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CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

EUROPEAN BUDGET RESTRUCTURING

APPROACH TO THE AGRICULTURE PRICE FIXING 1981

Memorandum by the Minister of Agriculture, Fisheries and Food

1. The attached note by officials discusses the tactics for our approach to the 1981 price fixing and the link with our wider objectives for CAP reform.

2. When we discussed our broad approach to budget restructuring, it was accepted that we should retain price restraint as a weapon. In deciding how we handle the approach to the 1981 price fixing discussions, however, we have to have regard to the following:-

a) the influence of the French Presidential Election;

b) the likely attitude of other Member States;

c) the Commission's objectives;

d) the interests of our own agricultural industry.

Influence of French Election

3. The French Presidential Election on 26 April means that, at most, there will be time for four Agriculture Councils between the end of January and the Election date. The French have made it clear that they will be looking for an increase of some 10 per cent on agricultural prices. Moreover, it will clearly be very difficult for the French Government to accept anything in the way of substantive reforms to the CAP which weaken the system before their Election. The most they are likely to be ready to contemplate are co-responsibility levies which they will want applied so as to benefit smaller producers.

Attitude of other Member States

4. When the recent meeting of Agriculture Ministers took place in Luxembourg I had bilateral discussions with each of the Ministers to ascertain what their attitude would be to the coming price fixing. The position that emerged is as follows:-

France - in excess of 10%;

Germany - whilst concerned about the budget, considered it was necessary to support the French Government in their objectives prior to the French Elections but would like to obtain some compensating levies;

Italy - 10% to 12%;

Holland - 7% to 8%;

Belgium - 10% to 12%;

Luxembourg - 10%,

Denmark - 13%,

Ireland - 12%,

All Ministers stated that inflation, combining with the price restraints of the last few years, had resulted in falls in farm incomes which could not be allowed to continue. In the case of Denmark, Ireland and Italy we know that there is very considerable political unrest from their farming sectors.

Commission objectives

5. References by Mr Gundelach to a settlement in "double figures" do not suggest that, if he remains Agriculture Commissioner, he will stand out against the French. The Commission's price proposals will not be finalised until January when the new Commission has taken over. They will then have to decide their proposals on prices and on other measures for changes in the CAP. They are committed to producing a proposal for a supplementary levy on milk. But there is no certainty that they will put forward any other major proposals.

UK producers

6. Although our own Annual Review arithmetic has still to be finalised, it seems clear that the aggregate "net income" of our industry will decline in real terms by some 15 per cent this year. This means that over a four year period, there will have been a fall of nearly a half. My officials are discussing with Treasury officials the basis of the "net income" calculation but we cannot avoid the fact that the industry as a whole (and the livestock sector in particular) will have suffered severe erosion of their profitability. With the prospect of our inflation rate remaining relatively high through 1981, we cannot ignore the pressures on our own industry in deciding our approach to the 1981 price fixing exercise. The problems would be compounded if we had to accept a revaluation in the green pound and hence a reduction in our positive MCAs.

Our approach

7. Against this background, we have to decide what line we should take in bilateral discussions with Member States and the Commission over the coming months in the lead up to the 1981 price fixing. I assume that our approach should be to be seen to be working towards an acceptable price settlement before the French Election and not

to try to block it. If it were to prove impossible to settle agriculture prices before the Election, it could not be in our political interests to be seen to be the sole cause of preventing a deal and so embarrassing the French President.

8. On prices, I conclude that our approach should be to argue for "severe price restraint" and to reinforce this by avoiding making any commitment on the revaluation of the green pound. To take up a more extreme position on prices would, I believe, be likely to weaken rather than increase our influence on the final outcome. At the same time, this formula would not commit us now on the price settlement that we should be ready to settle for.

9. In addition, we should emphasise to the Commission and other Member States that we shall be looking for the first steps to be taken in sensible reforms to the CAP in the context of the price settlement. The problem here is to decide how far we can expect realistically to get in advance of the French Election. But at least we must press the Commission to come forward with an effective supplementary levy proposal on milk; and we should press the Commission also to come forward with proposals for the other problem sectors which Ministers can begin to discuss even if substantive decisions are deferred until later in the year.

10. Finally, there is the question of a budget ceiling on FEOGA expenditure. I do not believe that it is realistic to expect to hold agricultural expenditure in 1981 at the figure in the draft 1981 budget. The 1 per cent VAT limit will itself begin to bite in 1981 and beyond. A separate FEOGA ceiling would be valuable if it provided for FEOGA's share of the total budget to be progressively reduced. I believe that this is the approach we should discuss with the Germans. In doing so, however, we must leave them in no doubt that we should not be ready to accept increased co-responsibility levies as a way around the limit.

Recommendations

11. I therefore recommend my colleagues to agree that we should be guided in our bilateral contacts with other Member States and the Commission by the approach outlined in this paper. In particular, I recommend that:-

a) on prices we should argue for a policy of "severe price restraint", thus acknowledging that some increases will be necessary but arguing that these should be contained below the rate of inflation;

b) on CAP reform, to press for the Commission to come forward with proposals in the context of the prices package so that the first steps towards reform can be considered at that time;

c) on a budgetary ceiling for FEOGA expenditure, we should explore with the Germans in the first instance what sort of ceiling might be imposed as an instrument for budget restructuring.

P W

Ministry of Agriculture, Fisheries and Food
29 October 1980

ANNEX

EUROPEAN BUDGET RESTRUCTURING

APPROACH TO THE AGRICULTURE PRICE FIXING 1981

Note by the Ministry of Agriculture, Fisheries and Food

Introduction

1. This paper is concerned with the tactics to be followed over the coming months during the lead up to the CAP price fixing discussions next spring. It considers how the settlement of agriculture prices next year can be used to further our broader objectives on CAP reform.

Timetable considerations

2. Under the budget settlement of last May, the Commission are required to produce proposals on budget restructuring by June 1981. Their price proposals for 1981 are expected to be presented to the Council in January. The first ballot for the French Presidential Election is due to take place on 26 April. If agreement on agricultural prices is to be reached before the French Election, there will, therefore, be less than 3 months for negotiations. During this period the Dutch Presidency has provided for four Agriculture Councils - 9/10 February, 2/3 March, 24/26 March and 13/15 April.

3. It is not yet clear how the Commission intend to fulfil their commitment to produce proposals by June of next year or how the package of proposals on agricultural prices will relate to the wider exercise. Ministers have agreed that we must retain price restraint as a weapon. It is unlikely that we shall be able to make progress on objectives outside the agriculture sector before the French Election is out of the way. Moreover it would be damaging to our relations with France and the Community generally if we were seen to be delaying a price settlement for reasons unconnected with the agricultural negotiations. These considerations suggest that our aim should be to ensure that the Commission come forward with substantive proposals for making progress on CAP reform in the context of the price negotiations, and that other Member States understand the importance that we shall attach to making progress in the price fixing with tackling the surplus problems and the cost of the CAP.

Objectives of other Member States

4. The preliminary discussion in the informal Agriculture Council on 13/14 October demonstrated that other Member States will be looking for a significant increase in agriculture prices in 1981. The following paragraphs summarise the approach which the others seem likely to adopt to prices and to CAP reform in the price negotiations.

5. The French will be concerned to secure a price settlement which will reinforce their President's chances of re-election. They have let it be known that they are looking for an overall price settlement of about 10 per cent. They are likely to want larger increases on their livestock products (including milk) than on cereals. As to reform, they must be expected in advance of their Election to resist any changes which would be seen as a weakening the CAP. Indeed, their declared policy is to expand their own agricultural production. They are concerned to strengthen Community preference and develop export markets in third countries on the basis of Community funding. The French are worried, however, about the prospect of a budgetary crisis when own resources are exhausted. They will therefore be looking for economies in FEOGA expenditure (where their interests are not affected). They will also favour increased use of co-responsibility levies differentiated to favour the medium and small producers.

6. The new German Government's policy towards the 1981 price fixing will be of critical importance and this will be substantially influenced by whether Herr Ertl continues as Agriculture Minister. They are less concerned about surpluses and price restraint than with the budgetary cost of the system. Indeed, a relatively high price settlement would give them the headroom to accept some revaluation of the green mark (for which the Commission, the French and the Danes will press) and increased co-responsibility levies. This would tie in with the German concern to find ways of reducing the budgetary cost of FEOGA. We cannot rely on them to support the sort of CAP reform which we should want to see. Nor are they likely to take a line which would bring them into direct conflict with the French before their Election.

7. The Danes, the Dutch and the Irish will be mainly concerned to avoid any commitments which would weaken the CAP and threaten the resource benefits they derive from it. The Irish and the Danes will go along with the French demands on the level of price increases and, although the Dutch may be content with a rather lower average increase, they are unlikely to be too worried if the French get their way. All three will support increased co-responsibility levies as a means of deferring the budgetary crisis. But while the Dutch and Irish seem likely to accept increases in general co-responsibility levies, the Danes will want the supplementary levy on milk charged on those responsible for the continuing expansion while the Irish (and possibly the Dutch) will strongly resist the supplementary levy.

8. The Belgians and Luxembourgers tend to favour relatively high price increases and they will tend to line up with the French in favouring differentiated co-responsibility levies.

9. Finally, the Italians and Greeks will be mainly concerned to secure relatively high price increases on the Mediterranean products and to resist proposals for changes in the regimes for these commodities which would weaken the level of support to their producers.

Commission proposals

10. Although the price proposals package will have to be decided by the new Commission, Gundelach has been saying that he expects a "double figure" price increase. The Commission will clearly be under pressure to reflect in their price proposals both the political needs particularly of the French Government, and the income requirements of producers. On the basis of their present thinking it seems likely that they may propose an increase (perhaps of 7 or 8 per cent) in common prices to be off-set in part by revaluations of green rates.

11. The Commission is understood to be reviewing the individual commodity regimes in order to identify the scope for possible budgetary savings and to develop proposals for limiting or removing the open-ended character of the guarantees to producers.

UK agriculture

12. Our own approach to the 1981 price fixing will need to be finally decided in the light of the outcome of the Annual Review which will be taking place between now and the end of December. Figures are still being calculated but the indications are that the aggregate income of the UK industry will decline in real terms by some 15 per cent in 1980.

Thus, over the last 4 years, aggregate net income has declined by nearly a half. The industry has met this pressure on its liquidity by cutting back on investment in fixed assets and by increasing substantially its bank borrowing. In the first half of this year, the volume of investment in plant, machinery and vehicles was down by a quarter. Bank borrowing increased by some 30 per cent in 1979 and information for 1980 shows a similar increase. The severest erosion of income has taken place in the milk and beef sectors and in pigs, eggs and poultry, while the arable sector has been least affected.

13. The UK industry has had to contend with a higher rate of inflation and higher interest rates than producers in other parts of the Community. Compared with an average inflation rate of some 11 to 12 per cent for the Community as a whole, inflation in the UK is expected to be some 18 per cent over the current year, second only to Italy with 20 per cent. Looking ahead to 1981, it is expected that the UK rate will be some 14 per cent compared with an average of 10 per cent for the Community as a whole. UK farmers are also paying substantially more for their overdraft facilities than producers in any other Member State except Italy. However inflation and interest rates develop over the next year, it seems likely that UK producers will be relatively badly placed compared with producers in other Member States.

14. Against this background, the UK agriculture industry will be looking for some increase in support prices in 1981, net of any green rate revaluation. Unless by the time of the price fixing the market rate for sterling has weakened to bring it close to the green rate, the Commission are very likely to propose a revaluation of the green pound. However, no Member State has been expected to revalue a green rate without an adjustment in common prices which enables the level of support in national currency to be increased.

We shall have to

consider at the time of the price fixing whether some adjustment in our green rate can be made. This will need to depend on the outcome of the negotiations on common prices and on the market rate for sterling at that time. However, an increase in the level of price support for our own industry is necessary. Our tactic over the coming months should therefore be to avoid any commitment to a revaluation in the green pound so as to maintain pressure for restraint on common price increases.

Negotiating line on prices

15. At the 1979 price fixing, the UK pressed for a reduction in the effective level of support for CAP commodities, particularly those in surplus. The outcome was an average increase of 1.3 per cent, with a freeze on the milk price. This year, we argued for a price freeze for commodities in surplus. The final settlement - arrived at in the context of the May budget deal - was an increase of 4.8 per cent, with an increase (net of increased co-responsibility levy) of 2.5 per cent on milk. Over the last two years, however, there had been scope for devaluations of the green pound. This enabled us to compensate partially our own industry for the adverse effect on their incomes of the high level of cost increases in the UK due to our relatively high inflation rate.

16. The outcome of next year's price fixing discussions is likely to depend heavily on the line taken by the new German Government. There is increasing concern about the heavy net budgetary cost falling on the German Exchequer. Much of the pressure for change is directed more towards reducing this cost (paricularly through co-responsibility levies on producers) than at more fundamental changes. The Germans have always resisted dismantling their MCA's except where common prices were sufficient to enable them to increase the level of support to their own farmers. The Germans may also be inhibited from pursuing a line on prices which would make difficulties for the French in advance of their Election. Whatever

line the Germans eventually do decide to take on prices, the attitude of other Member States suggests that they will all be pressing for increases above last year's figure and close to what the French are understood to want.

17. Against this background, if we take up an extreme position and argue for a freeze on common prices, we are likely to find ourselves quickly isolated in an 8 to 1 situation. Ministers have agreed that it is important to avoid this. It would, moreover, be impossible to justify to our own industry a policy which would leave them with no price increase to mitigate the erosion of their real incomes by our high rate of inflation.

18. We should be likely to gain more credibility, and hence leverage, with other Member States if we avoid a position which is recognised as tactical; and argue instead for a policy of "severe price restraint". In doing so, we should acknowledge that some modest increases in support prices would be necessary. However, we should press for the settlement to continue the reduction in the real level of support. We should argue strongly this year for a minimal increase in cereal prices because of their important influence on the resource costs of the CAP and because this would have a beneficial effect on input costs in the livestock sectors, thus making restraint on prices more acceptable. However, we have to recognise that the Germans have always resisted restraint on cereal prices because these determine the income level of their livestock producers.

19. In the final stage of the price negotiations, we may be faced with a choice between settling on a price increase which the French and others demand, or holding up a settlement until after the French Election. If, as in previous years, we were to find ourselves isolated, Ministers would be presented with a difficult political judgement affecting our relations with the French and the Community as a whole. Moreover, if we were responsible for blocking a price settlement before the French Election, this issue would almost inevitably become directly involved with the budget restructuring issue. It is not evident that this would necessarily improve the prospects of satisfactory outcome to the budget negotiations. We should therefore work over the coming months for a prices deal by April which we could accept. This means that we should use the leverage to be derived from "severe price restraint" to secure a package of decisions at the time of the price fixing which can be presented as the first steps towards our wider objectives on CAP reform.

Steps towards CAP reform

20. In deciding what we can realistically aim to achieve in terms of CAP reform at the 1981 price fixing, we are again faced with the timing of the French Election. The French will be resistant to any development of the CAP which could be presented to their farmers as a weakening in the system. Our aim, however, must be to get the Commission to come forward with a credible package of reform measures designed to begin tackling the over production and related surplus problems. We should, therefore, over the coming weeks, impress on the Commission the need for substantive progress on CAP reform in the context of the prices package and seek to ensure that they come forward with the following:-

a) an effective and acceptable supplementary levy scheme for milk; and a medium term plan designed to reduce the milk surplus over the next few years;

b) a standard quantity scheme for cereals based on varying the intervention mechanism to reflect the level of production;

c) proposals to reduce the level and cost of beef intervention;

d) proposals to modify the Mediterranean regimes to reduce surpluses and costs;

In addition, the Commission have already made proposals on sugar. But these are unsatisfactory from our point of view. Given the high level of world sugar prices from which the Community are benefiting in budgetary terms, there seems little prospect of early agreement on a new regime.

21. We shall not be able to reach agreement in detail on each of the sectors in the timescale of the price discussions next spring. We should, however, aim to secure agreement on arrangements to tackle the milk surplus; and we should want firm commitments by the Council on the need for decisions in the other sectors within the timescale of the Budget restructuring exercise.

Economies measures

22. The Commission's price proposals will almost certainly be linked with measures designed to reduce FEOGA expenditure. They may include some which would further reduce our receipts from FEOGA, including reduction or abolition of the UK butter subsidy and reduction in the suckler cow subsidy. We can expect pressure from other Member States to reduce the cost of these schemes to help reduce the cost of the CAP. It is important that we should defend all the arrangements from which we derive a net FEOGA benefit at present, including the butter subsidy and our benefits from the sheep regime. The removal of the butter subsidy would alone add 0.4 per cent to the FPI and 0.1 per cent to the RPI.

1981 Budget

23. An important influence on the discussions at the 1981 price fixing will be the outcome of the present negotiations on the 1981 budget. The Commission's draft budget left headroom of only some 550 MEUAs between the estimated expenditure and the own resources ceiling. This took credit for receipts of 175 MEUA from a supplementary levy on

milk. By pressing for reductions in non-agricultural expenditure, the French and Germans have succeeded in the Budget Council in amending the budget to increase the headroom to some 1.35 MEUAs. It seems likely that the Parliament will seek to restore the cuts in non-obligatory expenditure which the Budget Council have made. If they are successful, the Agriculture Council would be faced with having to contain the cost of the prices settlement in 1981 to some 550 MEUAs unless it could agree savings elsewhere in the budget provision for Agriculture.

A Budget ceiling on FEOGA cost

24. Ministers have agreed that we should seek the support of the Germans to keep the FEOGA expenditure in 1981 down to the limits agreed in the 1981 draft budget. The figure for guarantee expenditure in the Commission draft budget makes no allowance, however, for any increase in costs arising from the 1981 price fixing. If we argue for a ceiling at this figure, it implies that we are contemplating an overall price settlement which would be neutral in budgetary terms. Thus, price increases would have to be financed by compensating savings, increased co-responsibility levies or some form of national financing.

25. The Germans have themsleves given serious thought to some form of budget ceiling on FEOGA expenditure. In June their Cabinet concluded that they should seek to contain increases in FEOGA to less than the percentage increase in our resources. If this were applied in 1981, it would appear to allow virtually no increase in the FEOGA provision in the Commission's draft budget. But, while showing interest in a ceiling on FEOGA, the Germans are also concerned about the implications of an enforced system of national financing under which they could find themselves on the receiving end of surpluses resulting from action in other Member States to shift the cost away from their national exchequers.

26. It would not seem realistic to expect agreement on a ceiling which would hold agricultural expenditure in 1981 at the figure in the draft budget. The 1 per cent VAT limit will itself in 1981 and beyond begin to bite. A separate ceiling for FEOGA from that imposed by their own resources limit would be valuable only if it is possible to negotiate an arrangement for reducing progressively the proportion of the total Budget allocated to agriculture.

27. We should explore with the Germans possible methods of introducing a ceiling on FEOGA expenditure. At the same time it would be important to make it clear to them that we would not find it acceptable to finance expenditure in excess of the ceiling by increases in co-responsibility levies.

Conclusions

28. This paper points to the following conclusions about the tactics we should follow over the coming months on the 1981 price fixing:-

a) We should show our readiness to work for an agreement before the French Election in which we use the weapon of price restraint to secure a package of decisions which will mark the first steps towards tackling the surpluses and costs of the CAP;

b) our final objective on prices will need to be decided in the light of the outcome of our own Annual Review. But the industry will be looking for some increases in prices to offset the further substantial erosion in the real incomes of the industry;

c) although the German Government's position is unclear, all other Member States are indicating that they will be looking for a substantial average increase and most seem unlikely to object to the French figure of about 10 per cent;

d) against this background we would be likely to find ourselves quickly isolated if we press for a freeze. Instead, our leverage and credibility may be maximised by pressing for "severe price restraint", thus acknowledging that some small increases in support prices will be necessary, though well below the rate of inflation;

e) we should press the Commission to come forward with substantive proposals for reform along the lines outlined in paragraphs 20 and 21 emphasising in particular our concern to see detailed decisions on milk and beef in the price fixing discussions;

f) a ceiling on the budgetary cost of FEOGA in 1981 at the level of the provision in the draft budget is almost certainly unnegotiable because it would imply a price settlement which was neutral in budgetary terms. The 1 per cent VAT limit ceiling will, in any case, begin to bite in 1981. We should exploit the Germans' concern about the budgetary position and discuss with them possible formulae for imposing a ceiling which would progressively reduce the proportion of the total budget devoted to FEOGA.

29 October 1980