CONFIDENTIAL

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PRIME MINISTER

Liquid Milk Prices

(C(79) 41)

BACKGROUND

This paper is about the Minister of Agriculture's proposal to increase the retail price of milk by 1½p from 18th November in England, Wales and Northern Ireland and from 21st October in Scotland. Sir Keith Joseph minuted you on 1st October following an inconclusive discussion in E(EA). You discussed the state of British agriculture generally with Mr. Walker on Monday and expressed serious doubts about these particular proposals.

2. About 50 per cent of United Kingdom milk production is sold to consumer in liquid form; the remainder is made into cheese, butter, etc. Liquid milk is the more profitable. All milk produced by farmers is bought by the Milk Marketing Board and that part which goes to the consumer is sold through milk distributors. There is no import or export of liquid milk at present. The variable elements within the Government's control are the distributors margin and the retail price. These two between them determine the profit which the farmer gets for his liquid milk. The rest of his return depends on the price he gets for milk sold for dairy products, and this is governed in turn by CAP arrangements. Unless he is solely a dairy farmer his income will also vary with the return on his other activities. Since last March farmers have benefited from three devaluations of the Green Pound, amounting in all to 11 per cent. There is a case for reconsidering the whole system of regulated milk prices; Mr. Nott argued it strongly in July. But this would take time. Meanwhile, prices for this winter have to be settled now, within the existing framework.

3. The Government decided in May upon an increase in the retail price of milk of 1½p. The previous Government's deliberate postponement of a price decision meant that virtually the whole of this 1½p had to go to the distributors

to meet sharp increases in their costs and make good the two months' delay. You were reluctant to concede an increase of more than 1p at that time but agreed on an assurance from Mr. Walker that "it is to our benefit to do the $1\frac{1}{2}$p now, rather than be faced with the almost certainty of 1p now for which our predecessors will be blamed and at least 1p in October for which we will be held clearly responsible, with the October increase coming at a very sensitive time as far as the wage round is concerned". In the event distribution costs since May have increased more than expected. The second $1\frac{1}{2}$p increase now would mean a total increase of 22 per cent since May. It is argued that failure to give milk producers a sufficient profit margin will lead to reduced dairy herds and to a substantial increase in milk imports.

4. The Government is committed by the Manifesto to some improvement in farm incomes, but there is nothing specific about dairy farming. The exact quotation is "Labour have seriously undermined the profitability of these industries without protecting consumers against rising food prices which have more than doubled during their term of office. We must ensure that these industries have the means to keep abreast of those in other countries". The Minister of Agriculture is currently preparing a paper on the state of British agriculture which (if you agree) will probably come to Cabinet on 18th October, along with the reports on the public expenditure bilaterals.

5. There is a wider EEC dimension. The surplus of milk products is the most serious problem of the CAP, accounting for 37 per cent of CAP expenditure, and the Government has argued continually that the Community intervention prices are too high. But it is questionable whether this argument, which is also dependent on the strength of the pound, could be effectively maintained if our own producers' milk prices are increased. The return to milk producers in the United Kingdom was the lowest in the EEC in 1978 but this position is very sensitive to exchange rates. In short our milk producers get the lowest return because we choose not to devalue the Green Pound.

HANDLING

6. The memorandum is in the name of the Minister of Agriculture but the figures, over which there had been some disagreement, have now been agreed by the Treasury and the Department of Trade. You might ask the Minister of

Agriculture to introduce it. The Secretaries of State for Scotland and Wales support the proposed price increase and you might ask if they have anything to add. The Secretary of State for Northern Ireland might be asked to comment; he broadly supports the proposal that producers incomes should be increased but suggests an alternative approach; a 1p increase in milk prices plus a devaluation of about $7\frac{1}{2}$ per cent of the Green Pound, (which would have to apply to all products not just milk). He will also argue the continuation of the present milk aid scheme in Northern Ireland to offset the disadvantage Northern Ireland farms have vis-a-vis their Great Britain counterparts. If he presses the milk aid scheme, you might ask him to pursue it separately with the Chief Secretary; Cabinet need not spend time on it.

7. Thereafter you might invite the Secretary of State for Trade to speak. He is opposed to the increase on the grounds of the expected effect on the food and retail price indices and of possible adverse effects on the forthcoming wage rounds. He may additionally make the important political point that a second increase this year of the magnitude proposed may undermine the credibility of the Government. The Chief Secretary might also be invited to join in; he is likely to support Mr. Nott and will probably make the additional point that since Mr. Walker's main concern is with farm incomes, it would seem right to look at the retail milk price alongside other forms of support for farmers, notably the review of capital grants. On this, which is one of the Chief Secretary's bids for public expenditure reductions, you might like to know that there has been a complete deadlock in the bilateral discussions with the Minister of Agriculture. This explains Mr. Walker's intention (noted above) to circulate a Cabinet paper about agriculture. On the question of the EEC you might ask the Minister of Agriculture how a price rise can be justified when milk is in surplus, a substantial part of United Kingdom production is going into intervention, and the effect will be to reduce consumption.

8. The choices before Cabinet are:-

(a) To recommend increases of nil, $\frac{1}{2}$p, 1p, or $1\frac{1}{2}$p in the retail price of milk.

(b) To postpone a decision until milk prices can be considered alongside other forms of support for farmers in the paper being prepared by MAFF.

The subsidiary questions of the distributors margin and of the premium for sterilised milk are secondary and have to be fitted in to whatever is settled for the main increase. Clearly Mr. Walker will be reluctant to accept a nil increase but there are strong reasons for holding prices for the time being. The timing of the proposed increase would allow further consideration of milk prices alongside other forms of farm support at a subsequent Cabinet before reaching a final decision.

9. I suggest you deter the Cabinet from wandering into other attractive by-ways: they include:

(a) Future distributive arrangements for milk. There is an independent review going on at present and it would be a mistake to anticipate this.

(b) School milk, etc. Any increase in the retail price throws an additional cost on the Education budget, but this is not a major factor in determining the increase.

(c) Liberalisation. It sounds attractive and, under EEC rules, it may soon be necessary to open the market to imports of milk from Europe. But it would upset the doorstep delivery system and might put some British producers out of business. If the point is pressed you could ask officials of the Departments concerned to produce a report on the implications of abandoning price control for milk for consideration in E(EA).

CONCLUSIONS

10. In view of the political sensitivity of an increase in milk prices of the magnitude proposed and the milk surplus in the EEC there is a good case for holding milk prices at their current level for the time being (and you have favoured this course in private discussion). But the pressures from the agricultural lobby will be strong and you will need to be guided by the way discussion goes. The alternative conclusions available are:-

EITHER

(i) to agree now that there should be no further increase in milk prices this year;

<u>OR</u>

(ii) to agree <u>now</u> to a small price increase ($\frac{1}{2}$p, 1p?);

<u>OR</u>

(iii) to postpone a decision at least until the issue can be considered in the context of farm support generally. The position paper to be submitted by Mr. Walker to Cabinet shortly on the state of British agriculture, which would include figures on farm incomes, would provide the basis for a discussion - on 18th October - in which milk prices would be seen in context of other forms of farm support. This would still allow an announcement to be made in November (October for Scotland) if an increase was agreed.

11. In any event the issues of Northern Ireland milk support, the distribution margin and sterilised milk should be remitted for separate consideration in the light of Cabinet decisions on the main issue.

John

(John Hunt)

<u>3rd October, 1979</u>