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4 December 1979

CABINET

AGRICULTURE

Note by the Secretary of the Cabinet

1. At its meeting on 4 October 1979 (CC(79) 16th Conclusions, Minute 3) the Cabinet considered a memorandum by the Minister of Agriculture, Fisheries and Food (C(79) 41) proposing an early increase of $1\frac{1}{2}$p per pint, from 15p to $16\frac{1}{2}$p, in the maximum retail price of milk. The Cabinet agreed that there should be no increase in the retail price of milk at that stage, and that the question of milk prices should be looked at in the broader context of support for agriculture generally and against the background of the Common Agricultural Policy (CAP) and the subsidies which other members of the European Economic Community (EEC) gave to their agricultural industries.

2. The review has been undertaken by an Official Group (MISC 23), whose report is attached. It gives both the context and the detailed considerations for three decisions which the Cabinet is now invited to take:-

i. Whether or not to undertake a devaluation of the green Pound in the immediate future. The Minister of Agriculture, Fisheries and Food proposes that he should seek a devaluation of 5 per cent at the EEC Council of Ministers (Agriculture) on Monday 10 December. The case for this appears to be strong.

ii. Whether or not to increase the maximum retail price of milk. The Minister of Agriculture, Fisheries and Food confirms his earlier proposal for a $1\frac{1}{2}$p per pint increase as soon as possible. If there is no increase, the profit margin will fall very sharply indeed; the British consumer would gain from having milk that much cheaper; the British balance of payments would lose to the extent that we imported more butter; the Exchequer would gain its share of the savings to the EEC of less butter being sold into intervention. At some stage, EEC milk output will have to be cut and a step by the United Kingdom to reduce its own output by lowering the profitability of milk could be presented as a move in this direction. But it is questionable whether Britain should take this step alone. Apart from farmers' profit margins another argument for some increase in the price of milk is that at the next meeting of Agriculture Ministers of the EEC the United Kingdom will be taking a tough line and our own farming industry will be affected e.g. by an increase in the co-responsibility levy. A rise in the retail price of milk would help to

shield our own industry from part of the effects of the tough position we will need to take. One possible course would be to go for some increase in the retail price of milk, but less than the 1½p per pint which the Minister proposes.

iii. What to do about farm capital grants, a decision on which is required in order to complete the current public expenditure review. The Public Expenditure Survey (PES) provision in the inherited plans for 1983-84 is £160 million at 1979 Survey prices. The Chief Secretary, Treasury, proposes that this figure should be reduced by £60 million, and the Minister of Agriculture, Fisheries and Food proposes that it should be increased by £30 million. Either change would be achieved by means of a change in the percentage rates of grant payable on applications after 1 January 1980, and an Order for this purpose would need to be laid in Parliament before the Christmas recess. There would be consequential adjustments to the PES figures for 1981-82, 1982-83 and 1984-85. In the medium term a reduction in EEC agricultural output is necessary. An increase in the rate of capital investment would appear to point in the opposite direction. On the other hand, a decrease in the rate of grant implied by the Chief Secretary's proposals (55 per cent) would be very steep. The choice appears to be between no change and a decrease smaller than that proposed by the Chief Secretary.

Signed ROBERT ARMSTRONG

Cabinet Office

4 December 1979

AGRICULTURE

Report by the Official Group (MISC 23)

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AGRICULTURE

REPORT BY THE OFFICIAL GROUP (MISC 23)

INTRODUCTION

1. The Group was set up following the Cabinet's discussion of liquid milk prices on 4 October 1979.

2. The Group consisted of representatives of the Treasury, the Foreign and Commonwealth Office, the Department of Employment, the Ministry of Agriculture, Fisheries and Food, the Department of Trade, and the Central Policy Review Staff under Cabinet Office Chairmanship. In addition the Scottish, Welsh and Northern Ireland Agriculture Departments were represented at a number of the Group's meetings.

3. Ministers will shortly need to take decisions on three issues concerning agricultural support.

- Whether to devalue the Green £ by 5 per cent as recommended by the Minister of Agriculture, Fisheries and Food. (If Ministers so decide, it may be desirable tactically to secure this decision at the EEC Agriculture Council meeting on 10 December, so as to get it out of the way before the annual price-fixing begins. So it is desirable to have a decision one way or the other before then.)

- Whether or not to increase the maximum retail price of milk by 1½p per pint as recommended by the Minister of Agriculture, Fisheries and Food.

- Whether to reduce the level of farm capital grants as recommended by the Chief Secretary, Treasury, or to increase them as recommended by the Minister of Agriculture, Fisheries and Food. (This decision is necessary in order to complete this year's public expenditure review. If the level of grant is to be changed from 1 January 1980, an Order to this effect will need to be laid in Parliament before the Christmas Recess.)

4. The purpose of this report is to enable these issues to be looked at in the broader context of support for agriculture generally, and against the background of the Common Agricultural Policy (CAP) and the subsidies which other members of the EEC give to their agricultural industries.

THE UNITED KINGDOM AGRICULTURAL INDUSTRY

5. Agriculture consists of 250,000 individual farms requiring widely varying inputs, producing a wide range of commodities and facing differences of scale and of kind in the problems and opportunities they face. There is little resemblance between cash cropping on large, heavily mechanised farms in East Anglia, and small remote island farms or extensive hill farming in the uplands of southern Scotland, northern England or Wales. In total, agriculture accounts for 2.7 per cent of the United Kingdom's gross domestic product - about £3500 million in 1979 - and a similar percetage of civilian employment. Industries and services closely associated with agriculture account for about another 4 per cent in each case.

6. Agricultural production has for many years been on a rising trend. The industry's net product has been increasing in volume by 2½ per cent a year, and the proportion of our total consumption of temperate foods produced in the United Kingdom has risen from 62 per cent in 1970 to 70 per cent today. At the same time, the industry's usage of material inputs has remained virtually constant and both its land usage and the size of its labour force have decreased. The volume of output per man has been rising at an average rate of 4 per cent a year.

7. The growth of production and productivity is attributable to improvements in the yields of crops and livestock, the adoption of new technology, and the steady enlargement of productive units which have given economies of scale. The industry has become increasingly capital-intensive and farmers have been able to use capital, labour and other resources flexibly to achieve the most economic and productive combination.

Financial Position and Prospects

8. Table 1 below shows trends in farm incomes according to two indicators, farming net income which is a published series and farm family cash income (a concept devised for this Group) which shows profitability as the farmer himself might perceive it in the short term. The main differences between the two series are that farm family cash income does not count the costs of depreciation or of family labour, but does include as a cost annual expenditure on fixed assets net of grant. It also values stock changes at potential market prices rather than at cost (see also graph A at end.)

TABLE 1.

	1970	1973	1975	1976	1977	1978	1979 forecast	1980 projection
Net farm income £m	479	871	923	1137	1300	1120	1047	[835]
Farm family cash income £m	750	1190	1470	1840	1550	1800	1870	[1710]
NFI in real terms 1975 = 100	96	136	100	106	104	83	68	[47]
FFCI in real terms 1975 = 100	94	116	100	107	78	84	77	[61]

Both series show a decline in real income from the mid 1970s to 1978 with a further decline from 1978 to 1979

9. The projections for 1980 assume no change in EEC common prices, no change in the green pound, and no increase in the retail price of liquid milk, but they include the recently announced increases in aids to hill farmers. Costs are assumed to rise broadly in line with inflation and the farm wage bill to increase by 19 per cent following the recent award announced by the Agricultural Wages Board. Output prices have been taken to rise, reflecting market trends and increases in the pipeline following earlier green pound changes. The projections show that there will be a significant decline in real incomes from 1979 to 1980 unless action is taken to avert it*

*The measures of financial performance included in the report are mostly those which have been conventionally adopted in recent years to assess farmers' income position. However, discussions in the Group have indicated the desirability of a further analysis of the existing measures of income, and an exercise is to be conducted by the Agricultural Departments and the Treasury over the coming months. It is not suggested, however, that any new index will materially alter the projection of a fall in income next year if no action is taken.

10. Table 2 below shows trends in net margins for individual commodities for 1975/6 to 1980/1 (except for horticulture and hill livestock for which comparable data are not available). The assumptions for 1980 are the same as for the previous table.

TABLE 2

TRENDS IN NET MARGINS (1975/76 = 100)

	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80 forecast	1980/81 [projection]
Money values								
Cereals, potatoes, sugar beet	75	73	100	127	66	106	100	[76]
Beef, pigs, sheep, poultrymeat	58	Loss	110	89	100	110	98	[108]
Milk, eggs	73	25	100	73	129	94	89	[35]
Total	70	43	100	105	89	104	97	[76]
Real terms								
Cereals, potatoes, sugar beet	110	90	100	110	50	75	61	[40]
Beef, pigs, sheep, poultrymeat	85	Loss	100	77	76	77	60	[58]
Milk, eggs	107	31	100	64	98	66	54	[18]
Total	102	54	100	91	67	73	59	[40]

The net margin estimates are based on University Surveys in England and Wales of the main enterprises. They provide indicators of changes in the return to the farmer for his management and investment devoted to their production.

11. The squeeze on incomes in the current year has been borne mainly by the livestock sectors, especially the hill and upland farms which are not included in the table, and which account for 20 per cent of the total United Kingdom cattle breeding herd and 57 per cent of the sheep breeding flock. In this sector incomes in 1979/80 have been estimated to be between 15 per cent and 60 per cent lower than in 1978/79, with the largest falls occurring in Scotland and Northern Ireland. These declines reflect the consequences of the hard winter in 1979 and low prices, particularly for sheep, at the present

time. The prospects for 1980 are an improvement in margins for beef, pigs and sheep, but a severe decline in the crops sector and in milk, where increases in workers' wages will have a particularly marked effect.

Asset position of agriculture

12. Farmers' borrowing from banks, the greater part of their liabilities, have increased repidly in 1979 and are currently 33 per cent higher than at the same time in 1978. The increased borrowings are a consequence of declining real income, and thus the falling retentions of profits for investment purposes, but liabilities are only 7 per cent of networth compared with 14 per cent in 1970 (see Table A at end). 80 per cent of the industry's assets are land and buildings. As a result of the rapid rise in land values, from £1200 a hectare in 1976 to £2200 in 1978 and £3100 in 1979, total assets have risen sharply and the value of an average full-time farm is now £340,000. While land values remain buoyant the credit worthiness of owner occupiers, who account for 60 per cent of the land, should therefore remain sound. But only just over 1 per cent of land area is marketed each year, and thus an increase in sales arising from an income squeeze could generate a price fall. A further increase in borrowing, using land as collateral, would be possible and could provide a measure of income support to owner occupiers, but would carry a long-term cost. It is also questionable whether farmers will continue to invest in farming, if their incomes from farming, as distinct from their rising assets in land and buildings, continue to decline.

13. Investment in agriculture grew in real terms by 14 per cent between 1970 and 1973. Thereafter it fell back, but by 1979 it is forecast to have recovered almost to the level of 1973 (Table B at end). Both the initial rise and the subsequent fall were greater than the changes in investment in the economy as a whole over the same period. Most of the fluctuation in agricultural investment has been in investment in buildings and works. Investment in plant and machinery grew rapidly between 1970 and 1972 and has thereafter remained at roughly the same level.

SUPPORT SYSTEMS

Operation of the CAP

14. For most agricultural commodities produced in the United Kingdom, the support arrangements are now laid down by CAP market regulations. (The main exceptions are sheepmeat and potatoes.) Most CAP regimes operate on the

principle of managing commodity markets so that prices are high enough to give the producer what is judged to be the appropriate level of return. The standard model is one in which market prices are raised to the desired level by raising the price of third country imports through variable levies (import levies), by removing home production from the market (intervention), and by encouraging exports, by repaying the difference between Community prices and world prices (export restitutions).

15. There is some scope within the regulations, and subject to Community law, for member states to follow national policies. The United Kingdom, for example, has maintained arrangements for milk which depend heavily on controls over liquid prices and health regulations which restrict imports.

16. CAP support levels within each regime are set by means of "common" institutional prices which apply within the different mechanisms. These prices and amounts are fixed for the Community as a whole in units of account and are converted into national currencies at fixed exchange rates known as "green rates". By refusing to change their green rates by as much as the market rates of their currencies change, member states are able to manipulate their national prices to suit their own economic and political needs. In 1978, for example, the common price level was on average 33 per cent above the United Kingdom support price level. It is now about 10 per cent above.

Support to Agriculture in EEC Member States

17. In addition to CAP mechanisms, all member states pay national aids to agriculture. It is only possible to make rough comparisons of the value of these aids, and the results of a comparison by MAFF are shown at Table C at the end of the report. They give only a broad indication of the position, but they show the United Kingdom well down towards the bottom of the list.

Agricultural Incomes

18. One of the reasons for this is that the social problems of farmers and agricultural workers are greater in the rest of the EEC. A simple comparison of incomes per head in agriculture in the United Kingdom and in other EEC countries shows that only in the United Kingdom are agricultural incomes roughly equivalent to the national average. However in part the reason for this is that a higher proportion of farmers elsewhere are part-time and so

have other sources of income. Hence it is more sensible to compare incomes on full-time farms only. But even in this case the average income per head of all those working on farms is significantly higher, relative to non-agricultural earnings, in the United Kingdom than in any other country (eg, on 57 per cent of farms income per head is more than 120 per cent of average non-agricultural earnings, compared with the EEC figure of 31 per cent).

Comparison of support to agriculture with support to manufacturing industry in the United Kingdom

19. The basic difference between support to agriculture and to other industries in the United Kingdom is that farmers have a guaranteed outlet for their main products at assured prices. Manufacturing industry does not have such security in the market. On the other hand agriculture is subject to some uncertainties such as the weather and the incidence of disease, which do not affect manufacturing industry. Moreover Government support to manufacturing industry has been given in a more sporadic way than has been the case with agricultural support.

20. As regards import protection, United Kingdom agriculture has far more protection against imports from third countries than does United Kingdom manufacturing industry. But manufacturing industry does, at least, enjoy the same measure of protection as its counterparts in the other EEC countries. So far as agriculture is concerned, because of the green currency arrangements, the level of import protection varies from one country to another. The sizes of these differences are expressed in the monetary compensatory amounts which are used to adjust the level of import levies each member state applies against third countries. They also apply, as appropriate, as levies or subsidies in intra-community trade.

21. It follows that the comparison between United Kingdom agriculture and United Kingdom manufacturing industry differs depending on whether one is looking at third country trade or intra-community trade. As regards third country trade the average level of tariff on manufactured goods is equivalent to about 8 per cent of value added by United Kingdom manufacturing industry whilst agricultural levies are equivalent to about 42 per cent of value added by United Kingdom agriculture. As regards intra-community trade, there is no protection for manufacturing industry and agriculture faces imports which are subsidised through the MCA system. The size of this subsidy varies in accordance

with the origin of the imports. At current green and market rates of exchange the range is from 2.3 per cent for imports from Italy to 22 per cent for imports from Germany. The intention of the MCAs is to bridge the difference between support prices in the various member states although in practice they do sometimes over or under compensate for this. There are no price support arrangements for manufacturing products (though for some products, eg textiles, car, TV tubes, there are anti-dumping and trade restricting agreements).

22. There are different United Kingdom regimes of investment support for agriculture and for manufacturing industry. In 1978 grants represented some 13 per cent of gross capital formation in agriculture but only 9 per cent in manufacturing industry. (The public expenditure figures were £129 m and £534 m respectively.) Following the recent changes the figure for manufacturing industry will be about one-third less in coming years. In agriculture capital grants are available on investment in buildings and works but not generally on investment in plant and machinery. The rates differ as between the types of expenditure and geographical areas, but the average rate in less favoured areas is over 40 per cent and 22 per cent elsewhere. In manufacturing industry capital grants mainly take the form of regional development grants on investment in plant and machinery, though there is also some expenditure under the Industry Act. RDGs have hitherto been paid at rates of 20-22 per cent but have recently been reduced to 15 per cent in the development areas while at the same time the coverage of the total assisted areas has been reduced.

23. Some difference of treatment might be justified because, with a greater proportion of investment in buildings and works, the average lifetime of agricultural investment is longer than that of manufacturing investment - the longer lived the asset the larger the proportionate grant needed to produce the same change in the post-grant rate of return. But in any case, investment is also supported by investment tax allowances. If we deal with buildings and works only then manufacturing is treated slightly more favourably than agriculture; partly because of higher initial depreciation allowances and partly because RDGs are not netted off in calculating tax allowances. The two together imply that to put agriculture and manufacturing on the same footing (in areas where RDGs are payable) capital grants for agricultural buildings and works should be about four percentage points higher. But the actual difference in levels of grant is much bigger than this. In the case of plant and machinery,

however, RDG grants paid to manufacturing industry are also not netted off in calculating tax allowances which is a further benefit to that sector.

24. MAFF believe that a considerable difference in treatment between industry and agriculture can be justified because agriculture with its greater proportion of investment in buildings and works is able to make less use than manufacturing of the more generous tax allowances (and tax leasing arrangements) on plant and machinery. Also agriculture, being composed of unincorporated businesses is often unable to take full advantage of the allowances. Thus it is not clear that, within the development areas at least, the total value of all grants and tax allowances on all agricultural investment is more than the total value of all grants and tax allowances on manufacturing investment, even though agricultural investment programmes with the same mix of buildings and machinery as a given manufacturing project might receive more assistance.

25. The Treasury do not accept that this is a relevant consideration. They believe that it is reasonable that sectors with different weightings between the types of investment should have different weighted tax treatment, and that farmers are as capable as other sectors of arranging their affairs to make maximum use of tax allowances, and indeed they have been helped to do so by the special tax averaging arrangements introduced by the 1978 Finance Act. Hence they believe that differences in tax treatment only marginally offset the substantially more preferential levels of capital grant given to agriculture, and that to give the same rate of grant to agriculture as is given to industry, taking account of the differences in tax arrangements, would imply an average rate of 19 per cent in less favoured areas and 4 per cent in the rest of the country. These figures may be compared with the rates of 40-50 per cent in less favoured areas and 30-40 per cent in the rest of the country which have been proposed by the Minister of Agriculture, Fisheries and Food.

THE CASE FOR DIFFERENTIAL SUPPORT TO AGRICULTURE

26. Before dealing with the immediate issues we address ourselves to the fundamental reasons for supporting British agriculture. The classic argument for price stabilisation is that otherwise the uncertainty produced by fluctuations in returns, as a result of the weather combined with the inelasticity of demand, would lead to a lower level of output at a given average price.

This argument is generally accepted as are considerations of rural poverty and security of supply. In practice all developed countries given their agricultural industries some measure of support.

27. As members of the EEC, we have to operate within the framework of the CAP which commits us to support our agriculture (see paragraphs 14-16 above). But that framework leaves the United Kingdom some scope for national decisions - on the green £, retail milk prices, help for investment, hill subsidies, and the remaining national commodity guarantees. The practical question therefore is not whether agriculture should be supported at all, but how far the national measures should be used to add to or subtract from the support inherent in the CAP.

28. Some Departments believe that the size of British agriculture should be mainly determined by competition with imports at the prices at which the CAP permits them to enter. These prices (though excessively high and the cause of surplus EEC production) are the ones which determine whether or not it is economically worthwhile to devote extra United Kingdom resources to obtaining extra output. They therefore consider that when the green £ is aligned to the market rate, the Government should withdraw from subsidising or supporting agriculture (except for regional aid) other than through the CAP. It should then be ready to look upon fluctuations in agricultural profitability as signals which enable agriculture to adjust to its market (as in other industries) rather than as deviations requiring offsetting official action.

29. The Agriculture Departments believe that British agriculture should as far as possible be enabled to compete on level terms with its competitors in other member countries, which at present enjoy higher levels both of price support and of national aids; and that the British economy generally will benefit from giving more support to agriculture, whose relative efficiency and responsiveness to incentive assure a larger consequential increase in gross national product. They draw attention to the statement in the Conservative Manifesto that "Labour have seriously undermined the profitability of these [our agricultural and food] industries" and that "we must ensure that these industries have the means to keep abreast of those in other countries".

30. The Government has helped one relatively small but, in social and regional terms, important part of the industry by its decision to increase the hill livestock allowances for 1980 by about one-third at a cost of £21 million.

The three decisions which need to be taken next (set out in paragraph 3 above) all affect either major sections or the whole of the industry.

31. Any of the measures recommended in paragraph 3 would represent a transfer of resources to agriculture from the rest of the economy. The Agriculture Departments consider that the whole of the transfer would be justified. Implementation of these measures would still leave net farm income in 1980 below that in 1979 in real terms. Other Departments have expressed doubts whether all these measures are justified.

32. It is common ground that: if EEC support prices are frozen and no action is taken domestically, farming net income in 1980, like profitability in British industry at large, will be significantly down on the 1979 level, which itself is down in real terms from the levels of the mid-1970s. The Agriculture Departments argue that something ought to be done to lessen the decline. They further argue that a decline in incomes must eventually lead, through lack of investment, to a loss of future production and employment.

33. Taking the economy as a whole, a loss of agricultural production would not matter if the resources displaced from agriculture were put to at least equally valuable use elsewhere in the economy. But the Agriculture Departments argue that this will not happen, for three reasons -

i. they argue that agricultural resources are relatively difficult to transfer to other uses. This is obviously true of land, but less obvious as regards labour where there has already been a steady drift away from the land over many decades. On the other hand, an intensification of this drift could be severely damaging to rural communities.

ii. they argue that agriculture is relatively efficient at using investment. The key figures are that in agriculture, since 1970, the value of the capital goods used by the industry has increased by 29 per cent in real terms, the labour force has declined by 10 per cent, and net product has increased by 21 per cent. The figures for manufacturing industry from 1970 to 1978 are an increase in capital stock of 23 per cent, a decline in the labour force of 12 per cent, and an increase in volume of gross product

of $5\frac{1}{2}$ per cent. On the other hand, it has been argued that the 1970s were not a typical period given that production was stimulated by transition to EEC price levels. Figures for the period 1958-78 suggest that the relationship between investment and output is broadly the same for agricultural and for manufacturing industry even though the figures for manufacturing industry include the effect of the decline of several traditional industries.

iii. Agriculture imports a relatively small proportion of its inputs. Loss of food production will be replaced by imports of food. The Agriculture Departments argue that manufacturing industry is not likely to compete as successfully as agriculture with imports, so that the net effect is likely to be a loss of production and a continuing cost to the balance of payments. Other Departments dispute whether this is an overriding consideration during a decade in which North Sea oil will be reducing our import bill to such an extent that sterling is likely to remain strong despite the recent abolition of exchange control.

BACKGROUND TO THE IMMEDIATE ISSUES

Possible developments in the CAP

34. This report is not concerned with the need to reform the CAP to cut surpluses and reduce the burden which falls on the United Kingdom. The possible pattern of developments has, however, to be taken into account because of the implications for our farmers.

35. The United Kingdom's first aim will continue to be to hold down the real level of EEC price support. There is no question that this is the right objective for the United Kingdom but in assessing the implications for our domestic agricultural policy we have to bear in mind that most of the scope for green £ devaluations has already been used up and we can no longer assume that restraint of common prices will leave our producers unaffected.

36. However, while a prudent price policy for all CAP commodities should be our objective over the next few years, it might not, even if agreed in the Agriculture Council, be sufficient by itself to contain the cost of the CAP. For example an assessment of the position on milk, which accounts for 40 per cent of the cost of the CAP, suggests that after a four-year price freeze

followed by a period in which the price is held steady in real terms, milk production in the EEC as a whole might not, by the middle of the next decade, be significantly different from production in 1979. Accordingly it is to be expected that non-price measures to reduce the cost of the CAP, such as the increase in the co-responsibility levy on milk and the reductions in the quotas for sugar which the Commission have recently proposed, will become more important. It is not possible to forecast at this stage what may emerge but any measures that are agreed will have implications for United Kingdom producers.

37. It may be argued that, if the CAP produces uneconomic surpluses, restraint in production is essential in all member states. The view of the Agriculture Departments is, however, that as the United Kingdom remains a large net importer of temperate food, it is in our general interest to increase home production in the context of general Community restraint. It is also, they argue, in the Community interest to increase production in areas of greatest relative efficiency which for many commodities are in the United Kingdom. Other Departments doubt whether a policy of aiming at self-sufficiency in food, which may have made sense in the 1940s or in periods when we were attempting to prop up sterling at an artificially high level, is appropriate in present circumstances. Nor, they believe, would it be practical politics to expect other EEC countries to make a proportionately greater reduction in their production so as to accommodate both United Kingdom expansion and the diminution of surpluses.

DEVALUATION OF THE GREEN £

38. The Conservative Manifesto says that the Government will "aim to devalue the green £ within the normal lifetime of a Parliament to a point which would enable our producers to compete on level terms with those in the rest of the Community". Much has already been achieved, partly by two devaluations of the green £ since the Government came to office, and partly through the recent strength of the £ itself. The gap between green rates and market rates is currently some 10 per cent.

39. If the green £ is to be devalued further in the near future, it will probably be desirable on tactical grounds to propose the devaluation at the meeting of the Agriculture Council on 10 December. Any later proposal for a devaluation is likely to become entangled in the 1980 price-fixing negotiations.

40. The main options for a December devaluation are nil and 5 per cent. A significantly higher devaluation is unlikely to be negotiable because of the risk of creating positive MCAs.

41. The effect of a green £ devaluation of 5 per cent on 1980 calendar year income allowing for the lagged effect on producer prices will be about £120m. By the end of 1980 retail food prices would on average be higher by almost 1 per cent and the RPI by $\frac{1}{4}$ per cent. The full effects of the devaluation would not however be felt until 1981. The full year benefit to farm incomes would be about £175m (equivalent to only $2\frac{1}{2}$ per cent on the value of agricultural output because less than half this output benefits from a green £ change) and the other main consequences would be as follows -

TABLE 3

FULL YEAR EFFECTS OF 5 PER CENT DEVALUATION OF THE GREEN £

	Producers returns (net of feed) £m	Change in consumers' expenditure			PSBR effect £m (a)	Foreign exchange costs effect £m (b)	Public expenditure effect £m (c)
		£m	FPI	RPI			
5% Green £ change (ie +5.3% on support prices)	+ 177	+253	+.95%	+.25%	-28	+86	-2

(a) Net effect of a reduction in expenditure and increase in receipts.

(b) An increase in foreign exchange costs due mainly to a rise in food import prices. After production and consumption responses these losses should be eliminated.

(c) A saving in public expenditure.

LIQUID MILK DISTRIBUTION AND THE RETAIL PRICE OF MILK

42. The United Kingdom's system of liquid milk distribution is unique in Europe. Its main features are as follows -

i. Farmers sell all their milk to their local Milk Marketing Board (MMB). They receive a "pool" price reflecting the Board's total return from the liquid and manufacturing markets.

ii. The Boards sell milk for manufacturing (into butter, cheese, etc) and for liquid consumption. The price of milk for liquid consumption is 25 per cent - 1½p per pint - higher than that for milk for manufacturing. This difference is the "liquid milk premium".

iii. The Government sets both the maximum retail price of milk and the various wholesale prices payable to the MMBs for liquid milk, the difference between the two being the distributors' margin.

iv. The wholesale purchasers of milk for liquid consumption are the large dairies which operate the United Kingdom's system of door-to-door milk deliveries. These dairies also sell to retail outlets including supermarkets, but the price of milk in supermarkets is generally the same as that of milk delivered to the door.

43. It has been suggested that the retail price of milk could be reduced in two ways.

44. First, it is argued that the wholesale price should be set so as to reduce or eliminate the liquid milk premium. This would be in accordance with the criterion for agricultural support suggested in paragraph 28 above. Whether the premium could be completely eliminated is not clear: on the Continent, the producer typically sells to a producer co-operative, which in turn sells milk into manufacturing and liquid consumption at different prices, but the premium is not as great as in the United Kingdom.

45. Secondly, it is argued that the retail price of milk is kept artificially high by the dairies in the interests of protecting their door-to-door deliveries. One estimate is that of the current price of 15p per pint, 5p is accounted for by distribution costs. The Department of Trade estimates that in conditions of free competition the supermarkets might save 3p of this, but the Agriculture Departments consider this estimate highly optimistic. The supermarket chains certainly claim that the dairies charge them higher prices than they would in a fully competitive situation. It is argued that freer competition between shop and doorstep sales in England and Wales, as already occurs in Scotland and the Irish Republic, would provide a beneficial spur to both, and could make it unnecessary for the Government to set (and in times of inflation continually increase) the maximum retail price. The dairies' present trading practices are being examined by the Office of Fair Trading.

46. Against this, the Agricultural Departments argue that the supermarkets are free to negotiate with the dairies, and, if they dislike the dairies' prices, are also free to set up their own bottling plants which would enable them to buy milk direct from the MMBs. It would therefore be possible for competition to exist at any level of intensity between retail shops and dairies under the present system. It might well be that Government control of the retail price has prevented the dairies from abusing the present position and has depressed prices; this may indeed have reduced the stimulus to potential competitors to enter the market.

47. The main argument against change is the belief that lower shop prices would kill off the doorstep delivery, with unacceptable social and economic consequences. The reason for this belief is that only a minority of consumers would need to switch from delivered milk to shop bought milk in order for delivery rounds, with their high fixed costs, to become uneconomic. The evidence as to the viability of delivery rounds in these circumstances is not conclusive. The experience of Continental Europe, and of bread deliveries in the United Kingdom, suggests that they would largely if not entirely disappear, but they have survived in Scotland despite a measure of

competition from milk in the shops. Successive Governments have accepted the results of consumer choice in other fields, notably in the abolition of resale price maintenance and the consequential growth in supermarkets at the expense of small shops. But it is argued that milk distribution is different because the distribution system affects the volume of milk purchased as well as the place of purchase; and that because, unlike most foodstuffs, milk is both bulky and highly perishable, a reduction in doorstep delivery would almost certainly lead to a significant decline in the United Kingdom's consumption of liquid milk, to the detriment of United Kingdom agriculture.

48. Another potential cause of change is the import of liquid milk. There are at present no common EEC regulations governing the health and hygiene of the production, processing and packaging of milk so that Member States are free to maintain their own national measures. The United Kingdom regulations effectively prevent the import of pre-packed liquid milk into this country. The Commission has challenged our legislation on the grounds that it is an unfair restriction on intra-Community trade. It is likely that the issue will be referred to the European Court in the first half of 1980, but it is by no means certain that the United Kingdom will lose the case. If we were to lose it, we would probably be forced to permit imports of liquid milk by the end of 1980. If we won it, the eventual harmonisation of national health and hygiene regulations by the EEC would probably result in imports taking place early in 1982.

49. As already indicated in paragraph 45, the dairies' trading practices are being examined by the Office of Fair Trading. In addition the Ministry of Agriculture, Fisheries and Food has commissioned a study by accountants of distributors' margins. The result of both these investigations will be available in the New Year and will provide material for further consideration of the longer-term issues of milk distribution. But they do not require immediate decisions. The question now is whether the retail price of milk should be raised by $1\frac{1}{2}$p a pint, as proposed by the Minister of Agriculture, Fisheries and Food, Since the main purpose of this increase would be to help producers rather than distributors, the proceeds would be devoted largely to an increase in the wholesale price of liquid milk. It would thus have the effect of increasing the liquid premium.

50. Milk prices are normally reviewed each October and April. The previous Government postponed a decision in March 1979, and Ministers agreed to a $1\frac{1}{2}$p per pint increase in May. Almost the whole of this increase went to maintain distributors' margins. It was then hoped that the wholesale price could be increased in October sufficiently to give dairy farmers a reasonable return for the Autumn without a further retail price increase until the New Year.

51. In the event, the measured costs of the distributors increased more than had been expected and the wholesale price increase in October was only half of what had been expected in May. The Minister of Agriculture, Fisheries and Food accordingly proposed an increase of $1\frac{1}{2}$p per pint on the maximum retail price of milk from 18 November in England, Wales and Northern Ireland, and from 21 October in Scotland. The Cabinet decided on 4 October not to make any immediate increase in the retail price of milk.

52. The present position is that milk producers' net income in 1980 will be below the 1979 level in real terms unless two changes are made with effect from 1 January 1980 - a 5 per cent devaluation of the green £, and a $1\frac{1}{2}$p per pint increase on the maximum retail price of milk.

53. Within the Community we shall be pressing for a price freeze on milk amd milk products and hence for a decline in the real incomes of milk producers. The question arises whether it is sensible at the same time to maintain the real incomes of milk producers at home. The Agriculture Departments argue that it is, because our policy aim within the Community is to cut milk production by squeezing out the least efficient producers. This would not be achieved by applying the full rigours of the price freeze to the United Kingdom, since, until inflation is brought under control, a price freeze without other measures would have a disproportionate effect on United Kingdom milk producers who are more efficient than many others in the Community. Others argue that increasing the liquid premium runs the risk of stimulating investment in the dairy industry which will prove to be uneconomic when, as is bound to be the case sooner or later, liquid milk imports can no longer be prevented and a high liquid premium no longer sustained. Thus setting the premium at an excessive level represents an unnecessary burden on consumers and a wasteful use of resources. They also argue that increased milk production would lead to increased sales into intervention in the United Kingdom.

FARM CAPITAL GRANTS

54. In order to complete this year's public expenditure review Ministers have now to decide the level of expenditure on farm capital grants in 1981-82 and thereafter. A result of the lags between application and payment is that changes in expenditure in 1982-83 require rates of grant to be changed from 1 January 1980. The "base-line" for capital grants is £160 million in 1982-83. The Treasury propose that, as a contribution to the wider public expenditure savings exercise, this figure should be reduced by £60 million. Since some £50 million of the £160 million is already committed a cut of 55 per cent in the rates of grants would be needed. Alternatively the cut in rates might be somewhat reduced either by progressively delaying payments already contracted, or by taking some items out of grant altogether. In contrast to the Treasury proposal the MAFF propose that the grant should be increased by £30 million in 1982-83, allowing an increase in coverage and a somewhat higher average level of grant. This change would be accompanied by the streamlining of the grants system recommended by Sir Derek Rayner. The gap between the MAFF and the Treasury is, therefore, £90 million. This is equivalent to some 10 per cent of annual gross capital expenditure in agriculture.

55. MAFF say that past experience indicates that Government support is needed to stimulate investment since farmers, like other small businesses, are reluctant to incur long term debts. They suggest that the figures showing the relationship between past investment and increases in output (paragraph 58) demonstrate that such assistance is well worth while from the national point of view. They belivve that increased support is now necessary because investment in buildings and works is lower than it was in 1970, and is probably barely adequate to maintain the existing stock. Indeed a recent decline in applications for capital grants, reflecting waning agricultural confidence, suggests that there will be a sharp fall in investment if no further measures are taken. A further reason to increase the level of expenditure is to fulfil, at least in part, the Government's commitment to keep our agriculture abreast of its much more heavily subsidised and price-advantaged competitirs in other EEC member countries. MAFF calculate that if expenditure on agricultural investment here was subsidised down to the same level, the Exchequer cost would be double that of the current capital grants.

56. The Treasury view is that the MAFF proposals are inconsistent with the agreement already reached in Cabinet on the levels of public expenditure for 1980-81. Moreover they do not consider that they provide a basis for exempting agriculture from contributing to the overall reductions in expenditure to which the Government is committed in later years. The Cabinet has, for example, already agreed to reductions in the inherited industrial support programme rising by 1983 to more than £400 million (over 40 per cent) of which about half reflects the announced reduction in the coverage and rates of regional development grant.

57. The Treasury believe that, while in certain disadvantaged areas aids for agriculture can be justified in social terms, general aids should be considered on their economic merits. They do not believe that MAFF have demonstrated that investment in agriculture is more likely to promote output than would reductions in taxation. They argue that investment which needs the assistance of higher levels of grant is by definition marginal and that marginal investment could not be justified even if on average agricultural investment were more productive than investment elsewhere in the economy. Neither do they believe that expenditure can be justified by comparisons with the incentives available in other, mostly richer, EEC member states. Such aids are given for a variety of reasons, including social reasons, which are not applicable to the United Kingdom. In any case, as regards new investment, each member state's agricultural industry is competing for resources primarily against other sectors of its own economy rather than against agriculture in other member states.

58. One reason for the difference in approach between the Treasury and MAFF is a different view of the effect that changes in expenditure on investment grants might have. If we take the case of a £60 million cut, then MAFF believe that investment would fall by at least the full volume of the cut; the net stock of capital would therefore be lower by nearly £300 million after five years. This would probably result in a reduction of £100 million in gross product, a £150 million reduction in utput, and an increase in imports of food (net of savings on imported inputs) of about £140 million per annum. They

suggest that the effectiveness of investment grants in stimulating investment is demonstrated by the (time-lagged) changes in investment volume following recent changes in the rates of grant. Investment rose by 22 per cent between 1969 and 1973, following a 15-point increase in grant rates in 1970; fell by 36 per cent to 1976 after a reduction in rates in 1972-73; and recovered by 33 per cent in 1979 following increases in rates in 1976.

59. The Treasury on the other hand believe that fluctuations in investment have been due to changes in farmers' profits and prospects, and to short run changes in investment plans due to anticipation of changes in rates, and that the long run association between grant rates and investment is weak. They also doubt the simple causal relationship which is assumed between the level of capital stock and the level of output. Finally, they point out that, although food imports might be reduced if expenditure on farm capital grants led to extra agricultural production much of the expenditure would in fact lead to additional purchasing power by farmers and contractors, some of which would stimulate other imports. In these cases the grant represents a bonus which is available to the farmer for other spending. MAFF's answer to these points is that, whatever the possibilities for individual farmers, they expect the overall effect on expenditure on investment to be at least equal to the change in expenditure on grant.

60. Changes in expenditure in 1982-83 would be achieved by changes in the rate of grant. Because commitments to pay grant undertaken in any one year influence the pattern of expenditure on farm capital grants for several years ahead, it would be necessary to reduce grant rates from 1 January 1980 in order to achieve a lower target level of expenditure in 1982-83. We give below some examples of possible reductions.

TABLE 4

	1980-81	1981-82	1982-83	1983-84
Saving of £60m in 1982-83				
Reduction in rate of grant needed to achieve saving = 55 per cent				
Savings £m	25	47	60	72
50% Reduction in Grant Rates				
Savings £m	21	42	55	65
40% Reduction in Grant Rates				
Savings £m	~~12~~ 18	34	44	52
30% Reduction in Grant Rates				
Savings £m	13	25	33	39

POINTS FOR DECISION

61. Ministers are invited to take decisions on three issues - the green £, retail milk prices, and farm capital grants. The effect of the various proposals on farm net income and on the retail price index is set out below -

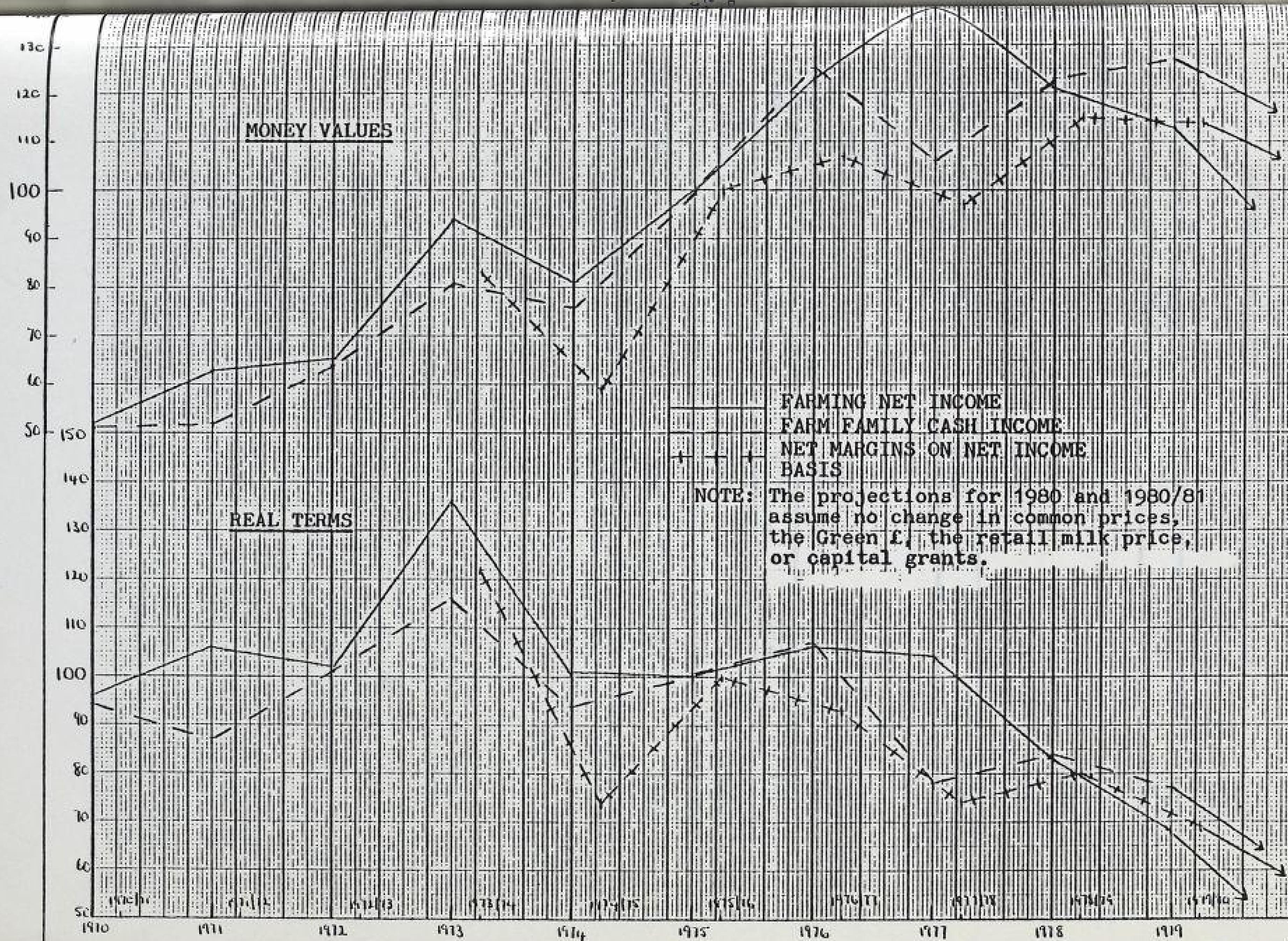
	£ million outturn prices	Index of Net Farm Income 1975 = 100	RPI Effect
Income 1979	1,047	68	
Income 1980 with no changes	835	47	
Green £ - 5% devaluation	120		+ 0.25%
	955	54	
$1\frac{1}{2}$p on milk price	195		+ 0.2%
	1,150	65	

The figure of 0.25 per cent represents the full-year RPI effect of a 5 per c[ent] green pound devaluation and corresponds to the additional consume[r] expenditure of £253 million and the producers' returns of £177 million [in] Table 3 on page 14.

62 Changes in capital grants will obviously affect the industry but do not count as changes in net income and have no direct effect on the r.p.i.

Cabinet Office

30 November 1979



GRAPH A

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TABLE A

AGGREGATE BALANCE SHEET OF UK AGRICULTURE

£million

	1970	1974	1978	1979
Assets				
Land and buildings	5800	14530	28842	40282
Other	3165	6050	11000	12125
Total	8965	20580	39842	52407
Liabilities				
Bank advances	500	910	1530	2030
Other	821	961	1382	1687
Total	1321	1871	2912	3717
Net worth	7644	18709	36930	48690
Net worth £ per ha	400	984	1958	2582

TABLE B

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GROSS FIXED CAPITAL FORMATION AT CONSTANT 1975 PRICES

£million

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979 forecast
Plant, machinery and vehicles	269	275	377	322	363	351	368	351	361	358
Buildings and Works	298	306	308	323	286	240	209	213	256	280
Total	567	581	585	645	649	591	577	564	617	638

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TABLE C

Indicators of Support to EEC Agriculture through Prices and National Subsidies

	UK	W Germany	France	Denmark	Ireland	Netherlands
[a]rage level of support prices EEC in 1979 relative to (UK=100)	100	128	108	115	114	118
[i]ional exchequer subsidies [r]essed in relation (%) to volume of gross value [a]ed.*	13½	21	18	5½	14	15

These percentages relate the value of the subsidies paid out in each member [sta]te on agricultural support (excluding social security, forestry development etc) [a]n estimate of the volume of gross product. The latter provides a broad indicator [of] the relative size in volume terms of each agricultural sector relative to [the] UK.

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