TREASURY

Part-A

FILE NUMBER PO-CH/NL/0804

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FILE BEGINS 29-1-86 ENDS 12-7-88

FILE TITLE

PO-CH/NL/0804 Part-A

Interest Rate And Mortgage Lending

Alternative Uses of Agricultural Land And Sources of Rural Employment

1987-88 Cash Limited

FOR REGISTRATION USE ONLY	REFER TO	DATE	REFER TO	DATE

1988

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T.R.1.

Interest Rates
and mortgage
lending

LR2.20

3rd Rdg of Bldg Socs Bill? Or sooner?

Ch/
See also D Peretz + Bridgeman's minutes of 7 Feb, which arrived after this was written - which addresses the immediate issue - what to do about the Cheltenham + Gloucester. RL 13/2

FROM: MRS R LOMAX
DATE: 29 January 1986

CHANCELLOR

MORTGAGE LENDING GUIDANCE

PS Howard's views below, as requested

There is a long string of correspondence here, which I have summarised. Questions for decision at the end.

Background

2. The guidance issued by both the Bank and the BSA in January 1982 seeks to limit one aspect of equity withdrawal, by asking lending institutions to ensure that where they are increasing the size of someone's mortgage, when they move house, "the bulk of the unencumbered proceeds of the sale are applied to the new acquisition". Similarly when mortgages are refinanced, the size of the mortgage should not normally be increased unless the property is to be improved.

3. The guidance has always sat oddly with the Government's attitude towards direct controls. The question of if, when and how it should be ditched has been rumbling around since 1983. At the time of the Building Society Green Paper, we looked at the matter quite carefully, and decided that while it would be good to be rid of it, explicitly withdrawing the guidance would give the wrong signals about the Government's attitude to broad money and credit. To begin with, this was fully agreed between HF and the Bank, though the Bank have become increasingly attached to the guidance since last summer - as evidenced by their behaviour.

4. Over the past 6 months or so there have been a few cases where the guidance has been clearly flouted in word or deed by eg. Halifax, Kleinwort Benson, the Bristol and West and the Cheltenham

and Gloucester Building Societies. All raised the question of whether we should reaffirm the guidance or seek to enforce it. Kleinworts were forced to withdraw their scheme, under pressure from the Bank. The building societies have, from time to time, been spoken to (though we turned a blind eye to Bristol and West). The banks have become increasingly restive, believing (with some justification) that the guidance is not being applied even handedly.

5. The Economic Secretary (21 November) took the view that while it would be undesirable to keep the guidelines permanently in place (both in policy terms and because they were unenforceable) it would give the wrong signal to withdraw them now. So the choice lay between trying to keep the guidelines in place for as long as possible; and keeping the guidelines in place for the immediate future, but doing so in a way which would make it possible to withdraw them when the opportunity arose. In response, you commented (25 November) that the present position is unsustainable; and ruled out solemnly reaffirming the guidance. But you were worried about the possible tax implications.

<u>Tax</u>

6. At your request, the Financial Secretary and Inland Revenue took yet another look at the tax angle. The Financial Secretary concluded (20 December) that removal of the guidance would make little difference to the present position, both in respect of improper claims for mortgage interest relief, or borrowing for house purchase by those who could have used their own capital instead. Inland Revenue have consistently pointed out that the guidance is not directly relevant to the question of fraudulent claims for tax relief (which they say is not a major problem anyhow). It is directed at one particular aspect of equity withdrawal. They find it difficult to envisage cost effective tax measures that could deal with this problem (assuming it is one). If we are worried about equity withdrawal, they say the right

approach is to strengthen the guidance by incorporating effective checks and sanctions.

Monetary Implications

7. In the midst of this came Kit McMahon's alarmist letter of 29 November, strongly advising you against announcing the abandonment of the guidance, on pain of dire monetary consequences. In contrast to previous Bank advice, he tried to argue that the guidance was effective and that its removal would quickly lead to a situation in which a considerable number of banks who are not currently significantly involved in mortgage lending would offer heavily advertised schemes to refinance existing mortgages and allow equity withdrawal. This would mean "an abrupt cheapening of an extremely large source of consumer credit, with a large effect on total credit and the rate of monetary expansion" - the end of which could only be pressure on the general level of interest rates. The Bank's strong preference was to hold the line in as low key a way as possible - essentially by arm-twisting.

8. You will recall that we also touched on this issue at your meeting on the MTFS and monetary targets. You and Terry argued that, providing the authorities were prepared to increase short term interest rates when credit was growing too rapidly, there was no role for direct controls; high short-term interest rates would not necessarily reduce the growth of credit, but they would make it less of a worry. Frank - and to a lesser extent Peter - were not entirely convinced.

Questions

9. Questions for this meeting seem to me quite straightforward:-

(i) is it agreed that the present position is unsustainable?

(ii) should we be aiming to withdraw the guidance at some stage? Or tighten it up?

(iii) if the guidance <u>stays</u>, <u>how</u> should it be changed/enforced?

(iv) if we want to <u>scrap</u> it, <u>when</u> would be a good time - should we/can we wait until there has been a more marked slowdown in the growth of mortgage lending (you thought the latest figures <u>did</u> suggest some gradual easing). Is the building societies legislation a consideration?

(v) if and when we withdraw the guidance, how should it be presented? Do we need to give any advance warning?

RL.

RACHEL LOMAX

P.S. (vi) What, in the light of all this, should be done about Cheltenham & Gloucester & others, I gather, there has been no action since Frank's minute of 15/11 (below)! See Peretz/Bridgeman of 7/2, and your response 11/2. - below.

1149e
R A BARNES

Assistant Director,
Banking Supervision Division

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

24 November 1986

Mrs Rachel Lomax
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Rachel,

The Chancellor has asked whether any supervisory action could be taken to limit on prudential grounds the extent to which banks and building societies lend to individuals against the value of their property.

It is open to the Bank to issue guidelines about lending characteristics which, in its judgment, could either constitute imprudent behaviour (and thus lead to the possible revocation of an authority) or to require, in the course of normal supervision, additional capital to be held against assets which were deemed to be riskier than the norm. But such guidelines would need to be justified in terms of protecting the interests of depositors.

Lending to individuals, whether secured against property or not, is not, of itself, an activity which has involved lenders in particularly pronounced risk. The lender's first line of defence is the borrower's capacity to repay rather than the value of the security. If the lender reduces his standards of judgment about the capacity to repay solely because he takes comfort from the security, the loan may become riskier. If, in addition, he lends more than he would otherwise have done, because he gives full value to the security, the riskiness of the loan may increase further. However, even in this case, the lender is not exposed, except in extreme circumstances, to total loss. Sometimes, where the capacity of the borrower to repay is undoubted, it may not be imprudent to lend against the full value of the security. Given this continuum of risk it would be difficult to draw up a detailed guideline affecting individual lending decisions which the institutions would accept as workable and justified.

But even if an institution does undertake some lending with riskier characteristics, that is not necessarily imprudent (if it is appropriately priced) in the context of its business overall, unless the volume of such business affects the quality of its total assets to an extent that depositors are threatened. Lending to consumers whether against security of a mortgage or not, rarely predominates within a bank's asset base. It does not justify a special risk-weighting within the broad-based risk asset measure which is currently in use. The situation may well be different for building societies where the assets are more homogenous and where variations in risk can properly be measured by more precise differentiations within a class of similar assets.

It would also be odd to single out this sort of lending specifically for detailed guidelines. Might it not be taken to be the precursor of similar guidelines, eg say, about margins to be taken on marketable securities when charged against loans, or about unsecured lending to small businesses? The Bank believes that a letter on the lines proposed in the draft you have already seen is a more appropriate supervisory response to any reduction of lending standards which may be occurring.

If, on the other hand, the concern expressed is not so much the supervisory issue of protecting depositors but concern about, say, overheating in the property market or changes in the personal sector's propensity to save, then it may be relevant to note that personal loans of this sort are also granted by non-deposit-taking companies which would not be subject to any guidelines the supervisors might issue.

I am conscious that this adds very little to the points which you made in your note of 17 November.

Yours sincerely

Roger Barnes

P.S. I am sending a copy of this letter to Michael Bridgeman.

PERSONAL

PMP

Sir Peter [illegible] 3/12.

[illegible]

FROM: A C S ALLAN
DATE: 3 December 1986

CHANCELLOR

MEETING ON MORTGAGE LENDING GUIDANCE

I have just heard (6.30pm) that neither Peter Middleton nor Rachel* can come to the meeting: they have to go to meet counsel on your libel case - no other time available and your list has to be in by Friday. Very bad, but can't reasonably cancel meeting: it would be very difficult to fix up another time when everyone can be present and a decision is needed soon. 8.45 pre-meeting with Peter is also off.

2. The main papers for the meeting are

- David Peretz's original minute of 11 November with the recommendation that we should withdraw mortgage lending guidance towards the end of this year.

- The letter of 24 November from Roger Barnes (B of E) to Rachel about the limited potential for prudential action to restrain the growth of mortgage lending by banks.

- Michael Bridgeman's note of 25 November explaining his (fairly positive) proposals for building societies.

- Martin Brown's minute of 1 December with new statistics about building societies, confirming the rapid growth in both 100% mortgages and in high income multiples.

3. On mortgage lending guidance itself, there does not seem to be much dispute that we shall have to get rid of it, and before the end of the year. There are no great attractions in hanging on: it increases the risk of legal challenge, and to include it in the Budget would anyway give it too high a profile.

* Rachel is sending Martin Hall.

4. The main issue is whether anything can be done - and announced - as a counter-weight, so as to offset the market effects.* This is where the Bank supervisors and building society supervisors diverge. Michael Bridgeman is clearly sympathetic, and has already proposed a higher capital requirement for loans at or near 100%; he is also concerned about the relaxation of income criteria but feels it is not practicable to take account of that in capital requirements, at least yet. The Bank supervisors (and FIM) see much less scope for action, mainly because mortgage lending is a relatively small part of the banks' overall portfolio, and is rather better quality than unsecured consumer credit. I gather the Governor spoke to Eddie George after you raised this point at lunch, and we can expect a slightly more forthcoming line at this meeting, though not I suspect a complete conversion.

5. There is a separate issue about whether we can do more to deter abuse of the tax relief on mortgage interest payments; FST is investigating but does not seem to be scope for any early announcement.

AA

A C S ALLAN

(* a 1% increase in interest rates is, of course, one possibility in the background).

3214/43

CONFIDENTIAL

FROM: P J CROPPER
DATE: 4 DECEMBER 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Ross Goobey
Mr Tyrie

This was precisely why I posed the dangers of 100% mortgages & high multiple lending & why I convened the mtg. Despite the supervisory authorities' relaxed approach, I remain uneasy. But the proposal of the Dostrevski, ~~[illegible]~~ have agreed equity would make matters far worse. N.

MORTGAGE LENDING GUIDANCE

A few thoughts following this morning's meeting. The spectre which nobody mentioned is that of a sharp set back in house prices. There is nothing imprudent about borrowing 110% of the purchase price of a house if one knows for certain that it is going to appreciate steadily for the rest of time. But a replay of 1975-6 in the next year or two would give a lot of recent house purchasers sleepless nights.

2. Does not this underline two points:

(i) there is a strong case for believing that, in economic terms, mortgage tax relief has served its purpose in getting the owner occupancy rate up to 64 per cent, and from now onwards it may well do more harm than good to our monetary policy, our housing policy, and to many individuals (by luring them to their over-borrowed doom).

(ii) that a revived private rented sector is fast emerging as a social necessity. The Chief Secretary spoke of people dropping out of house ownership and relapsing into council housing because they cannot keep up their mortgage payments. Many of them are likely to be people who lacked the business acumen to manage a £60,000 asset on borrowed money in the first place. They should be able to revert to renting in the private sector, not to becoming a charge on the parish.

3. Thirdly, it strikes me as a very unstable situation in which people have to pay 27% or so to borrow on "plastic", while they can borrow at 13% from a building society and get tax relief at that. Should the two rates not converge?

4. If we are comparing quality of security on the basis of (i) bricks and mortar and (ii) second hand washing machines, there may (just) be logic in the discrepancy between 27% and 13%. But if we are judging security on the basis of the borrower's earning power and salary multiple, we are looking at the self same person and the self same income in both cases. All that differs is that, £ for £, the loan arrangements for a washing machine are disproportionately expensive to process compared with those for a house. That certainly does not justify the difference between 27% and 13%.

5. Standing back from it all, do not things point to an inevitable upward pressure on the mortgage rate compared with other rates of interest, and to big dangers when the house price boom turns downwards?

PJC

P J CROPPER

PS A secondary point, which does cause aggro, concerns people who have the security to borrow more against their house, but can only exploit their full £30,000 entitlement by selling their house and buying another, or by saying they are going to erect a wrought iron conservatory. Not everybody wants to move, or to build a conservatory. Any tidying up of mortgage relief ought to include arrangements whereby people could get their full £30,000 mortgage tax relief entitlement automatically, if they wanted it. Costly? Then that is an argument for cutting back the whole thing.

PJC

3736/003

CONFIDENTIAL

FROM: N J ILETT
DATE: 5 December 1986

PRINCIPAL PRIVATE SECRETARY

cc: PS/Economic Secretary
Sir P Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Peretz
Mr C W Kelly
Mr Neilson

Ch
Clearly got our timing exactly right with $4 billion. But potentially some worries about banks' liquidity — tho more serious in US. Don't mind the sound of planning to intervene in Euromarkets!!
AA

Right. PSR ask Mr Ilett for a note on the crisis wh. we might wish to intervene in. I am surprised.

THE FLOATING RATE NOTE MARKET

You will have seen press comment on recent price falls and the suspension of trading on Wednesday in the $FRN market (examples attached for ease of reference). Perpetuals have been particularly affected but other FRNs have also moved down - for example our recent issue is trading at LIBID or very slightly below rather as against the issue price of LIBID -8.

2. We have talked this over with the various people who have an interest at the Bank. As press reports suggest, the reasons seem to include;

(i) Belated recognition that instruments which yield less than LIBID are only of limited interest to banks whose marginal cost of funds is LIBID;

(ii) Rumours that Japanese banks are unloading holdings of FRNs issued by non-Japanese institutions so as to be able to take up FRNs issued by Japanese institutions should the Japanese authorities allow perpetual FRNs to count towards capital;

(iii) Market indigestion - issuing banks which have tied up money supporting new issues are reluctant to keep on doing so;

(iv) Belated realisation that "perpetual" means what it says, so that if the market turns it may be difficult to get rid of holdings.

3. As yet, there are no grounds of substance for supposing that this is more than a bad attack of indigestion or that the market is in any danger. The fixed rate sector is in good shape.

4. The supervisors at the Bank are not worried - while British banks may find it harder to add to their capital through perpetuals in the future, this does not affect the capital they have already raised, and British banks' holdings of FRNs are not large enough for price movements so far to cause worry. A fall in FRN asset values would be of greater concern to the US and Japanese supervisors. However, Dr Oonagh McDonald has written to the Bank to express disquiet at these developments and to ask what the Bank is doing about them. We have asked to see this letter and the draft reply.

5. I see more grounds for worry about two related points, ie our readiness and ability to handle major upsets in the Euromarkets and the state of thinking on the circumstances, if any, in which it would be right for us to attempt to intervene, and the techniques we would use. The first question is mainly about systems and the allocation of responsibility within the Bank, where a number of senior people have clear interests (Mr Plenderleith, Mr Gill, Mr Quinn and (on the international side) Mr Price and Mr D Green) but there is overall lead responsibility and, so far as a series of telephone conversations over the past couple of days has suggested, no serious consideration so far of a more structured approach. (The Bank has not itself been involved in the Euromarkets' internal meetings). On the second point, we would need to do quite a lot of work before we could give a convincing answer. At present, the Euromarkets are correctly thought to fall outside the area in which the UK authorities would be likely to intervene.

V unclear *why* we should contemplate intervening

6. Within the Treasury, FIM and MG are keeping in touch on the basis that FIM has lead responsibility except where MG is

operating in the markets for reserves management purposes.

for N J ILETT

Reference..

COMMENT Kenneth Fleet

DFC4

Floating note market sinks alarmingly

Earth tremors of serious magnitude were recorded yesterday in an exotic but very important market. Prices of euro-dollar floating rate notes which had been weak for the four preceding trading days succumbed to panic selling in the morning and the market ceased to function.

A meeting was hastily convened at the offices of Shearson Lehman, attended by some 40 market-makers. Only after they agreed, with misgivings, to quote much wider dealing spreads and to deal in smaller quantities, were dealings resumed. Prices, however, continued to fall, especially of the perpetual floating rate notes (like War Loans their effective redemption date is eternity). We have here the makings of a financial storm in which certain banks holding FRNs – they are classed as money market instruments – might get very wet.

For the time being the Bank of England is standing calmly, but no doubt vigilantly, on the touch-line. The Bank refused to intervene on the grounds that it was up to the market to sort out its own problems. It also decided that it was too early to say whether this "market phenomenon" would have any implications for British clearing banks' use of perpetual FRNs as a source of primary capital.

The Bank altered its guidelines in 1984 to permit banks to enlarge their capital base by issuing this kind of paper. Two that have had recourse to perpetual FRNs are Royal Bank of Scotland and National Westminster Bank.

It is not yet wholly clear why this market has got the jitters though it must be related to anxiety among dealers about where prices are heading, particularly if the Japanese, normally major buyers of FRNs after the turn of the year, are not in the mood to buy.

CODE 18-77

Clare Pearson explains why investors have deserted a fragile market

FRN traders struggle to restore stability

YESTERDAY'S CRISIS meeting of more than 40 floating rate note (FRN) traders, prompted by a free fall in the prices of perpetual notes, was the most serious measure to restore trading stability ever taken in the Eurobond market.

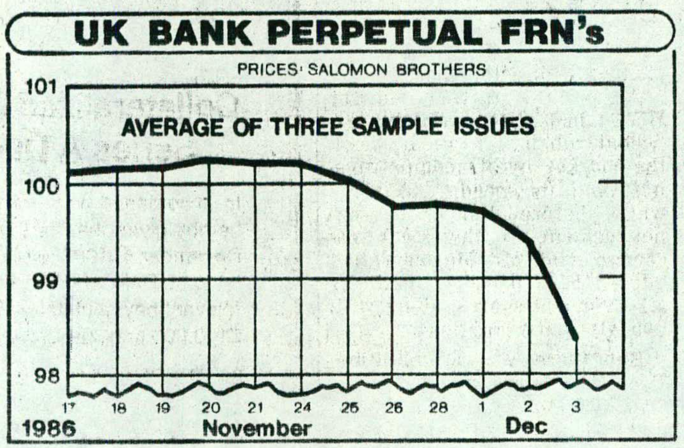
Yet even after the meeting, during which voluntary agreement was reached on dealing sizes and bid/offer spreads to restore stability, the market remained in a shaky state. It was not clear that the downward spiral is over.

After the opening, when prices fell by up to 1½ percentage points, some dealers reported that selected issues were showing an upward correction towards the end of the day. But many dealers remained reluctant to trade, despite the morning agreement.

The episode underlines the fragility of the FRN market, which has been trading nervously for some months but is now suffering a serious loss of confidence under the impetus of the desire to cut down inventory before the year-end.

It is also a measure of the difficulties that the self-regulatory bodies in the Eurobond market face in establishing agreed practices in this previously free-wheeling market.

A body of market makers, under the auspices of the Association of International Bond Dealers, recently agreed on trading guidelines in the tfixed rate market that will come into effect on January 2.



The rules do not so far extend to the FRN market, although a sub-committee has been set up to consider their applicably. If in force, they would forbid a suspension of market-making of the type seen yesterday morning before the meeting.

Perpetual issues have borne the brunt of the market loss of confidence, at the simplest level, because of increased awareness on the part of investors that the issues, which provide primary capital for banks, may never be repaid.

A reassessment of their value has been triggered by the general vulnerability of the market. Their fundamental attraction—their relatively high current yield—has looked increasingly less enticing as falling prices for fixed-term bonds have been improving their yields.

Yet issuing houses have greatly overestimated the retail investor demand for perpetuals. For one thing, investors are aware that a substantial flow of undated deals could be in the offing from banks in the US, France, and perhaps Japan, where a go-ahead from the authorities to treat perpetuals as primary capital debt is awaited.

Meanwhile the appearance of US-style asset-backed, dated FRNs, such as collateralised packages of mortgages, have been appearing to challenge the yield appeal of the undated bonds. These provide both a triple-A credit guarantee and a comfortable yield over Libor.

Such end-investor demand as there is has been eroded by the behaviour of the market-makers, many of whom have sold deals short in the hope of profiting from further price falls.

Confidence hit a new low point last week when a $200m FRN for Standard Chartered Bank was launched. This looked fairly generous compared with deals for the British clearing banks, but dealers found that even a yield spread of 15 basis points over six-month Libor and 50 basis point fees were not enough to stop the price from hurtling downwards in the absence of investor demand.

Yesterday's meeting was a desperate attempt to maintain liquidity. This was particularly pressing, given that the ability to trade is essential for an investor in perpetual FRNs.

But the perpetuals' collapse is also a sign of the more genera erosion of confidence in the FRN market which has been evident for some months.

The problem started during the summer, when Libid-based new paper for sovereign issuers made an appearance. Such bonds may attract large institutional investors with cheap sources of funding, but are mainly held by banks, the traditional FRN investors, only at a funding loss.

Traders agree that pricing at this level was never really accepted by the market. When professionals started marking prices down investors took flight, and have only recently begun bargain-hunting at lower price levels.

Bereft of end-investors, the market has been trading extremely thinly. This has been brought into focus by some erratic price movements in seasoned issues and widespread short-selling of new bonds. Dealers say the market has been heading towards a fundamental realignment for some time.

For many dealers, attempts like yesterday's touch only the tip of the iceberg. The fundamental problem, they argue, is a lack of evaluation ability among both investors and dealers, many of whom have never seen a bear market.

"They're scratching around for direction," said one market participant. "At least 50 per cent of them are very poorly equipped to cope with the market."

Reference ....

Floating rate note crisis deepens

FT DECS

By Clare Pearson

THE CRISIS in the floating rate note sector of the Eurobond market deepened yesterday as many dealers said they would abandon making firm prices in perpetual issues.

Dealers are facing substantial potential losses on perpetuals, which have no final maturity date, following very heavy price falls in recent days as institutional investors have shunned them.

The sector showed scattered signs of stabilising yesterday after yet another sharp price drop of up to one percentage point at the opening of business. Later in the day, prices of some issues—notably those of UK clearing banks, for which perpetuals have been an important source of capital—had risen from their lows.

The episode has highlighted divisions between large and small Eurobond firms and underlined the problems faced by the market as a whole because of tough competition. to manage new issues. This has caused too much paper to be issued on terms unattractive to investors.

For the second consecutive day, representatives of about 40 firms held an emergency meeting after trading in perpetual bonds had failed to revive. This was in spite of the previous day's agreement to reduce minimum dealing sizes and to widen the spreads between bid and offered prices.

Mr Tom Beacham of Wood Gundy, a prominent figure in the Association of International Bond Dealers and chairman of the meeting, said: "What we're trying to do is to get people to pick up their telephones again and re-establish some kind of dialogue."

Many dealers who attended the second meeting said that instead of quoting firm prices at which they would be committed to deal, they would merely indicate prices for a temporary period up to about the New Year. This was intended to stem nervousness and to assist a return to liquidity.

CODE 18-78

Eurobond dealers' pact

By Richard Thomson, Banking Correspondent

Eurobond dealers held an emergency meeting yesterday for the second successive day to find a way of stemming the sharp drop in prices which is undermining confidence in the perpetual floating rate note market.

Senior representatives of nearly 40 firms dealing in the bonds thrashed out a method of operating the market which dealers hope will tide them over at least until Christmas.

Six of the main market-makers decided to continue making firm two-way prices in perpetuals, while the majority agreed to give "basis" prices, which would serve only as indicators of the level at which they were willing to deal.

Mr Jerry Goldstein, managing director of Sanwa International, who was host for the meeting, said: "Wednesday's meeting was clearly not effective in stabilizing the market."

Yesterday, prices in perpetuals continued to tumble by one or two points.

506/41

Thanks: I have warned LPW, who quite understands. N

FROM: B O DYER
DATE: 5 February 1986

01-233 4749

C/ For 5.15pm meeting.
RO 5/2

CHANCELLOR

BUILDING SOCIETIES BILL : HOUSE OF LORDS STAGE

Your diary indicates that you are seeing the Leader of the House of Lords at 5.15pm today. In this context, you may wish to be aware - and, if you judge it appropriate, mention to the Lord President - that there are likely to be a significant, but not excessive, number of Government amendments tabled to the Bill during the Lords Committee Stage.

2. There are a number of reasons for this. But probably the most politic to deploy, if pressed, is that it is largely due to the Opposition Front Bench spokesmen wishing to clear the Bill's Commons Committee Stage as quickly as possible; to enable them to participate in the parallel Standing Committee on the Financial Services Bill. In brief, due to the Opposition's rapid consideration of some of the Bill's clauses in Standing Committee, officials and Parliamentary Counsel are finding it extremely difficult, and on some occasions impossible, to draft and table Government amendments within the contracted timescale. Report Stage in the Commons will be used to rectify this as far as possible, but some amendments will, alas, need to be deferred to Committee Stage in the Lords.

B. O. Dyer

B O DYER
Parliamentary Clerk

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

PMP

From D Y Pitts
Date 10 December 1986

PS/CHANCELLOR

MORTGAGE LENDING GUIDANCE

A note of meeting inevitably compresses all that is said but in paragraph 4 of the note of the 4 December meeting compression has, I am afraid, rendered a statement made by myself untrue. My recollection is that we were then discussing loans for purchases of council houses sold at a discount, ie where the valuation exceeded the purchase price. In that context, tax relief on advances of more than 100 per cent of valuation would be available only if the excess was for a qualifying purpose, usually improvements, other than purchase.

But as a general statement - as it appears in paragraph 4 - it is not true. In the more usual case, the purchase price is <u>greater</u> than the valuation. Tax relief would then be available on an advance of more than 100 per cent of valuation up to the purchase price.

This is a complex subject and I think it is important that there should be no misunderstanding.

The underlying point is of course that tax relief is available only for interest paid for one or more qualifying purposes, and whether the loan is more or less than valuation is in itself irrelevant.

pp. D Y PITTS

10 DOWNING STREET

LONDON SW1A 2AA

CH/EXCHEQUER
REC. 29 JUL 1987
ACTION PS/EST
COPIES TO Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Peretz
Mr C W Kelly
Mr Culpin
Mr Cropper

28 July 1987

From the Private Secretary

pup

Dear Alex,

INTEREST RATES

The Prime Minister this afternoon held a meeting to discuss interest rates. There were present the Chancellor of the Exchequer, the Governor of the Bank of England and Sir Peter Middleton.

The Chancellor recalled that in an earlier discussion he had said that if there were an opportunity to raise base rates by half a per cent, that would be desirable. The economy appeared now to have a lot of steam behind it, and credit was growing particularly fast. There were widespread concerns - though in some cases greatly exaggerated - that the economy was growing too fast for comfort, and the markets were edgy. The position would be eased if the Government gave a clear signal that it remained firm in its intention to keep financial conditions adequately tight. This would reduce the risk of difficulties in the autumn and possibly the need for an increase greater than half a per cent. It would be undesirable for the Government to be pushed by events.

The Prime Minister was not convinced that an increase in base rates was needed now. Total borrowing had fallen as a proportion of GDP since 1979 from 13 per cent to 11 per cent, so it was difficult to argue that there was excessive growth of credit. The disturbing scale of the settlement backlog at the Stock Exchange might also be a factor. The tone of the markets had improved today, and there was little evidence of edginess. Moreover, personal assets had increased by more than liabilities and of the deterioration in the current account in May, only a quarter was attributable to imports of consumer goods. It would in any case be wrong to take action on the basis of one month's figures. The June forecast had shown a substantially better prospect for the current account than the Budget forecast. An increase in base rates now would damage confidence and might well simply create a higher base for another increase in interest rates. Indeed the markets might well react badly to an increase, believing that the Government was aware of bad news not known to them.

In further discussion the Governor argued that the markets expected the next move in interest rates to be upwards, and the only question was one of timing. The yield curve now sloped upwards. The Chancellor agreed with the Prime Minister that many of the fears now being expressed were exaggerated. Nevertheless, his judgement was that conditions now warranted a small tightening. Figures for the past several months, including those for MO, supported this view. The confidence of the markets was of the first importance. Sir Peter Middleton noted that the growth of money GDP was uncomfortably high, and that there were at present poor prospects for a further reduction in the underlying rate of inflation.

Concluding the discussion, the Prime Minister said that the figures for monetary growth in July and the balance of payments in May had been known last week. An increase in base rates now would lead to accusations that the Government had simply delayed taking action until the Parliamentary recess. The June balance of payments figures would be known a few days before 11 August and there might also by then be indications of monetary growth in July. The need for an increase in base rates could be reconsidered if these figures suggested a case for action.

I am copying this letter to John Footman (Governor of the Bank of England's office).

Yours,

David.

DAVID NORGROVE

Alex Allan, Esq.,
H. M. Treasury

SECRET

SECRET AND PERSONAL

10 DOWNING STREET

LONDON SW1A 2AA

Refer to Alex before copying to anyone

From the Private Secretary

27 July 1987

Dear Alex,

INTEREST RATES

The Prime Minister and Chancellor this morning discussed policy towards interest rates.

The Chancellor noted that the CBI survey to be published tomorrow showed good results. However there was concern about the high rate of growth of the economy and there were signs of some looseness in financial conditions. Action now to raise rates by a half per cent would avoid the Government giving an appearance of reluctance, and might forestall a possible larger increase later.

The Prime Minister was very doubtful about the wisdom of an increase now. It could have an effect on mortgage rates, pushing up the RPI ahead of the September figure on which social security upratings were based. It would also harm exporters and this would be particularly damaging at a time when exports seemed to be turning down. An increase now would simply raise the starting level for any further increases.

The Chancellor noted that he might need to return to the Prime Minister on this within the next week or so.

Yrs,

David.

DAVID NORGROVE

Alex Allan, Esq.,
H.M. Treasury.

SECRET

SECRET AND PERSONAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

Refer to Alex before copying to anyone

PRP

6 August 1987

Dear Alex,

INTEREST RATES

The Prime Minister discussed with the Chancellor of the Exchequer this morning his proposal for a one per cent increase in interest rates.

The Chancellor of the Exchequer said that the market's reaction to the forthcoming trade figures would depend on its underlying tone. Information on the forthcoming money figures was based on a first guess and partial information, but it looked as if they would be a source of concern to the market. A particularly worrying feature was the indication of the underlying growth in MO, which was a good indicator of monetary conditions. Since he had last spoken to the Prime Minister there had been a slight deterioration in the tone of the markets, and sterling had drifted down despite some support. He remained of the view that it would be prudent to increase interest rates now. Monetary conditions were loose and we would regret it in the Autumn if there was not an increase now. Monetary policy was no longer bearing down on inflation. We could not afford to continue with a relaxed monetary stance or risk a gradually depreciating exchange rate. Without an increase in interest rates the chances of reducing inflation in the medium term would be reduced. He did not expect that one per cent increase in interest rates would reduce growth in any significant way. Of course inflation in the short term would be higher, for example, because the building societies would not proceed with the mortgage rate cuts envisaged for next month (which would add some 0.1 per cent to the RPI). But in the medium term an increase in rates now would reduce the level of inflation below what it would otherwise have been.

The Prime Minister said that she was most unconvinced about the need for any increase in interest rates. Sterling had maintained its position better than other currencies in the face of recent dollar strengthening. An increase in interest rates would be associated with tensions in the Gulf and could lead to damaging financial repercussions throughout world financial markets. A one per cent increase in rates would look as if the Chancellor was defending a particular exchange rate prior to entry into the EMS. She feared that it would increase unemployment and inflation damaging those sections of society whom the Government wished to help most. It would make it harder for exports at the very time when the current account needed strengthening. Nor should it be overlooked that the total borrowing (public and private) was down, and that the fiscal stance was tighter than had been expected. She feared too that the increase in interest rates would come just at the wrong moment when the economy was beginning to slow down on its own accord.

After further discussion, the Prime Minister said that she would not wish to stand in the Chancellor of the Exchequer's way if he was intent upon the increase in interest rates. He should make himself responsible for the public presentation of the increase by giving many TV and radio interviews over the next few days. The arguments of Labour Party spokesmen like Mr. Gould and Mr. Hattersley, had to be countered right from the beginning.

being redrafted

Finally, the Prime Minister said that she would welcome a note on bankers' balances held at the Bank of England, indicating the factors which determined their level and the significance, if any, that they had for monetary policy. She also asked the Chancellor to consider whether it would be worthwhile to make arrangements so that the authorities had earlier information about the direction of bank lending.

Yours ever

Nigel Wicks

(N. L. WICKS)

Alex Allan, Esq.,
HM Treasury.

chex.md/mw/61

SECRET

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cricc
Miss O'Mara
Ms Ryding

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

17 October 1988

Rt Hon Robin Leigh-Pemberton Esq
Governor
Bank of England
Threadneedle Street
London EC2R 8AH

Dear Robin

Thank you for your letter of 11 October. I concur with your conclusions and agree that the unpublished interest rate band should be set at 12-14 per cent.

Yours
Nigel

NIGEL LAWSON

CHIEF SECRETARY

REC. 23 SEP 1986

ACTION Mr Bonney

COPIES TO Mr Butler Mr Anson Mr Scholar Mr Cropper

Mr Monck Mr Burgner Mr Tyrie.

Mr Jameson Mr Edwards

Mr Shaw C Mr Instone

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

CONFIDENTIAL

PRIME MINISTER

ALTERNATIVE USES OF AGRICULTURAL LAND AND SOURCES OF RURAL EMPLOYMENT

At my meeting with you and other Ministers on 19 March to discuss a longer term strategy for reforming the Common Agricultural Policy, you summed up by saying that "there was broad agreement that price restraint was an essential element of our strategy for the CAP but that it would not be sufficient in itself to achieve the necessary objectives ... It was also now necessary to look at alternative uses of some agricultural land, in particular possible ideas on "set-aside" and the encouragement of alternative employment in the countryside". You invited me to consolidate proposals on these points into a paper for colleagues.

To do the preparatory work, I established an Interdepartmental Working Party of officials from the Departments most concerned. This has now produced a lengthy report and your officials can let you see this and the Chairman's covering note.

To try to identify the scale of the problem, the Group analysed the possible impact of reductions in surpluses on UK agriculture and the rural economy. The central estimate was a reduction in cereals of some 700,000 hectares (18%) and some 500,000 less (7%) for dairying. Given the normal loss from agriculture to other developments, this could leave some 1 million hectares of 'spare' land. The immediate impact of such a development would be likely to be in the marginal cereals and milk areas, ie the South-West, central and North Eastern England, East and South West Scotland and parts of Wales. Some farmers in these areas would turn to beef and sheep and this would have a knock-on effect, with implications for future levels of support, for farmers in the less favoured areas.

The speed and extent of these changes will of course depend on developments in Brussels which are notoriously difficult to predict. However, the steps which have already been taken by the Council of Ministers to cut surpluses - notably for milk and cereals, necessary as they were - have already caused problems, including cases of economic hardship, in both agriculture and the ancillary industries. Yet more needs to be done. We are tabling UK proposals for a form of 'set-aside' for cereals. We are working for improvemetns in the beef regime.

The harder we push and the more successful we are in these further discussions, the greater the extent to which we will be criticised for failing to take sufficient care not only of the farming industry, where incomes have been cut back, but also of the rural areas. To counter that we need to be able to demonstrate that we are taking positive action to promote alternative economic activity in the countryside and to safeguard the rural environment.

The key points to emerge from the report are as follows:-

(a) We do not face an exclusively agricultural problem. The impact of the squeeze on agriculture will have an impact on the whole countryside. This will be particularly serious in the remoter areas which are already suffering from major problems of depopulation and economic decline. This will concern not only those who live and work in the countryside, but the increasing number of city dwellers who take an interest in the welfare of the countryside.

(b) The Working Party has come up with a wide-ranging list of recommendations. Some of the policies are deliberately aimed at alternative uses of land currently producing surpluses - eg forestry. These would strengthen our hand in attracting support for any tough surplus-cutting policies. However, the basic purpose of the recommendations is the need to sustain the total rural economy and environment at a time of uncertainty and change.

(c) From amongst the recommendations, I believe that there are three aspects that demand particular attention if we are to respond to current problems in a balanced way (naturally with some flexibility to reflect differing circumstances in different areas). These are:-

- encouragement for a major increase in the planting of trees, particularly on better quality land than hitherto. This would have the maximum effect on surplus production. It can be achieved both by schemes directly to encourage tree production or by voluntary tree production as a result of "set-aside" measures such as we are advocating in Brussels;
- an increased effort to assist diversification into both agricultural and non-agricultural enterprises so as to sustain employement in the countryside;
- some relaxation in current planning policies, both specifically in relation to recreation and more generally in relation to industrial and urban development, subject to the general aim of protecting the best quality agricultural land.

Not all these proposals cost money. But it is clear that to make the maximum impact on public opinion, the Government must be seen to be making some additional effort. This will involve new resources rather than just reshuffling existing commitments in order to sustain the rural economy and the rural environment. Some action may be possible in the EC context, but this would take time to negotiate and might well not be what we want for the CAP. National action is necessary and could be cheaper.

Given the problem in defining the extent of the difficulties the UK industries face, the likely dilatoriness of Brussels over further action on surpluses and the range of policies we already have, it could be argued that there is no need for the Government now to intensify its efforts in this way - particularly if this involves increased expenditure. However, this would mean us standing by as farmers' financial problems multiply, as other rural industries get into increasing difficulties and as dereliction creeps back into the countryside. I do not consider this course to be politically sustainable.

My conclusion is that the government must be seen to be taking a positive stand in support of the rural economy and the environment to mitigate the effects of the cutbacks we must make in agricultural production. Now is a timely moment to do so. I am convinced that we can win support in the rural areas without alienating the conservationist lobbies. Indeed, we can present our policies - in contrast to those of Labour - as reconciling the interests of good conservation with the need to support agriculture and the rural economy.

I have already discussed with you the possibility of issuing a policy document before the end of the year. Attractively presented and realistic about the situation and what needs to be done, I believe we can respond effectively to what the Party wants (as witness the resolution for the Conference). But not if it contains mere platitudes. We need to point to positive measures which we have taken or intend to take to show our concern for the rural economy.

<u>Recommendation</u>

I accordingly recommend colleagues to agree:-

(i) that there is a need for a positive programme to sustain the rural economy and environment to mitigate the problems associated with tackling CAP surpluses;

(ii) that this programme should be based on the recommendations in Section IV of the Working Party's Report;

(iii) that amongst these recommendations, particular attention should be paid to the encouragement of greater planting of trees; diversification both on and off farm; and some relaxation in the planning policies in relation to recreation and the development of agricultural land; and that in addition the Government's intention to maintain support for agriculture in the less-favoured areas should be assured.

(iv) that such a programme should be announced in a suitable form along with our general approach to the CAP and to the role of the agricultural and food industries in the national economy.

If this is agreed, officials can be instructed to work up urgently the most cost efficient way of implementing these new ideas; and to prepare the draft of a strategy document.

I have discussed this with my agricultural colleagues who agree with my conclusions and recommendations. I have also put some proposals to the Chief Secretary about the financial implications, in the context of this year's Public Expenditure Survey.

Copies of this minute go to the Lord President, the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer, the Secretaries of State for Wales, Northern Ireland, Scotland, Environment, Employment and Trade and Industry, the Chancellor of the Duchy of Lancaster, the Chief Secretary and Sir Robert Armstrong.

M.J.
22 September 1986

NOTE PMP
Told Caroline Ryder M-Dight that CST wld represent HMT.
DL 4/11

S
Are you content to leave this to the CST?
Yes D 3/11

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

3 November 1986

Dear Joan,

The meeting on obscenity legislation scheduled for after Cabinet (approximately 12 noon) on Thursday 13 November has been changed to after Cabinet on Thursday 20 November. The Ministers attending this meeting are:-

Lord President
Home Secretary
Lord Privy Seal
Secretary of State for Trade and Industry
Attorney General
Mr David Mellor

The meeting on ALURE which was to have been held after Cabinet on Thursday 20 November will now take place on Thursday 13 November.* The Ministers attending this meeting are:-

Lord President
Minister of Agriculture, Fisheries and Food
Foreign Secretary
Chancellor of the Exchequer
Secretary of State for Wales
Secretary of State for Scotland
Secretary of State for Northern Ireland
Secretary of State for the Environment
Secretary of State for Employment
Secretary of State for Trade and Industry
Chancellor of the Duchy of Lancaster
Chief Secretary
Sir Robert Armstrong
Mr David Williamson

I am copying this letter to all the relevant Ministers.

Yours sincerely
Caroline Ryder

Caroline Ryder

Miss Joan MacNaughton
Lord President's Office.

* after Cabinet

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

CH/EXCHEQUER
REC. 10 NOV 1986 10/11
ACTION CST
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CONFIDENTIAL

PRIME MINISTER

ALTERNATIVE USES OF AGRICULTURAL LAND AND SOURCES OF RURAL EMPLOYMENT

We are meeting on 13 November to discuss my minute of 22 September and the report of the interdepartmental group of officials.

In preparation for the meeting, my officials here have been working with the Treasury on the financial implications of my proposals and I attach at Annex A an agreed note. This explains the different proposal and analyses their impact on land, agricultural surpluses, farm income, employment, the environment and on Government expenditure. Table 2 at the end shows the balance between direct savings in agriculture, support costs under the CAP and the costs of the package in the first 5 years. There will be some lag in the savings, and we have therefore included figures for the tenth year which show how savings will build up over time. The savings would be in addition to the benefits that would derive from general reform of the CAP.

It is of course of the essence of my approach that, in vigorously pursuing our objective of reducing the cost of the CAP, we should not at the same time lose the confidence and support of the rural sector. We are committed to urgent reform in the CAP systems which support surpluses in key commodities like milk and beef. We are pursuing our land diversion initiative for cereals which could make a major contribution to solving the problems in that sector and bring about net gains in expenditure terms. All this will be hard work. Price proposals from the Commission will have emerged by the turn of the year and I am sure we shall want to endorse these if, as I expect, they are aimed at reducing CAP support significantly. Faced with these strong adjustment signals, we do not want our efforts undermined by criticism that we are failing to safeguard the interests of our own producers. This was the message I got from the Party Conference this year.

The measures I now propose are modest. They could not fully cushion the industry from the effects of a tougher CAP. But they will give farmers some alternatives so that they can direct their efforts and skills into something other than producing surpluses. To retain their confidence we need to provide these options now at the same time as we are pressing for significant CAP changes.

I should like to stress that our problems in agriculture, whether in Brussels or at home, are not going to be solved with a single master stroke. The policy I am suggesting draws on ideas for alternative non-surplus production opportunities, especially trees, for safeguarding the environment, for encouraging alternative enterprises among farmers and small rural businesses, for providing assistance to those in the less favoured areas, and for loosening our land use policy. It offers farmers choice. It is voluntary. But it represents a package which should be seen as a whole. If we provide farmers with these opportunities they would not be able to lay the claim that our stance on CAP reform completely ignores the farming sector.

The same goes for presentation. The impact of the new proposals will be lost unless we present them as a whole. And the domestic measures need to be seen in the context of our policy on the CAP and our support for international efforts to put world agriculture on to a more sensible basis. We need to explain that as a Government we have a coherent view as to how all these inter-connected problems should be tackled. Hence my proposal for a policy document. I am also attaching at Annex B to this minute a synopsis of a policy document on which my officials are working with the other agricultural Departments It does of course crucially depend on being able to announce the new policy directions which I have proposed. The full text will need to be discussed at official level with all Departments concerned and cleared with colleagues in the usual way. I would hope to publish early in the New Year. I believe the full package, announced in this way, would bring long term financial benefits and an immediate political advantage.

I am copying this minute to the Lord President, the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer, the Secretaries of State for Wales, Northern Ireland, Scotland, Environment, Employment and Trade and Industry, the Chancellor of the Duchy of Lancaster, the Chief Secretary and Sir Robert Armstrong.

M J
10 November 1986

ALTERNATIVE USES OF AGRICULTURAL LAND AND SOURCES OF RURAL EMPLOYMENT (ALURE)

(Note by officials in HM Treasury, the Agricultural Departments and the Forestry Commission)

1. This note considers the objectives and financial implications of the specific proposals made by the Minister of Agriculture in the context of his minute of 22 September to the Prime Minister.

General Objectives

2. Agriculture Ministers consider that there is a need for an integrated package of policy measures which taken together would serve to reduce expenditure on CAP support, to provide opportunities for farmers to maintain farm income, to sustain rural employment and have a positive impact on the environment. In their view the proposals comprise a modest, but nevertheless essential, response to the structural change facing the agricultural sector over the next 10 years which the ALURE Working Party projected as the consequence of a reduction in the level of CAP support. **Table 1** summarises in schematic form the expected effect of the individual proposals on land use, farm income, rural employment and the environment and also the relationship with surpluses and any proposed action at EC level.

3. It is necessary to consider the direct costs of the measures proposed, consequent savings in agricultural support expenditure and the relative effectiveness of each measure as a means of achieving the overall objectives. Details of the Agriculture Departments' estimated costs and savings over the first 5 years together with an indication of the position in year 10 are set out in **Table 2**.

4. In the 1986 PES discussions Agriculture Ministers have agreed not to pursue a bid for additional funds, pending collective discussion. This is on the understanding that if agreement is reached on the merits of the proposals the Chief Secretary will be prepared to consider a claim on the 1987/88 Reserve, if necessary, and that savings in IBAP expenditure could be regarded as a legitimate offset to any bid where

there is a fair guarantee that land is being taken out of surplus production. The Chief Secretary nonetheless considers that any new expenditure arising out of the ALURE recommendations should be financed within the current planned total PES provisions for domestic agriculture, forestry, fisheries and food of some £950m, if necessary by the re-allocation of priorities within existing programmes.

5. The following paragraphs discuss the proposals and relevant assessments in more detail. If the proposals are accepted in principle, more work will have to be done on the detailed implementation of the schemes, including the scope for targetting them on specific objectives. The costs and savings will need to be reviewed in the light of progress on CAP reform in view of their sensitivity to market circumstances for key products viz beef, sheep and cereals.

Traditional Forestry

£m

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline (Forestry Commission total grant in aid)	53.8	54.2	55.1	-	-	-
additional bid	+4.9	+5.0	+5.2	+5.3	+5.4	+ 7.7
CAP savings	-	-7.0	-11.1	-18.2	-7.5	-36.2

Note: No baseline provision has been agreed beyond 1989-90. The bids assume a 2½% pa increase in future years.

6. The proposal is to encourage extra private sector planting of woodlands of some 20,000 ha a year, ie a doubling of the present planting rate. The objectives would be to divert a substantial area of land from agriculture to forestry, thereby achieving a consequent reduction in surplus agricultural production; to increase timber production and to provide a source of rural income and employment. The Forestry Commission estimate that there would be a gross gain of some 1,600 jobs, some in local towns. The net gain would depend on the extent of any reduction in agricultural employment. The environmental effects would depend on the areas planted, the species involved, previous land

use, landscaping etc. Close attention would be given to these aspects under the Forestry Commission's consultation procedures. Achievement of these objectives would be evaluated by monitoring the additional area planted by type of land use and surveying the net effect on employment and income.

7. The costs of the proposals are based on the assumption that the area envisaged would be taken up at existing grant rates. The Forestry Commission take the view that to secure this take-up on better land than at present, a further fall in land prices - perhaps of as much as 15-20% - and some relaxation of clearance criteria by the agricultural departments would be required. The level of grants is periodically reviewed and could in principle be raised or lowered if necessary. Grant expenditure on planting is demand-led, but has in practice been contained within the cash limited grant-in-aid to the Forestry Commission.

8. The savings allow for a year's lag after planting before savings in CAP support are realised. In anticipation of some success in reforming the CAP they assume a 2% per annum cut in CAP support costs from 1988/89 onwards. Although it is not at present the practice to direct planting to any particular grade of land, it is assumed that 50% of the additional planting would take place on poorer quality lowland and 50% in the disadvantaged areas (LFA Area B in the **attached map**), as opposed to the severely disadvantaged areas (LFA Area A) where afforestation is more likely to come into conflict with environmental interests. The majority of land would be diverted from beef production which is the most marginal enterprise in many of the areas in question. In addition some sheep and barley production would be affected. It is also assumed that farmers would divert their less good land. Details of the assumptions are provided in the notes attached to **Table 2.** It will be noted that the savings in the 5th year are shown to decline. This is intended to reflect a reduction in the support costs of the EC beef regime at that time. Over the longer term however savings would cumulate and by the 10th year exceed costs appreciably.

Farm woodlands

£m

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline	0	0	0	-	-	-
additional bid	+ 3.0	+ 7.0	+9.3	+11.6	+14.1	+30.0
CAP savings	-	- 3.4	-11.1	-18.2	-7.6	-36.5

9. The proposal is to introduce a new farm woodland scheme which would offer farmers an annual payment (as well as planting grants) to reflect the agricultural income they would forgo and recognise the lack of income from timber until thinning starts (years 15 to 20). The objectives would be diversion of land from agriculture (assessed to be about 7,500 hectares in year 1 and 15,000 hectares thereafter) and a consequent reduction in surplus agricultural production; provision of an opportunity for farmers to maintain income and employment; and the enhancement of wildlife and the landscape, which would be aided by the scattered nature of farm woodland planting. Monitoring and evaluation would be on the same lines as for traditional forestry. The aim would be to introduce effective expenditure control systems, but further consideration of this aspect is required.

10. The payments would be made to farmers, but not forestry companies. They would vary by quality of land to avoid making unduly generous provision on poorer land and would be subject to review. There would be a minimum plot size and a condition that land planted should have been in agricultural production. It would have to be decided whether the new scheme would be administered by the Forestry Commission or the Agricultural Departments, but it would be designed to encourage responsible management of the timber crop, effective marketing (including encouragement of on-farm processing) and environmentally sensitive planting. It might be introduced under powers in the Forestry Acts or the necessary legal vires might be contained in the forthcoming EC proposals on forestry.

11. The costs assume that a scheme would generate a positive response, particularly from marginal farmers. Annual payments of about £150 per hectare in the lowlands, £50 per hectare in the disadvantaged areas and £30 per hectare in severely disadvantaged areas, in addition to existing forestry grants, are judged to provide a sufficient incentive. The calculations assume nearly 30% of broadleaves and the grant costs would rise if the proportion were higher.

12. The savings are on the same basis as those for traditional forestry, but assume 80% planting on poorer quality lowland, 10% in the disadvantaged areas and 10% in the severely disadvantaged areas. Again the majority of land would be diverted from beef production. By the 5th year of the scheme cumulative savings would almost equal cumulative costs, but over the longer term, as shown above, would exceed costs.

13. Consideration might also be given to a premium to encourage the use of better cereals land if farmers were only showing interest in devoting grassland to forestry, but this would depend on EC decisions on a cereals diversion scheme. Such an approach would increase costs, but the savings would also be greater.

Environmentally Sensitive Areas (ESAs)

	£m					
	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline	5.0	6.0	6.0	-	-	-
additional bid	+4.0	+6.3	+6.5	+6.7	+6.9	7.8
CAP savings	-	Around £1.5m year.				

14. The proposal is to approximately double the present provision for ESAs in which grants may be paid to farmers who agree to maintain traditional farming practices. The objectives would be primarily environmental, but there would be some effect on CAP support since one of the objectives of the ESAs is to restrain and in some cases reduce agricultural production on participating farms. The original set of ESAs have not yet been implemented and information about their cost effectiveness is not yet available. However, the additional bid would enable Agricultural Departments to designate all the remaining short listed areas for which a strong and pressing case has been made out. Agriculture Ministers would have to decide on the additional areas that might be designated and on the territorial allocation of the additional funding. The new ESAs would be evaluated in the same way as the ESAs about to be designated, as required by legislation.

15. This proposal would involve a long term commitment to public expenditure. Expenditure would be borne on the Agricultural Departments non-cash limited Votes, but subject to the expenditure controls recently agreed for the capital grants programme. Partial EC reimbursement of ESA expenditure could become available if a current Commission proposal is adopted.

16. The savings can only be assessed in the broadest terms. The order of magnitude given above is based on the likely difference between the volume of production within the existing ESAs with and without designation.

Diversification

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
	£m					
PES baseline						
(i) diversification* grants	2.0	2.0	2.0	-	-	-
(ii) marketing support	11.4	11.1	11.1	-	-	-
bids						
(i) diversification	3.1	3.2	3.2	3.3	3.4	3.8
(ii) Marketing support	1.0	1.1	1.1	1.1	1.1	1.2
CAP savings			marginal			

* relates to capital grants on tourism and crafts in the LFAs, the only existing agricultural aid for diversification. The overall provision for all agricultural capital grants is about £134m (1987-88).

17. The first proposal is to introduce a scheme for grants to ancillary farm-based industries under Section 22 of the Agriculture Act 1986. The objectives would be to enhance and maintain farm incomes by assisting farming families to look to alternative forms of activity other than increased surplus production; to widen rural employment opportunities; and to extend to the non-LFA the incentives to farm diversification already offered under the capital grants scheme. The scheme would cover 15% (30% in LFAs) of the capital cost of providing facilities for value-added processing of produce from the farm eg fresh dairy products, meat products, bread and bakery products and ready prepared meals; preparation of fruit and vegetables; timber, wool and skin treatment; and the provision of recreational facilities. The grants would be aimed directly at the needs of farmers, unlike assistance from other rural aid agencies, such as COSIRA, which they would be designed to complement. Further work on how this would be achieved is already in hand.

18. The second proposal is to encourage co-operatives to extend their activities into value added processing and to help them market their products. The objective would be to improve farm income and awareness of new marketing opportunities. This proposal could involve new primary legislation.

19. The success of these two schemes would be evaluated by surveying the durability of the projects in question and the impact on income and employment, using case studies where appropriate.

20. The costs are derived from estimates of existing craft and tourism grants in the LFAs and existing marketing activities. Expenditure would be controlled in the same way as under existing programmes.

Research and Development

21. The proposal is to fund new R & D into novel crop and livestock possibilities and to conduct further woodland experiments. The cost would be met from the existing PES provision. The objective would be to develop new ways for farmers to diversify away from the production of surplus commodities. The private sector would be unlikely to undertake this research by itself in view of the long term nature of the potential benefits. The success of this work would be evaluated in the same way as the rest of the R & D programme.

Land use planning and recreation

22. The proposal is to review the policy on the protection of agricultural land with a view to facilitating the release of land for recreation, horses and certain other developments. The objectives would be the encouragement of enterprise and employment in rural areas and some savings in CAP support costs. There could be problems with countryside interests unless the changes were handled in a sensitive way. The success of this new approach would be evaluated by analysis of land use statistics.

23. It is not possible to estimate what effect changes to the policy on the protection of agricultural land would have. The extent to which the policy was relaxed, and the impact this would have, would depend on decisions following public consultations. At present, transfer of land to uses other than forestry is running at 14,600 hectares a year in England and Wales, 1,000 hectares in Scotland and 500 hectares in Northern Ireland. However, a total of about 5,500 extra hectares a year might be used for sport (notably golf courses), horses and other recreational uses. If this was wheat and barley land yielding on average 6 tonnes per hectare the savings would be as follows:

						£m
	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
CAP savings	-	-3.0	-6.0	-9.0	-12.0	-30.0

In view of the uncertain effect of the proposed changes in policy, such savings cannot be guaranteed and it would not be prudent to adjust the IBAP baseline on this count.

Administrative costs

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline						
(i) MAFF	213.5	222.1	226.1	-	-	-
(ii) Forestry Commision (Forestry Authority)	8.5	8.8	9.0	9.3	9.5	-
Total additional bid	+5.1	+7.6	+7.7	+8.0	+8.2	+9.3
Savings on planning		-0.2	-0.2	-0.2	-0.2	-0.2

24. The additional (costs set out in detail in **Table 3**) primarily reflect the high administrative costs for forestry and farm woodlands because of the need for close supervision of forestry, mainly to ensure environmentally sensitive planting, the cost of the associated consultation procedures and farmers lack of experience in forestry.

7 November 1986

CONFIDENTIAL

POSSIBLE POLICY DOCUMENT: DRAFT SYNOPSIS

Note: the intention is to produce an illustrated booklet, using colour photographs and graphs (but no tables of figures) and an attractive layout.

FARMING TODAY: ACHIEVEMENT, CHALLENGE, PROSPECT

Introduction

- agriculture provides both food and core of rural economy;

- but challenge of changing consumer preferences and surpluses; Government commitment to CAP reform;

- need for balance (farming/rural economy/conservation/public enjoyment) in the countryside;

- hence emphasis shifting to enable farming to rise to new challenges.

The Achievements of Agriculture and Food Industries

a) Brief account of UK farming industry and domestic and EC support arrangements; emergence of surpluses and its causes (CAP incentives and increases in technical efficiency of production) significance of related industries (notably food and drink); export performance.

b) Recent achievements of the industries and major actions by Government.

c) Farming is only part of wider rural economy; contributions made by Development Commission and employment programmes (and Scottish/Welsh/Northern Irish equivalents).

The Challenge of Surpluses and Changing Demand

a) Surpluses are a world problem, not just an EC problem; food aid not a solution.

b) Options for the CAP; price cuts must feature large in solution, disadvantages of quotas or other physical restrictions; "co-responsibility"; land diversion.

c) Farmers face CAP changes. Government approach to negotiations based on three principles:

- surplus problem must be recognised and tackled effectively by measures bringing supply and demand into better balance;

- the measures must give greater weight to market conditions and include firm price restraint;

- policies must be evenhanded and fair;

d) Prime function of farmer is to feed consumer: changing demand (lifestyle, health, convenience). Need for farmers to present and market their produce; and to respond to public concerns (eg pollution, animal welfare)

Responses by Industry and Government

a) Government commitment to competitive economy.

b) Farming is an enterprising small business industry. Continuing need for efficient and competitive farm and food industries within EC and World context. Industries need to exploit opportunities and technology more effectively, but not to produce unwanted food. Some Government back-up appropriate (support for hills, R&D, advice). Alternative crops (ALURE).

c) Better marketing: examples of successive initiatives; industries need to support Food from Britain.

d) Farming remains key element in wider rural economy. Need for balance (s17, Agriculture Act 1986). New AIS includes grants for tourism and crafts on farms in less favoured areas; intention to introduce scheme for supporting further alternative enterprises on farms (activating s22, Agriculture Act 1986) (ALURE).

e) Opportunities for rural enterprise off farms - eg Development Commission (DoE, DEm, DTI to supply as appropriate)

f) Most farmers sensitive to environment. Environmental protection already built into grants. ESAs a major new initiative; proposal to increase funding (ALURE).

g) Forestry and woodlands. UK still major timber importer. Policy of expanding private sector traditional forestry will continue, with more on better land (ALURE). Proposal to introduce farm woodland scheme aimed at encouraging planting as part of the normal farm enterprise on land no longer needed for food production (ALURE). Brief mention of rehabilitation of existing woodland and short-rotation coppicing (ALURE).

h) Land use: proposal for relaxation of agricultural land protection policy without threatening green belts or rural heritage (ALURE).

Conclusions to cover:

(a) efforts in concert with Community partners to secure a satisfactory outcome to the GATT negotiations on agricultural trade;

b) Improvements within the Common Agricultural Policy to be based on three principles set out above.

c) achievement of these objectives will bring major adjustments in the industry. Government intends to assist process through existing and new schemes, better directed R&D, changes in land use constraints, etc all aimed at offering opportunities for enterprise to flourish;

d) encouragement to British food and farm industries to be competitive and to seize opportunities to take a larger share of the available market in Europe and beyond.

ALURE PROPOSALS

TABLE 1

Main options considered	(i) land used over 5 yrs ('000 ha)	(ii) ag. surpluses	(iii) farm income	(iv) net rural employment	(v) environment	(vi) exchequer cost over** 5 yrs	(vii) savings in* CAP support costs over 5 yrs	(viii) any relevant EC initiatives	(ix) particular regional implications
1a. Forestry	100	positive	nil	neutral	positive if sensitively handled	£34m	£44m		Mainly in marginal agricultural areas in England
1b. Farm woodlands	67	positive	neutral	marginal	positive	£68m	£40m	)EC forestry)proposals)expected, but)may not be in)UK interest	
2. ESAs	nil	marginal	neutral	neutral	positive	£36m	£6m	EC part funding of ESAs proposed	
3. On-farm diversification	nil	marginal	positive	positive	probably nil	£25m	-	no	Impact slight in regions remote from populations
4. R&D on alternative crops and livestock & forestry	eventually 2-300	positive in long term	positive in long term	positive in long term	neutral	-	-	EC input envisaged in socio-structural package	
5. Land use planning & recreation	28 (mostly relates to horses)	positive	positive	positive	needs careful handling	-£1m	£30m	no	Impact slight in regions remote from population

*Assumes 2% pa cut in CAP support costs starting in 1988/89.

**No account has been taken of tax benefits, which would tend to occur after the 20th year.

TABLE 2

ILLUSTRATIVE ESTIMATES OF ADDITIONAL EXPENDITURE AND POSSIBLE SAVINGS ARISING FROM THE IMPLEMENTATION OF ALURE RECOMMENDATIONS FOR EACH PES YEAR

	Additional Expenditure (£m)					
	1987/88	1988/89	1989/90	1990/91	1991/92	1996/97 (9)
EXPENDITURE (including Forestry Commission)						
1. Forestry and farm woodlands						
(i) Traditional forestry (20,000 ha/year expansion) (2)	4.9	5.0	5.2	5.3	5.4	7.7
(ii) Farm woodlands (15,000 ha/year from mid 1987/88) (3)	3.0	7.0	9.3	11.6	14.1	30.0
2. Conservation and recreation						
Environmentally Sensitive Areas	4.0	6.3	6.5	6.7	6.9	7.8
3. Diversification						
(i) Action under Section 22, Agriculture Act 1986	3.1	3.2	3.2	3.3	3.4	3.8
(ii) Marketing support	1.0	1.1	1.1	1.1	1.1	1.2
4. R & D						
Novel crops and livestock and forestry	-	-	-	-	-	-
5. Administrative Costs	5.1	7.6	7.7	8.0	8.2	9.3
Total additional expenditure	21.1	30.2	33.0	36.0	39.0	59.8
SAVINGS						
Land occupied by forestry (4)	-	-7.0	-11.1	-18.2	-7.5 (8)	-36.2
farm woodlands (4)	-	-3.4	-11.1	-18.2	-7.6 (8)	-36.5
environmentally sensitive areas	-	-1.5	- 1.5	- 1.5	-1.5	-1.5
planning and recreation (5)	-	-3.0	-6.0	-9.0	-12.0	-30.0
Total savings (6) (7)	-	**-14.9**	**-29.7**	**-46.9**	**-28.6**	-104.2

Explanatory Notes

1. PES cash factors of 2½% are used.

2. The figures assume that removing existing limitations on the use of better land for private forestry plantation coupled with a fall in the price of such land to about £1000 per hectare would double the rate of planting. Thus the estimates are based on current Forestry Commission grant levels. If, in fact, the response were less and either grant rates were increased or more planting were done by the Commission itself, the cost would rise. It is assumed that 50% of the land used would be on poorer

3. The figures are based on a 80:10:10 per cent split of new farm woodland planted annually in lowland, disadvantaged area and severely disadvantaged area respectively. They assume, that as well as existing forestry grants, annual payments are made to farmers of £150 per hectare in the lowland, £50 per hectare in the disadvantage areas, £30 per hectare in the severely disadvantaged areas. It is assumed that 15,000 hectares will be planted annually except in the first year when 7,500 hectares will be planted. The annual payments are consistent with those used in developing the UK cereals land diversion proposals.

4. The figures assume that every hectare planted with trees would, directly or indirectly, substitute for a hectare of beef, sheep or cereals inn appropriate proportions. The figures assume that in the lowlands 75% of the new area planted to trees would be switched from beef production; 15% from sheep and 10% from barley. In the disadvantaged areas the corresponding figures would be 75% beef and 25% sheep; and in the severely disadvantaged areas 80% sheep and 20% beef. It is assumed that the lowland and disadvantaged area planted to trees would be only 80% as productive as the average and that in the severely disadvantaged area would be 60% as productive as the average. These adjustments allow for the fact that farmers would tend to plant their less good land.

5. The figures for planning and recreation assume the release of cereals land yielding 6 tonnes per hectare.

6. To allow for the effect of CAP reform a 2% per annum cut in CAP support levels from 1988/89 to 1991-92 is assumed.

7. A lag of one year has been built into the savings in CAP support levels and it has been assumed that the annual payments under the farm woodlands scheme would operate with a similar lag.

8. The reduction in savings in your 5 reflects an assume no beef intervention after 1990-91. Savings thereafter relate to export refunds only rather than intervention, storage costs and refunds in earlier years.

9. The assessment for 1996/97 serve to demonstrate the cumulative nature of some of the CAP support cost savings if land diversion to trees etc were to continue in the medium term.

Table 3

BREAKDOWN OF ADMINISTRATIVE COSTS

	1987/88	1988/89	1989/90	1990/91	1991/92
Traditional Forestry	1.5	1.6	1.6	1.7	1.7
Farm Woodlands	2.5	5.0	5.1	5.2	5.4
ESAs	0.6	0.6	0.6	0.7	0.7
Diversification	0.5	0.4	0.4	0.4	0.4
Total	**5.1**	**7.6**	**7.7**	**8.0**	**8.2**

Notes

1. The costs associated with traditional forestry are based on current average rates of Forestry Commission expenditure of £30 per £100 of planting grant paid.

2. On the basis of existing expenditure in England, the farm woodland administrative costs are estimated by the Forestry Commission at £80 per £100 of planting grant paid.

3. The figures for the ESAs are based on the the expected cost of administering the current scheme (9% of grant expenditure) when it becomes fully operational in 1987/88.

4. The cost of administering the diversification grants is based on the estimated cost for running the Agricultural Improvement Scheme grants for 1987/88 (11.7% reducing to 9.1% for subsequent years as the new scheme settles in). The costs associated with running the marketing support element are estimated at 6% of grant expenditure which is the current level for the Agricultural and Horticultural Co-operative Scheme.

Ministry of Agriculture, Fisheries and Food
7 November 1986

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PRIME MINISTER

ALTERNATIVE USES OF AGRICULTURAL LAND AND SOURCES OF RURAL EMPLOYMENT

Your meeting on 13 November will be the opportunity to decide how we are to develop and present a convincing set of policies for rural areas before the next election. Michael Jopling rightly says the issues are not only agricultural; obviously, however, falls in farm income will produce problems in those areas where farming is already only marginally viable.

From my point of view, I would like us to focus on the following questions in particular:

i. MAFF advise that Government expenditure on the CAP is running at over £1.6 billion and we will not get it down much in the immediate future. Can we under present EC law, switch more money towards our priority areas? Are there achievable EC legislative changes we should seek in order to do this more freely?

ii. The Working Party's report paints a picture of production rising inexorably. What is the sensitivity of output trends to adjustments in the CAP? Can we not find ways of steering a freer market towards opportunities for less intensive farming? This would have other benefits such as reducing the use of nitrogenous fertilisers which in turn, would significantly improve water quality.

iii. Some land is bound to be released from farming, although falling land prices will enable new entrants to start farming at less cost than in the past. In so far as we want to support agriculture as an industry, we should be thinking about ways of easing the farming community into alternative forms of activity - at minimum cost to the Exchequer - rather than paying them to do nothing.

SECRETARY OF STATE FOR THE ENVIRONMENT

iv. Forestry must be an important alternative land use. But should we really pay farmers to plant trees? In forestry, as in other sectors of the economy, we should surely be seeking less, not more, intervention. Moreover, current trends in afforestation are having effects on the environment which give cause for concern. Cutting both tax incentives for forestry and the agricultural support which has inflated land prices could well produce a more acceptable pattern of planting. I note Malcolm Rifkind's concern about the afforestation of the uplands: there are similar pressures in England. Some carefully targetted incentives may be necessary to direct forestry of particular sorts and to particular areas. For all these reasons, I think we need a radical review of the fiscal concessions for forestry, and the role of the Forestry Commission in future. I attach a short paper raising these issues in more detail.

v. We should investigate other land uses further. The expansion of sports such as shooting can generate both income and employment. Then there is scope for more recreation and tourism, as long as we maintain and enhance the wildlife and landscape interest of the countryside.

vi. We have in the past lost some attractive and interesting countryside - including heaths, wetlands and chalk grasslands; I believe there would be considerable public support if less intensive production allowed some such areas to revert to their former state. We therefore need to consider very carefully the type of set-aside scheme which would prove negotiable and also likely to prove environmentally beneficial. A permanent set-aside scheme as opposed to rotational fallow would be much the preferable option from the environmental point of view, and I believe from the farmers point of view, because it can provide alternative income.

SECRETARY OF STATE FOR THE ENVIRONMENT

vii. David Young regards the Working Party's key recommendation as the need for some relaxation of planning in relation to agricultural land. In fact it is not planning policy that is at issue here but agricultural land policy. In the past, the protection of agricultural land from development has been accorded priority and the planning system has been used as the means to enforce this. It is therefore not the planning system which needs some modification but the national priority given to the protection of farm land. We need now to take more account of other objectives, including the need to diversify the rural economy, but it would be quite wrong to abandon our policy of protecting the countryside from development which could go onto urban or previously used land.

These issues are all difficult, and very important politically. I think there is a case for a White Paper, but I do not believe we will be ready to produce it by Christmas.

I am copyng this to recipients of Michael Jopling's minute to you of 22 September.

NR

NR

7 November 1986

CONFIDENTIAL

THE CASE FOR A REVIEW OF FORESTRY POLICY

1. There is increasing concern that current forestry policy is producing a pattern of afforestation in Britain which is environmentally damaging.

2. Since the end of the First World War the main objective of forestry policy has been to subsidise the expansion of domestic timber production. This has been pursued directly, through grant-in-aid to the Forestry Commission and indirectly by grants and tax incentives for private forestry. Total Government subsidy for forestry planting amounted to nearly £60m in 1984/85: £41m to the State Forestry Enterprise; £6m in grants to private foresters and at least £10m in tax incentives (providing a subsidy of up to 70% of planting costs in some cases).

3. In terms of this objective, the policy has been successful: there are now some 2.2 million hectares of woodland in Britain today, compared with 1.2 million in 1924. Nearly all the growth has been accounted for by coniferous forests, especially in the uplands. The last five years have seen a particularly rapid expansion of private coniferous forestry, where the tax incentives appear to have been a particularly potent force in stimulating large-scale, uniform coniferous afforestation with absentee ownership.

4. It is the rapid development of this kind of afforestation which is worrying from many points of view. There is concern that it has an adverse visual effect on the landscape; that it reduces wildlife habitat and breeding grounds; that it causes acidification of streams and water courses; and that it restricts public access to previously open land. Moreover, the growth in coniferous forests has been accompanied by a steady decline in the more environmentally desirable broadleaved woodland.

5. But concern about the environmental impact of current forestry policy and incentives raises wider doubts about the validity and value for money of that policy. It gives poor value for taxpayer's money, and employs relatively few people. And the rapid expansion of softwood plantations, in some areas at the expense of hardwood forests, may not provide the balance we seek in forestry policy terms alone.

6. The rationale for promoting timber production has, since the creation of the Forestry Commission in 1919, rested on a combination of strategic, economic and social objectives. Current forestry policy (set out by the then Secretary of State for Scotland in a Parliamentary statement in 1980) gave first priority to reducing our dependence on imported wood. A secondary objective was maintaining employment in forestry and associated industries.

7. It was then envisaged that new planting should continue at the post-war rate of about 30,000 hectares per annum. It must, however, be open to question whether continued planting of coniferous forests on this scale - which is in practice what the present tax arrangements apparently encourage - can be maintained without causing further environmental damage. Against this background, a number of questions present themselves:

i. What is the case for subsidising import substitution of timber as compared with any other product? In general the Government has not pursued a policy of subsidising uneconomic industries in order to keep out exports. Is any realistic expansion likely to make a significant impact on the 90% of timber demand currently met by imports?

ii. Alternatively is there a case for building up yet further a strategic reserve of timber? Are we still at risk either from a major disruption of softwood supplies from overseas or do we envisage a future world shortage of hardwoods?

iii. Does the relatively small number of jobs in the forestry and wood-processing industries provide adequate value for money?

iv. In the past we have pursued a policy of encouraging planting on the poorer agricultural land and protecting the better land from forestry. There has recently been some relaxation of this policy in Scotland: but as more land comes out of agricultural use do the present arrangements provide sufficient encouragement to small-scale planting (particularly of broadleaved hardwoods) by individual farmers and landowners?

8. There may well be a valid case for subsidising forestry. We need to be clear what that case is. The current pattern of incentives encourages large scale softwood planting on environmentally valuable uplands. It appears to provide relatively little encouragement for individual farmers wishing to manage effectively existing hardwood forests. It may even have deterred those wishing to develop forestry to diversify their sources of income on land suitable for forestry but which has been used until now for agricultural production. All this suggests that we need to review the objectives of forestry policy as a whole and the mechanisms used to achieve them.

Pps pl
(with Debbie?)

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

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REC. 04 NOV 1986 4/11
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The Rt Hon Margaret Thatcher MP
10 Downing Street
London SW1

4 November 1986

My Dear Prime Minister

In advance of your meeting on agricultural land use and related issues scheduled for 20 November, you may be interested to see the enclosed letter from Emma Nicholson. I have replied to it in suitable terms.

In my view, it does emphasise the importance politically of our bringing forward positive policies to maintain political support in our rural heartlands. At a time when quite properly farmers are being asked to retrench in a world of agricultural surpluses, there is a need to show them that we are bent on moving forward, and that there is a measure of hope and encouragement for their future.

I am sending copies of this letter to the Lord President, the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer, the Secretaries of State for Wales, Northern Ireland, Scotland, Environment and Employment, the Chancellor of the Duchy of Lancaster, the Chief Secretary and Sir Robert Armstrong.

Yours Ever

Michael

MICHAEL JOPLING

Conservative Central Office
32 Smith Square Westminster London SW1P 3HH
Tel. 01-222 9000 Telex 8814563 Fax. 01-222 1135

From
THE VICE CHAIRMAN OF THE PARTY
Miss Emma Nicholson

6 October 1986

The Rt Hon Michael Jopling MP
Minister for Agriculture, Fisheries and Food
Whitehall Place
LONDON
SW1

Dear Michael -

The reports which I received from a number of area branches of the Conservative Womens National Committee expressed a good deal of concern amongst farmers about the future of agriculture.

These reports indicate that farmers believe it is insufficiently realised that they have become the victims of their own success in increasing productivity more than has been achieved in most British industry. It is realised that there are food surpluses within the EEC and that the building up of these surpluses cannot continue indefinitely. But, farmers make the point that certainly over the last 2 years their incomes have been reduced in real terms - in some cases quite substantially - whereas profits and earnings in the rest of the British industry and commerce have on average increased in real terms. Farmers are worried that if this trend is allowed to continue many of them, particularly those farming on a small scale will be forced out of the business and this is thoroughly bad for jobs in rural areas. They believe that the farming industry is being left in a state of uncertainty and are badly in need of reassurance about the future.

I would be most grateful for your comments and it would be very helpful if I could have them by the end of this month.

Yours,
Emma

EMMA NICHOLSON

CHIEF SECRETARY TO THE TREASURY

RP

FROM: **JILL RUTTER**

DATE: **6 November 1986**

MR BONNEY

cc:
Chancellor
Financial Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Monck
Mr Lavelle
Mr Burgner
Mr Edwards
Miss Peirson
Mr Scholar
Mr Turnbull
Mr Instone
Mr Gray
Mr G White
Mrs Imber
Mr Donovan
Mr Crawford
Mr Cropper
Mr Tyrie

ALTERNATIVE USES OF AGRICULTURAL LAND AND SOURCES OF RURAL EMPLOYMENT: (ALURE)

The Chief Secretary has now considered your minute of 23 September. There is to be a meeting at No. 10 on 20 November and the Chief Secretary would like to put a minute to the Prime Minister in advance of that. The delay since the circulation of that report inevitably requires amendments. The Chief Secretary does not wish to make the procedural points you recommend. And now PES has been satisfactorily sown up without Mr Jopling receiving any provision for ALURE. These passages can therefore be excised in the draft.

2 In your minute you suggest that the scenario on which the ALURE report is constructed is implausible. The Chief Secretary disagrees. He thinks it is quite a plausible scenario if we do get necessary EEC action - and we must press for that. He thinks therefore it is a legitimate basis for analysis.

3 The Chief Secretary would like to get over two fundamental

points in his draft minute to the Prime Minister. His first point is that we cannot engage in schemes with an additional public expenditure cost in advance of the savings being realised. He would also like to make clear to Mr Jopling that there can be no question of spending the full amount of any saving on ALURE schemes. IBAP expenditure has created enough problems for the planning total such that we could not allow the full benefit of any savings to be hypothecated to schemes of this kind. So we would only be talking about a small proportion of the potential savings.

4 But the Chief Secretary believes that in the interim we should undertake a rigorous financial appraisals of schemes which involve additional public expenditure. The Chief Secretary notes the support of Messrs Channon and Ridley for this approach. He notes that the appraisal of the Forestry scheme looks particularly weak. The Chief Secretary sees a high risk in a commitment to schemes involving additional public expenditure while CAP expenditure is still on an upward track.

5 On the planning issues the Chief Secretary would argue the position is rather different. He agrees there may be a case for looking again at the present criteria particularly in the context of employment - a point made by Lord Young.

6 I would be grateful if you could supply a draft letter for the Chief Secretary to send to the Prime Minister in advance of her ~~next Thursday's~~ meeting.

Jill Rutter

JILL RUTTER

Private Secretary

papers on

30/1511

CONFIDENTIAL

FROM: R J BONNEY
DATE: 7 November 1986

CHIEF SECRETARY

cc Chancellor 14/2
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr F E R Butler
Mr Monck
Mr Lavelle
Mr Burgner
Mr Edwards
Miss Peirson
Mr Scholar
Mr Turnbull
Mr Instone
Mr Gray
Mr G M White
Miss Sinclair
Mrs Imber
Mr Donovan
Mr Crawford
Mr Deaton
Mr Cropper
Mr Tyrie

ALTERNATIVE USES OF AGRICULTURAL LAND AND SOURCES OF RURAL EMPLOYMENT

1. You are due to attend the Prime Minister's meeting on 13 November which will discuss Mr Jopling's minute of 22 September on the ALURE Report. I offered initial advice on this in my minute of 23 September. This submission suggests (i) a revised draft minute for you to send to the Prime Minister on the lines suggested in Miss Rutter's minute of 6 November, and (ii) a line to take at the meeting.

Background

2. At a meeting on CAP strategy on 19 March the Prime Minister concluded that there was broad agreement that price restraint was an essential element of the UK's strategy for the CAP, but that it would not be sufficient in itself to achieve the necessary objectives. She suggested that it was also necessary to look

at alternative uses of some agriculture land, in particular possible ideas on "set aside" and the encouragement of alternative employment in the countryside. The ALURE working party was set up under MAFF chairmanship to consider this remit. Its report sent to Mr Jopling in September produced a very tentative analysis of the extent of structural change in the agricultural sector in ten years' time, and a list of specific actions which the Government could take to ease the process of adjustment if Ministers considered that any further Government intervention was justified. As the Treasury representative on the Working Party, I was obliged to reserve our position on the need for further intervention and the specific recommendations because it had not been demonstrated that the associated costs could be financed within existing PES programmes.

3. In his minute to the Prime Minister of 22 September Mr Jopling sought general endorsement for announcing a "positive" programme to sustain the rural economy and environment based on the specific recommendations in the ALURE Report and agreement that such a programme should be announced in a suitable form along with the Govrnment's general approach to the CAP and the role of the agriculture and food industries. His letter of the same date to you made clear that he was also bidding for additional PES of some £20m in 1987-88 rising to £30m in 1989-90. These bids were withdrawn in the PES discussions on the understanding that Mr Jopling would not be debarred from making a bid on the Reserve if policy approval for his proposals was obtained in collective discussion.

4. In subsequent discussions at official level we have persuaded MAFF that a supplementary note on the financial implications and objectives of the specific proposals should be circulated by Mr Jopling before the Prime Minister's meeting. The latest draft of this is at Annex A.

Views of other Ministers

5. Mr Jopling's minute has provoked mixed reactions from his

colleagues. We understand that the Prime Minister has expressed little enthusiasm for the forthcoming meeting and may return to her earlier view that we should first secure genuine reform of the CAP before introducing measures to alleviate the effects on farmers. Mr Norgrove's letter of 20 October simply notes that the report will need a thorough discussion and that the ideas discussed in it should not be mentioned or hinted at in public in order to avoid raising expectations. (Despite this injunction, the existence of the working party has recently been reported in the press.)

6. Mr Rifkind in his minute of 7 October predictably supported the general thrust of Mr Jopling's proposals but was more cautious about the implications of any major increase in forestry (which could be expected to affect Scotland disproportionately). Mr Ridley (30 September) doubted whether the report provides an adequate basis for introducing the positive programme which Mr Jopling recommends, and seeks further analysis of the costs and benefits and sensitivity to adjustments in the CAP. Lord Young (29 September) agreed on the need for decisive action but considered that the focus should be as much as possible on giving private enterprise the opportunity to flourish by removing unnecessary barriers, rather than looking to subsidy or direct intervention as the answer. Mr Channon (14 October) questioned whether a further injection of Government funds for agriculture would be appropriate, but both he and Lord Young strongly supported the proposed relaxation of planning restrictions which limit the development of agriculture land on land quality (as distinct from environmental) grounds.

Treasury Views

7. Against that background there seems to be a reasonably good prospect that the Prime Minister's meeting will not simply endorse Mr Jopling's proposals as they stand. But you will wish to send a minute to the Prime Minister in advance of the meeting to ensure that your views are adequately reflected. In addition to the two main points mentioned in Miss Rutter's minute, we suggest

that you might wish to record some comments on Mr Jopling's specific proposals, as described in his forthcoming paper on financial implications. The main points to register at this stage might thus be:

(i) Entirely appropriate to consider consequences for rural economy if and when we secure substantial reform of CAP. But no need to rush into announcing new programmes before we know what sort of CAP reform can be achieved and what PES savings will be realised.

(ii) There can be no question of spending the full amount of any PES saving from CAP reform on ALURE schemes. The IBAP programme has caused enough problems for the Planning Total in recent years. It would be unreasonable to work on the assumption that any future savings should be hypothecated in favour of the agriculture programme.

(iii) In any case should not automatically assume that further Government intervention (in what is already highly protected sector) will be justified. Extent of change envisaged by ALURE report <u>over next 10 years</u> not all that dramatic and very widely dispersed.

(iv) Fully agree with DE and DTI that the emphasis in any adjustment programme should be on creating right environment for private enterprise. (Relaxing planning restrictions on development of agricultural land seems good candidate.)

(v) Would not rule out new interventionist measures of pump priming nature if it can be demonstrated that they will produce a net benefit to the economy as a whole, that they will be time limited and that they can be financed within existing PES totals. More work needs to be done by officials on Mr Jopling's proposals within these parameters.

(vi) Mr Jopling's proposals for increased tree planting pose particular difficulties, not only on environmental grounds, but also because of long term nature of expenditure commitment. Take some convincing that further incentives for forestry, which already benefits from grants and generous tax regime, could be justified. The proposed farm woodland scheme would barely break even in 10 years' time, if account is taken of the administrative costs (which are estimated at 80% of the programme expenditure).

(vii) His other proposals for more ESAs, diversification grants and R & D are likely to have minimal impact on the scale of CAP surpluses and (if otherwise desirable) should be financed by reordering priorities within existing programmes.

8. I attach a revised draft minute on these lines at Annex B, and a somewhat fuller brief for the meeting at Annex C.

RJB

R J BONNEY

DRAFT (not yet approved by Mr Jopling)

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ANNEX A

ALTERNATIVE USES OF AGRICULTURAL LAND AND SOURCES OF RURAL EMPLOYMENT (ALURE)

(Note by officials in HM Treasury, the Agricultural Departments and the Forestry Commission)

1. This note considers the objectives and financial implications of the specific proposals made by the Minister of Agriculture in the context of his minute of 22 September to the Prime Minister.

General Objectives

2. Agriculture Ministers consider that there is a need for an integrated package of policy measures which taken together would serve to reduce expenditure on CAP support, to provide opportunities for farmers to maintain farm income, to sustain rural employment and have a positive impact on the environment. In their view the proposals comprise a modest, but nevertheless essential, response to the structural change facing the agricultural sector over the next 10 years which the ALURE Working Party projected as the consequence of a reduction in the level of CAP support. **Table 1** summarises in schematic form the expected effect of the individual proposals on land use, farm income, rural employment and the environment and also the relationship with surpluses and any proposed action at EC level.

3. It is necessary to consider the direct costs of the measures proposed, consequent savings in agricultural support expenditure and the relative effectiveness of each measure as a means of achieving the overall objectives. Details of the Agriculture Departments' estimated costs and savings over the first 5 years together with an indication of the position in year 10 are set out in **Table 2.**

4. In the 1986 PES discussions Agriculture Ministers have agreed not to pursue a bid for additional funds, pending collective discussion. This is on the understanding that if agreement is reached on the merits of the proposals the Chief Secretary will be prepared to consider a claim on the 1987/88 Reserve, if necessary, and that savings in IBAP expenditure could be regarded as a legitimate offset to any bid where

there is a fair guarantee that land is being taken out of surplus production. The Chief Secretary nonetheless considers that any new expenditure arising out of the ALURE recommendations should be financed within the current planned total PES provisions for domestic agriculture, forestry, fisheries and food of some £950m, if necessary by the re-allocation of priorities within existing programmes.

5. The following paragraphs discuss the proposals and relevant assessments in more detail. If the proposals are accepted in principle, more work will have to be done on the detailed implementation of the schemes, including the scope for targetting them on specific objectives. The costs and savings will need to be reviewed in the light of progress on CAP reform in view of their sensitivity to market circumstances for key products viz beef, sheep and cereals.

Traditional Forestry

£m

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline (Forestry Commission total grant in aid)	53.8	54.2	55.1	-	-	-
additional bid	+4.9	+5.0	+5.2	+5.3	+5.4	+ 7.7
CAP savings	-	-7.0	-11.1	-18.2	-7.5	-36.2

Note: No baseline provision has been agreed beyond 1989-90. The bids assume a 2½% pa increase in future years.

6. The proposal is to encourage extra private sector planting of woodlands of some 20,000 ha a year, ie a doubling of the present planting rate. The objectives would be to divert a substantial area of land from agriculture to forestry, thereby achieving a consequent reduction in surplus agricultural production; to increase timber production and to provide a source of rural income and employment. The Forestry Commission estimate that there would be a gross gain of some 1,600 jobs, some in local towns. The net gain would depend on the extent of any reduction in agricultural employment. The environmental effects would depend on the areas planted, the species involved, previous land

se, landscaping etc. Close attention would be given to these aspects under the Forestry Commission's consultation procedures. Achievement of these objectives would be evaluated by monitoring the additional area planted by type of land use and surveying the net effect on employment and income.

7. The costs of the proposals are based on the assumption that the area envisaged would be taken up at existing grant rates. The Forestry Commission take the view that to secure this take-up on better land than at present, a further fall in land prices - perhaps of as much as 15-20% - and some relaxation of clearance criteria by the agricultural departments would be required. The level of grants is periodically reviewed and could in principle be raised or lowered if necessary. Grant expenditure on planting is demand-led, but has in practice been contained within the cash limited grant-in-aid to the Forestry Commission.

8. The savings allow for a year's lag after planting before savings in CAP support are realised. In anticipation of some success in reforming the CAP they assume a 2% per annum cut in CAP support costs from 1988/89 onwards. Although it is not at present the practice to direct planting to any particular grade of land, it is assumed that 50% of the additional planting would take place on poorer quality lowland and 50% in the disadvantaged areas (LFA Area B in the **attached map**), as opposed to the severely disadvantaged areas (LFA Area A) where afforestation is more likely to come into conflict with environmental interests. The majority of land would be diverted from beef production which is the most marginal enterprise in many of the areas in question. In addition some sheep and barley production would be affected. It is also assumed that farmers would divert their less good land. Details of the assumptions are provided in the notes attached to **Table 2.** It will be noted that the savings in the 5th year are shown to decline. This is intended to reflect a reduction in the support costs of the EC beef regime at that time. Over the longer term however savings would cumulate and by the 10th year exceed costs appreciably.

Farm woodlands

£m

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline	0	0	0	-	-	-
additional bid	+ 3.0	+ 7.0	+9.3	+11.6	+14.1	+30.0
CAP savings	-	- 3.4	-11.1	-18.2	-7.6	-36.5

The proposal is to introduce a new farm woodland scheme which would offer farmers an annual payment (as well as planting grants) to reflect the agricultural income they would forgo and recognise the lack of income from timber until thinning starts (years 15 to 20). The objectives would be diversion of land from agriculture (assessed to be about 7,500 hectares in year 1 and 15,000 hectares thereafter) and a consequent reduction in surplus agricultural production; provision of an opportunity for farmers to maintain income and employment; and the enhancement of wildlife and the landscape, which would be aided by the scattered nature of farm woodland planting. Monitoring and evaluation would be on the same lines as for traditional forestry. Effective expenditure control systems would be introduced.

10. The payments would be made to farmers, but not forestry companies. They would vary by quality of land to avoid making unduly generous provision on poorer land and would be subject to review. There would be a minimum plot size and a condition that land planted should have been in agricultural production. It would have to be decided whether the new scheme would be administered by the Forestry Commission or the Agricultural Departments, but it would be designed to encourage responsible management of the timber crop, effective marketing (including encouragement of on-farm processing) and environmentally sensitive planting. It might be introduced under powers in the Forestry Acts or the necessary legal vires might be contained in the forthcoming EC proposals on forestry.

11. The costs assume that a scheme would generate a positive response, particularly from marginal farmers. Annual payments of about £150 per hectare in the lowlands, £50 per hectare in the disadvantaged areas and £30 per hectare in severely disadvantaged areas, in addition to existing forestry grants, are judged to provide a sufficient incentive. The calculations assume nearly 30% of broadleaves and the grant costs would rise if the proportion were higher.

12. The savings are on the same basis as those for traditional forestry, but assume 80% planting on poorer quality lowland, 10% in the disadvantaged areas and 10% in the severely disadvantaged areas. Again the majority of land would be diverted from beef production. By the 5th year of the scheme cumulative savings would almost equal cumulative costs, but over the longer term, as shown above, would exceed costs.

13. Consideration might also be given to a premium to encourage the use of better cereals land if farmers were only showing interest in devoting grassland to forestry, but this would depend on EC decisions on a cereals diversion scheme. Such an approach would increase costs, but the savings would also be greater.

<u>Environmentally Sensitive Areas (ESAs)</u>

	£m					
	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline	5.0	6.0	6.0	-	-	-
additional bid	+4.0	+6.3	+6.5	+6.7	+6.9	7.8
CAP savings	-	Around £1.5m year.				

14. The <u>proposal</u> is to approximately double the present provision for ESAs in which grants may be paid to farmers who agree to maintain traditional farming practices. The <u>objectives</u> would be primarily environmental, but there would be some effect on CAP support since one of the objectives of the ESAs is to restrain and in some cases reduce agricultural production on participating farms. The original set of ESAs have not yet been implemented and information about their cost effectiveness is not yet available. However, the additional bid would enable Agricultural Departments to designate all the remaining short listed areas for which a strong and pressing case has been made out. Agriculture Ministers would have to decide on the additional areas that might be designated and on the territorial allocation of the additional funding. The new ESAs would be <u>evaluated</u> in the same way as the ESAs about to be designated, as required by legislation.

15. This proposal would involve a long term commitment to public expenditure. Expenditure would be borne on the Agricultural Departments non-cash limited Votes, but subject to the expenditure controls recently agreed for the capital grants programme. Partial EC reimbursement of ESA expenditure could become available if a current Commission proposal is adopted.

16. The savings can only be assessed in the broadest terms. The order of magnitude given above is based on the likely difference between the volume of production within the existing ESAs with and without designation.

Diversification

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
	£m					
PES baseline						
(i) diversification* grants	2.0	2.0	2.0	-	-	-
(ii) marketing support	11.4	11.1	11.1	~~11.1~~ —	~~11.1~~ —	-
bids						
(i) diversification	3.1	3.2	3.2	3.3	3.4	3.8
(ii) Marketing support	1.0	1.1	1.1	1.1	1.1	1.2
CAP savings			marginal			

* relates to capital grants on tourism and crafts in the LFAs, the only existing agricultural aid for diversification. The overall provision for all agricultural capital grants is about £134m (1987-88).

17. The <u>first proposal</u> is to introduce a scheme for grants to ancillary farm-based industries under Section 22 of the Agriculture Act 1986. The <u>objectives</u> would be to enhance and maintain farm incomes by assisting farming families to look to alternative forms of activity other than increased surplus production; to widen rural employment opportunities; and to extend to the non-LFA the incentives to farm diversification already offered under the capital grants scheme. The scheme would cover 15% (30% in LFAs) of the capital cost of providing facilities for value-added processing of produce from the farm eg fresh dairy products, meat products, bread and bakery products and ready prepared meals; preparation of fruit and vegetables; timber, wool and skin treatment; and the provision of recreational facilities. The grants would be aimed directly at the needs of farmers, unlike assistance from other rural aid agencies, such as COSIRA, which they would be designed to complement. Further work on how this would be achieved is already in hand.

18. The <u>second proposal</u> is to encourage co-operatives to extend their activities into value added processing and to help them market their products. The <u>objective</u> would be to improve farm income and awareness of new marketing opportunities. This proposal could involve new primary legislation.

19. The success of these two schemes would be evaluated by surveying the durability of the projects in question and the impact on income and employment, using case studies where appropriate.

20. The costs are derived from estimates of existing craft and tourism grants in the LFAs and existing marketing activities. Expenditure would be controlled in the same way as under existing programmes.

Research and Development

21. The proposal is to fund new R & D into novel crop and livestock possibilities and to conduct further woodland experiments. [The cost would be met from the existing PES provision.] The objective would be to develop new ways for farmers to diversify away from the production of surplus commodities. The private sector would be unlikely to undertake this research by itself in view of the long term nature of the potential benefits. The success of this work would be evaluated in the same way as the rest of the R & D programme.

Land use planning and recreation

22. The proposal is to review the policy on the protection of agricultural land with a view to facilitating the release of land for recreation, horses and certain other developments. The objectives would be the encouragement of enterprise and employment in rural areas and some savings in CAP support costs. There could be problems with countryside interests unless the changes were handled in a sensitive way. The success of this new approach would be evaluated by analysis of land use statistics.

23. It is not possible to estimate what effect changes to the policy on the protection of agricultural land would have. The extent to which the policy was relaxed, and the impact this would have, would depend on decisions following public consultations. At present, transfer of land to uses other than forestry is running at 14,600 hectares a year in England and Wales, 1,000 hectares in Scotland and 500 hectares in Northern Ireland. However, a total of about 5,500 extra hectares a year might be used for sport (notably golf courses), horses and other recreational uses. If this was wheat and barley land yielding on average 6 tonnes per hectare the savings would be as follows:

£m

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
CAP savings	-	-3.0	-6.0	-9.0	-12.0	-30.0

In view of the uncertain effect of the proposed changes in policy, such savings cannot be guaranteed and it would not be prudent to adjust the IBAP baseline on this count.

Administrative costs

	1987-88	1988-89	1989-90	1990-91	1991-92	1996-97
PES baseline						
(i) MAFF	213.5	222.1	226.1	-	-	-
(ii) Forestry Commision (Forestry Authority)	8.5	8.8	9.0	9.3	9.5	-
Total additional bid	+5.1	+7.6	+7.7	+8.0	+8.2	+9.3
Savings on planning		-0.2	-0.2	-0.2	-0.2	-0.2

24. The additional (costs set out in detail in **Table 3**) primarily reflect the high administrative costs for forestry and farm woodlands because of the need for close supervision of forestry, mainly to ensure environmentally sensitive planting, the cost of the associated consultation procedures and farmers lack of experience in forestry.

7 November 1986

TABLE 1

ALURE PROPOSALS

Main options considered	(i) land used over 5 yrs ('000 ha)	(ii) ag. surpluses	(iii) farm income	(iv) net rural employment	(v) environment	(vi) exchequer cost over** 5 yrs	(vii) savings in* CAP support costs over 5 yrs	(viii) any relevant EC initiatives	(ix) particular regional implications
1a. Forestry	100	positive	nil	neutral	positive if sensitively handled	£34m	£44m		Mainly in marginal agricultural areas in England
1b. Farm woodlands	67	positive	neutral	marginal	positive	£68m	£40m	)EC forestry)proposals)expected, but)may not be in)UK interest	
2. ESAs	nil	marginal	neutral	neutral	positive	£36m	£6m	EC part funding of ESAs proposed	
3. On-farm diversification	nil	marginal	positive	positive	probably nil	£25m	-	no	Impact slight in regions remote from populations
4. R&D on alternative crops and livestock & forestry	eventually 2-300	positive in long term	positive in long term	positive in long term	neutral	-	-	EC input envisaged in socio-structural package	
5. Land use planning & recreation	28 (mostly relates to horses)	positive	positive	positive	needs careful handling	-£1m	£30m	no	Impact slight in regions remote from population

*Assumes 2% pa cut in CAP support costs starting in 1988/89.

**No account has been taken of tax benefits, which would tend to occur after the 20th year.

ILLUSTRATIVE ESTIMATES OF ADDITIONAL EXPENDITURE AND POSSIBLE SAVINGS ARISING FROM THE IMPLEMENTATION OF ALURE RECOMMENDATIONS FOR EACH PES YEAR

	Additional Expenditure (£m)					
	1987/88	1988/89	1989/90	1990/91	1991/92	1996/97 (9)
EXPENDITURE (including Forestry Commission)						
1. Forestry and farm woodlands						
(i) Traditional forestry (20,000 ha/year expansion) (2)	4.9	5.0	5.2	5.3	5.4	7.7
(ii) Farm woodlands (15,000 ha/year from mid 1987/88) (3)	3.0	7.0	9.3	11.6	14.1	30.0
2. Conservation and recreation						
Environmentally Sensitive Areas	4.0	6.3	6.5	6.7	6.9	7.8
3. Diversification						
(i) Action under Section 22, Agriculture Act 1986	3.1	3.2	3.2	3.3	3.4	3.8
(ii) Marketing support	1.0	1.1	1.1	1.1	1.1	1.2
4. R & D						
Novel crops and livestock and forestry	-	-	-	-	-	-
5. Administrative Costs	5.1	7.6	7.7	8.0	8.2	9.3
Total additional expenditure	21.1	30.2	33.0	36.0	39.0	59.8
SAVINGS						
Land occupied by forestry (4)	-	-7.0	-11.1	-18.2	-7.5 (8)	-36.2
farm woodlands (4)	-	-3.4	-11.1	-18.2	-7.6 (8)	-36.5
environmentally sensitive areas	-	-1.5	- 1.5	- 1.5	-1.5	-1.5
planning and recreation (5)	-	-3.0	-6.0	-9.0	-12.0	-30.0
Total savings (6) (7)	-	**-14.9**	**-29.7**	**-46.9**	**-28.6**	-104.2

Explanatory Notes

1. PES cash factors of 2½% are used.

2. The figures assume that removing existing limitations on the use of better land for private forestry plantation coupled with a fall in the price of such land to about £1000 per hectare would double the rate of planting. Thus the estimates are based on current Forestry Commission grant levels. If, in fact, the response were less and either grant rates were increased or more planting were done by the Commission itself, the cost would rise. It is assumed that 50% of the land used would be on poorer quality lowland and 50% in the disadvantaged areas.

3. The figures are based on a 80:10:10 per cent split of new farm woodland planted annually in lowland, disadvantaged area and severely disadvantaged area respectively. They assume, that as well as existing forestry grants, annual payments are made to farmers of £150 per hectare in the lowland, £50 per hectare in the disadvantage areas, £30 per hectare in the severely disadvantaged areas. It is assumed that 15,000 hectares will be planted annually except in the first year when 7,500 hectares will be planted. The annual payments are consistent with those used in developing the UK cereals land diversion proposals.

4. The figures assume that every hectare planted with trees would, directly or indirectly, substitute for a hectare of beef, sheep or cereals inn appropriate proportions. The figures assume that in the lowlands 75% of the new area planted to trees would be switched from beef production; 15% from sheep and 10% from barley. In the disadvantaged areas the corresponding figures would be 75% beef and 25% sheep; and in the severely disadvantaged areas 80% sheep and 20% beef. It is assumed that the lowland and disadvantaged area planted to trees would be only 80% as productive as the average and that in the severely disadvantaged area would be 60% as productive as the average. These adjustments allow for the fact that farmers would tend to plant their less good land.

5. The figures for planning and recreation assume the release of cereals land yielding 6 tonnes per hectare.

6. To allow for the effect of CAP reform a 2% per annum cut in CAP support costs from 1988/89 to 1991-92 is assumed.

7. A lag of one year has been built into the savings in CAP support costs and it has been assumed that the annual payments under the farm woodlands scheme would operate with a similar lag.

8. The reduction in savings in your 5 reflects an assume no beef intervention after 1990-91. Savings thereafter relate to export refunds only rather than intervention, storage costs and refunds in earlier years.

9. The assessment for 1996/97 serve to demonstrate the cumulative nature of some of the CAP support cost savings if land diversion to trees etc were to continue in the medium term.

United Kingdom Less Favoured and Environmentally Sensitive Areas

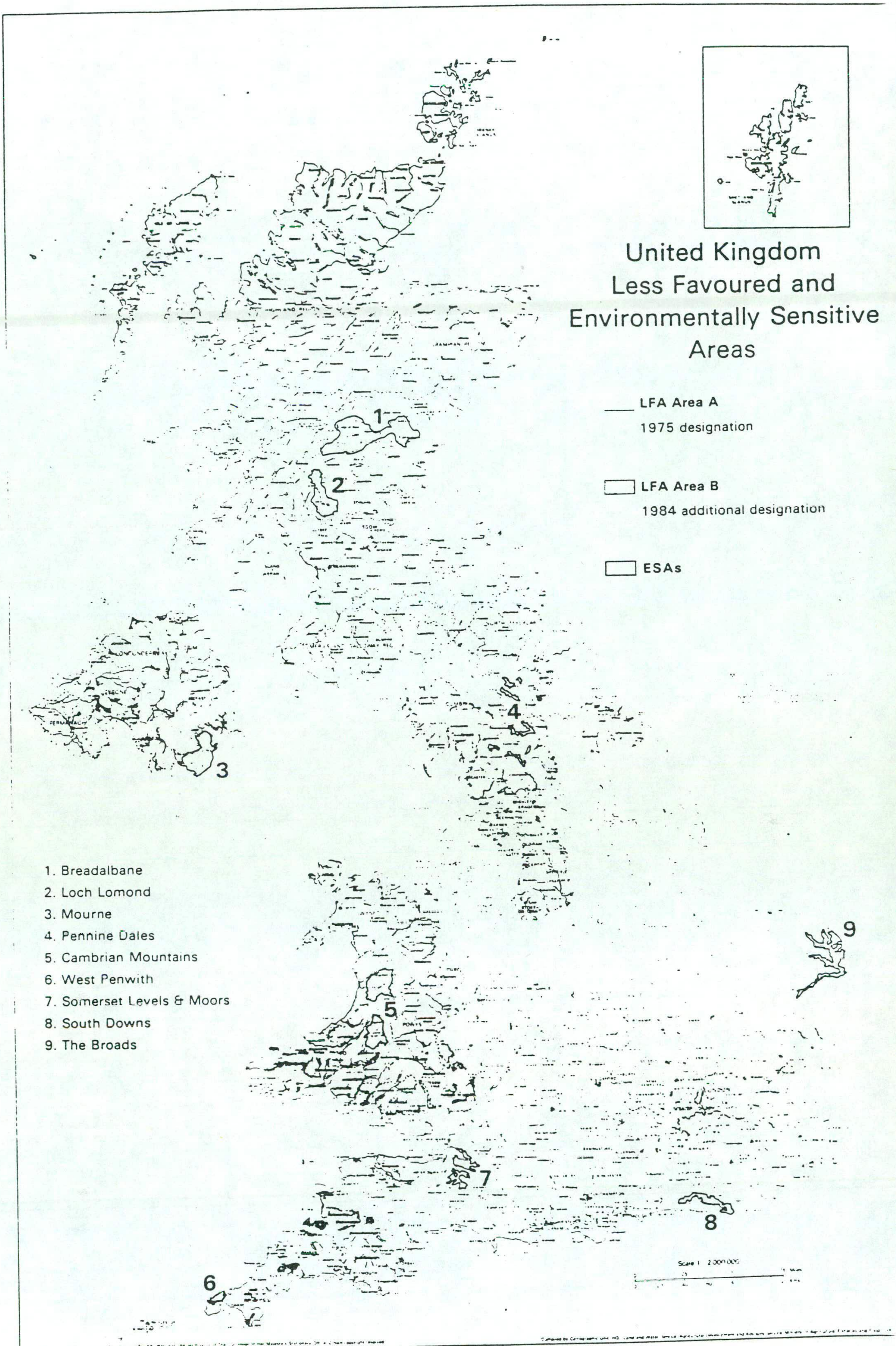

Table 3

BREAKDOWN OF ADMINISTRATIVE COSTS

	1987/88	1988/89	1989/90	1990/91	1991/92
Traditional Forestry	1.5	1.6	1.6	1.7	1.7
Farm Woodlands	2.5	5.0	5.1	5.2	5.4
ESAs	0.6	0.6	0.6	0.7	0.7
Diversification	0.5	0.4	0.4	0.4	0.4
Total	**5.1**	**7.6**	**7.7**	**8.0**	**8.2**

Notes

1. The costs associated with traditional forestry are based on current average rates of Forestry Commission expenditure of £30 per £100 of planting grant paid.

2. On the basis of existing expenditure in England, the farm woodland administrative costs are estimated by the Forestry Commission at £80 per £100 of planting grant paid.

3. The figures for the ESAs are based on the the expected cost of administering the current scheme (9% of grant expenditure) when it becomes fully operational in 1987/88.

4. The cost of administering the diversification grants is based on the estimated cost for running the Agricultural Improvement Scheme grants for 1987/88 (11.7% reducing to 9.1% for subsequent years as the new scheme settles in). The costs associated with running the marketing support element are estimated at 6% of grant expenditure which is the current level for the Agricultural and Horticultural Co-operative Scheme.

Ministry of Agriculture, Fisheries and Food
7 November 1986

CONFIDENTIAL

ANNEX B

DRAFT MINUTE

FROM: CHIEF SECRETARY

TO: PRIME MINISTER

COPIES TO: MINISTER OF AGRICULTURE
LORD PRESIDENT
FOREIGN SECRETARY
CHANCELLOR OF THE EXCHEQUER
SECRETARIES OF STATE FOR WALES, NORTHERN IRELAND, SCOTLAND, ENVIRONMENT, EMPLOYMENT, TRADE & INDUSTRY
CHANCELLOR OF THE DUCH OF LANCASTER
SIR ROBERT ARMSTRONG

ALTERNATIVE USES OF AGRICULTURE LAND AND SOURCES OF RURAL EMPLOYMENT

1. I have been following with interest the correspondence on this subject starting with Michael Jopling's minute to you of 22 September. I understand that Michael will be circulating a further note on the financial implications and objectives of his proposals for your meeting on 13 November. But you may find it helpful to have a note of my views before we meet.

2. My view is that, whilst it is entirely appropriate for us to consider the consequences for the rural economy of a substantial reduction in the current levels of CAP support, it would be premature to rush into announcing a new programme of support measures until we have a better idea of the scale and the direction of the sort of CAP reforms which can be achieved and the PES savings which can thereby be realised. I understand that the

Commission have promised to bring forward far reaching proposals in next year's Price Fixing and their "ex novo" review of the Community's finances. Drastic action is certainly required in view of the budgetary situation and the current level of intervention stocks. But it remains to be seen exactly what measures the Commission will propose and, more important, what proposals the Council of Ministers can be persuaded to adopt. The effects on land use, farm income and employment in the UK could differ substantially depending on the means adopted to reduce CAP budgetary costs.

3. We should obviously avoid introducing new schemes with additional expenditure before the CAP savings have been achieved. Moreover, given the problems which IBAP expenditure has caused the PES planning total in recent years, we should not proceed on the assumption that all savings on the IBAP programme can be hypothecated in favour of the agriculture programme, although I would be prepared to concede that a small proportion of the potential savings might be used to assist the necessary process of adjustment.

4. In any event, we should not automatically assume that further Government intervention in what is already a highly protected sector will necessarily be justified. The extent of structural change over the next ten years envisaged by the ALURE Report is not all that dramatic and likely to be widely dispersed. In other sectors of the economy we have been prepared to allow proportionately much greater structural changes to take place without Government intervention. I therefore fully agree with David Young and Paul Channon that the emphasis in any adjustment programme should be on creating the right environment for private enterprise to flourish. Relaxing the current planning restrictions on the development of agriculture land would seem to be a good candidate in this context.

5. I would not seek to rule out of consideration altogether some new interventionist measures of a pump priming nature, if they can be justified in terms of the accepted rationale for

Government intervention in industry, ie if it can be demonstrated that they will produce a net benefit for the economy as a whole (not just for farmers); that they will be time limited and that they can be financed within the existing PES totals. I hope that we can agree that any further work at official level on Michael's proposals should be aimed at satisfying us that they will be cost-effective in these terms.

6. On Michael's specific proposals, those for increased tree planting pose particular difficulties, not only on environmental grounds, but also because of the long term nature of the expenditure commitment. We would need to see strong arguments to justify any further incentives for traditional forestry which already benefits from grants and a peculiarly generous tax regime. The main problem I see with the proposed farm woodland scheme is that if it were introduced in the short term to compensate for current levels of CAP support, in two or three years' time it might seem excessively generous, if some genuine reduction in CAP support had by then been achieved. Even on the assumption that current CAP policies continue, the scheme would barely break even in financial terms in ten years' time if account is taken of the consequential administrative costs (assessed by the Forestry Commission at 80% of programme expenditure).

7. The proposals for doubling the provision for environmentally sensitive areas (ESAs) seems a bit premature before we have introduced (let alone evaluated the success of) the original areas. Those for diversification and marketing grants and increased R & D could in my view be financed by reallocating priorities within the substantial existing PES programmes for agricultural capital grants and R & D, much of which is still (somewhat perversely) directed at improving the productive capacity of British agriculture.

8. I am sending copies of this minute to Michael Jopling and the other recipients of his minute of 22 September.

[JM]

ANNEX C

BRIEF FOR MEETING ON 13 NOVEMBER

1. **OBJECTIVES**

(i) To avoid any general endorsement of Mr Jopling's proposals or of his proposed early public announcement.

(ii) To seek agreement that a structural adjustment package would not be justified until some further serious CAP reforms have been achieved, with identifiable PES savings.

(iii) To ensure that any new measures should meet the normal criteria for Government support (ie net benefit to the economy, time limited and with specific monitorable objectives).

(iv) Avoid agreement to any increase in PES totals or bids on Reserve.

POINTS TO MAKE

Link with CAP reform

2. Entirely appropriate to consider consequences of CAP reform for rural economy. But premature to announce/introduce new structural adjustment programme until serious CAP reform has been achieved and consequential PES savings assessed.

3. Commission have promised drastic proposals in 1987 Price Fixing and "Ex Novo" Review. Should at least wait to see what direction these take and reactions in Agricultue Council.

4. Different types of reform (price reductions, quotas, increased

coresponsibility levies) will have different effects on land use, farm income and employment and between UK regions. Some further structural measures (eg cereals set aside and forestry) may be proposed in EC context.

Need for Government intervention

5. Not convinced that structural consequences of negotiable CAP reform will be all that dramatic. ALURE analysis suggests 1 million "spare" hectares in 10 years time (5.4% of UK agriculture area); 50,000 reduction in employment below current trends (8% of current total). The effects are likely to be widely dispersed.

6. Farm income effects largely dependent on method of CAP reform (eg quotas could well be compensated by higher farm prices). In any case, farm income highly volatile: substantial fall in 1985 likely to be reversed in 1986 (buoyant crop prices, lower input costs for fuel and fertilizer). (Recent Lloyds Bank review suggests that on average farmers not overborrowed.)

7. In other sectors Government has allowed proportionately much greater changes to happen without intervening.

Criteria for intervention

8. Should agree that any new proposals for Government support should meet usual criteria for intervention (in Annex G to ALURE Report) viz:

(i) net benefit to economy as a whole;

(ii) additionality (ie project would not go ahead without Government support);

(iii) time limited, pump priming nature;

(iv) specific, monitorable objectives.

9. Emphasis should be on creating right environment for private enterprise (eg by relaxing planning restrictions).

PES

10. There should be no net addition to recently agreed PES totals. Should not introduce new schemes until CAP savings secured and should not assume that all IBAP PES savings can be hypothecated to agriculture programme.

11. In case of schemes which are themselves claimed to generate IBAP savings could only accept them as genuine, if schemes set up in such a way that reduction in IBAP costs could realistically be guaranteed. In any case forecast savings would need to be recalculated in light of any changes to CAP (eg reform of beef regime) which could substantially reduce their size.

12. Considerable scope for redirecting priorities within capital grants and R & D programmes (now around £140m and £150-160m per year respectively).

SPECIFIC PROPOSALS (if raised)

Forestry

13. Very doubtful whether increase in present support for forestry (through grant and tax system) would be justified, but unclear that expansion foreseen will actually happen without higher incentives.

14. Could be serious environmental objections to increased conifer planting, but broadleaves (taking twice as long to grow) would require much higher grants.

15. [if raised] Agree that tax regime should be considered in any further work on forestry.

Farm Woodlands

16. Cost effectiveness crucially depends on timing of introduction. Level of compensatory allowance and consequential CAP savings will need to be reviewed in light of any changes to CAP regimes. On current assumptions scheme would barely break even in 10 year s' time if account is taken of the very high administrative costs (80% of programme expenditure).

17. Further work on proposed scheme needs to concentrate on how genuine reduction in agricultural production can be ensured; how to secure environmental benefits without drastically increasing costs and how to avoid open-ended commitment.

ESAs

18. Clearly premature to propose doubling provision before original ESAs even designated (still less before success of scheme evaluated).

19. When policy originally agreed in 1984, Michael Jopling undertook to finance it within agreed PES provision for capital grants.

20. Link with CAP savings or respone to reduction in CAP support extremely tenuous anyway. (ESAs mainly intended to encourage farmers to retain existing production methods and levels of production).

Diversification and marketing

21. No case yet made that these new grants justified. Have already made clear in correspondence on 1986 Agriculture Act that MAFF should (a) ensure that there is no overlap with existing grant schemes (eg from Development Commission) and (b) find money within existing capital grants programme.

R & D

22. The small sums proposed can easily be found within MAFF's substantial R & D programme (£150-£160m a year). Several recent reports have noted that disproportionate share of Government R & D expenditure goes on agriculture. [MAFF may now be prepared to absorb these costs of less than £1m a year].

Administrative costs

23. The costings in Mr Jopling's paper seem disproportionately high and will need further investigation. The presumption should be that administrative costs should be absorbed.

Relaxation of planning restrictions

24. Agree that this option should be pursued. Presentation will need careful handling but no additional PES involved. Projected IBAP savings could not be guaranteed and therefore are not available for reallocation.

BACKGROUND

25. See covering minute.

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FROM: MISS S M CHALK
DATE: 12 July 1988

1. MR RICHARDSON mcr 12/vii
2. MR J ANSON
copy attached for Chancellor
3. CHIEF SECRETARY

(excluding White Paper tables)

cc PEX
HEGs
Mr Potter
Mrs Brown
Mr Gilhooly
Mr Mowl
Mr Luce
Mr Hansford
Mr Baker
Mr Binns
Mr Tarkowski
Mr Dyer
Mr I Taylor
Mr Tyrie

Ch/ to be aware [I have spared you the full paper]
mpw

1987-88 CASH LIMITS: PUBLICATION OF PROVISIONAL OUTTURN

1. This submission seeks your approval to our publishing the Cash Limits Outturn White Paper (CLOWP) on 21 July and to the accompanying press notice and briefing. Drafts are attached. It also reports on the performance of cash and running costs limits in 1987-88.

2. The CLOWP is an annual publication which has been issued every year since cash limits were first widely used in 1976-77. It shows, as has been the pattern in previous years:

i. Provisional outturn for cash-limited expenditure in 1987-88

ii. Changes to cash limits agreed during that year;

iii. Final outturn for cash limited expenditure in 1986-87;

iv. Outturn against provision information for nationalised industries' EFLs in 1987-88;

v. Provisional outturn for running costs limits in 1987-88;

vi. Changes to running costs limits agreed during that year;

and for the first time this year:

vii. Final outturn on running costs limits in 1986-87 (the first year in which running costs limits were set).

3. The CLOWP does not attract very much attention outside government, but we regard it as an important part of the discipline of cash and running costs limit control. Every agreed change to limits is itemised and explained, and the date of announcement shown - thus underlining that such changes are regarded as exceptional. Cash limit and running costs limit breaches are separately identified on the first page of the text.

4. By its very nature, the CLOWP concentrates on the exceptions to the overall record of good cash and running costs limit control; but the summary text makes the more positive point that, despite the small number of breaches, the overall outturn for both cash limited and running costs expenditure was within total final provision (ie after allowing for agreed changes during the year). Again, for both cash limited and running costs expenditure, outturn exceeded original provision set at the beginning of 1987-88 by a very small margin (less than 1 per cent). The press briefing also emphasises these points.

5. The outturn figures for central government cash limits and running costs limits in 1987-88 are described as provisional because they could be revised between now and publication of the final Appropriation Accounts in the Autumn. But any adjustment is likely to be very small. The figures for the other (non-voted) cash limits are likely to be subject to more change particularly in the case of local authority capital expenditure. But delaying publication would have little purpose and weaken the document's function as part of the cash limit control regime.

Breaches of Cash and Running costs limits

6. There were five breaches of cash limits in 1987-88; four on cash limits on voted expenditure and one on non-voted local authority

capital spending in Wales. Of the four, one by DTI on sale of shares in Rolls Royce plc, was only technical (and token) in that unavoidable bills were £112,000 higher than originally estimated, but were covered by receipts from the sale which could not be Appropriated-in-Aid in the absence of Estimate authority. The others are £1,585,000 on the DTp roads vote; £1,203,000 on the Welsh Office tourism, roads and transport vote, and £72,000 on the General Register Office for Scotland Vote.

7. The final position on the non-voted local authority capital cash limits is still uncertain. Local authorities are still sending in late returns. But on the figures available, the cash limit for Welsh local authority capital expenditure (WO/LA1) is breached by £87.3 million, compared with a breach of £72 million in 1986-87.

8. There were two running costs limit breaches in 1987-88: for MOD (£7,027,000), and the Home Office (£361,000). Neither contributed to a cash limit breach.

9. The reasons for and proposed action to be taken as a consequence of each breach will be covered in separate submissions to you by expenditure divisions. For cash limits the standard procedure is that this year's cash limit is reduced by an amount equivalent to the breach last year and concrete control improvements sought and are agreed following an investigation by the departments. However, since the DTI breach results in only a token excess, a penalty of this sort is inappropriate. IAE2 will be reporting to you on why DTI did not foresee the additional expenditure in time to take a Supplementary Estimate to avoid the Excess. Although the expenditure is covered by the receipts, to the extent that these were lower than forecast there was an opportunity cost to the Reserve. LG1 are considering the case for imposing a cash limit reduction on WO/LA1 and will be pressing the Welsh Office for effective action to reduce a capital overspend forecast for 1988-89; they will be advising in due course. Proposals to reduce the other three voted cash limits will be submitted shortly. For running costs breaches a reduction in this year's limit does not follow so automatically; an investigation in each case is required and improvements in control will be agreed, together with a running costs limit reduction if appropriate. The

White Paper text follows previous years' practice of omitting any specific reference to the procedures adopted following a breach. Instead, it refers obliquely to 'the usual corrective procedures'.

Underspending

10. Underspending on finally agreed provision for cash limited central government expenditure was in aggregate 1.6 per cent or £1,051 million in 1987-88 compared with 1.5 per cent in 1986-87. This is discussed in the press briefing. For capital programmes, the underspending shown is the basis of eligibility for roll-forward under the end year flexibility scheme. A draft PQ announcing the increases in 1988-89 cash limits under the scheme will be submitted to you shortly. For non-voted cash limits the underspend on finally agreed provision was 9.4 per cent or £807 million, compared with an overspend of 2.4 per cent or £184 million in 1986-87.

11. Underspending on finally agreed provision for running costs limits totalled £47 million (0.4 per cent), compared with underspending of £103 million (0.8 per cent) in 1986-87.

Nationalised industries' EFLs

12. In aggregate, the estimated 1987-88 outturn for the nationalised industries was £274 million, ie £305 million (53 per cent) below final EFLs and £418 million (60 per cent) below 1987 PEWP plans. £59 million of this undershoot reflected BAA's outturn up to privatisation. The estimated outturn for those industries still under government control was £283 million, £246 million below final EFLs and £359 million below PEWP plans. Factors contributing to the undershoot against final EFLs include LRT's increased revenue from the sale of fixed assets, BR's continuing buoyant revenue position and proceeds from NBC's disposals programme.

13. In total, there were three EFL breaches last year:

i. BSC: the £10 million breach was against an EFL that had been reduced by £366 million and reflects a delay in expected property receipts; in view of privatisation, a reduction this year is not appropriate.

ii. NSHEB: the £5 million breach reflects the early repayments of overseas loans following changes to the Exchange Cover Scheme. Since this breach was caused by early repayment at Treasury request it was agreed that no action would be taken to reduce the 1988-89 EFL.

iii. STG: The £5 million breach results from strong competition from de-regulated local bus routes, and industrial action by SBG crew. PE2 are reviewing whether to impose a penalty reduction in 1988-89.

14. In line with past practice, no details of the EFL breaches are given in the Press Notice or in the text of the White Paper; the sponsoring departments would be responsible for answering specific queries.

<u>Clearance</u>

15. We are required to notify the Prime Minister's Office about the proposed timing and to circulate the text, subject to your approval, to your colleagues for information. I attach a draft Private Secretary letter for this purpose.

<u>Conclusion</u>

16. I should be grateful for your approval of:

i. the draft White Paper (summary text at Annex A and, for you only, the complete White Paper is at Annex D)

ii. its publication at 2.30pm on 21 July.

iii. its circulation to colleagues under the attached letter.

iv. the draft press notice at Annex B.

It would be helpful if we could have your approval by close on Friday 15 July.

17. This submission has been agreed with RC, LG1, IDT, PE2, Pay and other relevant divisions.

Sue Chalk

MISS S M CHALK

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CONFIDENTIAL

DRAFT LETTER TO:

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cc Private Secretaries to Members of Cabinet and Sir R Butler

CASH LIMITS FOR 1987-88

We are now ready to publish the annual White Paper showing provisional for 1987-88. The Chief Secretary proposes to publish it on 21 July at 2.30pm.

2. I attach a copy of the proof. It follows the strictly low-key format of previous White Papers and has been agreed in draft with departments. The text is kept short, in accordance with the usual practice. The White Paper is published primarily as a matter of record.

3. I am sending copies of this letter to the Private Secretaries of other members of Cabinet and to Trevor Wooley.

PRESS NOTICE

ANNEX B

CASH LIMITS 1987-88: PROVISIONAL OUTTURN

The Treasury today published the Cash Limits Outturn White Paper (Cm XXX) showing:

i. Provisional outturn for 1987-88 cash limits; nationalised industries External Financial Limits (EFLS); and running costs limits;

ii. Final outturn for 1986-87 cash limits and running costs limits.

2. As in previous years, cash limited expenditure was kept within final cash limits for virtually all cash limits. In their second year of operation running costs limits also held in virtually all cases. The overall position for 1987-88 was:

£ million

	Original cash limits	**Final Cash Limits**	**Total provisional outturn**
Voted cash limits	62,915	64,305	63,254
Non voted cash limits	8,717	8,559	7,751
EFLs*	642	529	283
Running cost limits	13,073	13,197	13,151

*excluding industries privatised in 1987-88

3. There were 4 breaches out of a total of 127 central government voted cash limits; 1 breach out of 11 non-voted cash limits; and 2 breaches out of a total of 51 departmental running costs limits. Details are given in the White Paper, the summary text of which is attached.

Note to Editors

Further details are available in the White Paper.

Similar White Papers have been published in previous years (last year's was Cm 189). Enquiries on the general subject of cash limits and running costs limits should be addressed to Treasury Press Office. Questions on individual limits should be addressed to the Departments concerned.