by their competitors. There must be no open-ended subsidies for any energy technologies and our energy mix should deliver the required reductions in carbon emissions at the least cost. The government must impose and stick to strict limits on the costs that can be loaded onto electricity bills.

8. ***Boost funding for Catapult centres***
   Catapult centres are critical in supporting mid-stage technology readiness levels. While new, they already have a commanding interest and support from business. Over the course of this Parliament, core funding for Catapults should be increased and benchmarks set for SME engagement beyond that.

ABOUT US

EEF is dedicated to the future of manufacturing. Everything we do is designed to help manufacturing businesses evolve, innovate and compete in a fast changing world. With our unique combination of business services, government representation and industry intelligence, no other organisation is better placed to provide the skills, knowledge and networks they need to thrive.

We work with the UK's manufacturers, from the largest to the smallest, to help them work better, compete harder and innovate faster. Because we understand manufacturers so well, policy makers trust our advice and welcome our involvement in their deliberations. We work with them to create policies that are in the best interests of manufacturing, that encourage a high growth industry and boost its ability to make a positive contribution to the UK's real economy.

Our policy work delivers real business value for our members, giving us a unique insight into the way changing legislation will affect their business. This insight, complemented by intelligence gathered through our ongoing member research and networking programmes, informs our broad portfolio of services; services that unlock business potential by creating highly productive workplaces in which innovation, creativity and competitiveness can thrive.

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