E.R.

PRIME MINISTER

FUTURE OF THE COMMON AGRICULTURAL POLICY

Although the meeting of Ministers to discuss this is not until next Wednesday, you may want to glance at the papers this weekend.

You saw an earlier note by the Policy Unit and commented favourably on it (A).

The MAFF have now produced a paper. It stresses price restraint as the main instrument for controlling surpluses: that must be right, though it has proved extraordinarily difficult to put into practice. But it ignores or dismisses alternatives to this such as income aids. And does not deal at all with 'nationalisation' of farming aid.

You will probably want at the meeting to press for a bolder and more radical study, with which the Policy Unit should be directly involved.

C.D.P.

Charles Powell

21 June 1985

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

From the Minister

CC N/S

CDP 26/6.

CONFIDENTIAL

PRIME MINISTER

FUTURE OF THE CAP

1. I welcome the meeting you have called for 26 June and I thought it might be helpful to have the attached background paper on the issues the Commission are considering in their current review of the CAP with particular reference to the points mentioned in your Private Secretary's letter of 5 June.

2. Over the past decade the Commission has undertaken many "reviews" of the CAP - the precise description has varied but they have all been essentially the same exercises. The factors responsible for this constant heart-searching have been apparent for some time. They are:-

(a) continuous improvements in agricultural productivity which coupled with over-generous price settlements have resulted in EC production of many commodities increasing faster than consumption. The EC system is such that for many commodities the extra budgetary cost of any marginal increase in production increases dramatically as the Community achieves self-sufficiency because of the need to subsidise (eg by export refunds) the disposal of the extra production. As production has increased therefore the costs of the market regimes have increased even more;

(b) farm income, though it varies from year to year for climatic and other reasons, is declining in real terms in most member states. In the UK total real farm income was lower in 1984 (a good year) than it was in the mid-1970s though since the number of holdings has also declined income per holding has been more stable. However, the reduction in the number of holdings, which has occurred in all member states, is itself regarded as a problem by some. The maintenance of the standard of living of the agricultural community is explicitly mentioned in Article 39 of the Treaty of Rome. This is frequently mentioned by members of the Agriculture Council and the reference is clearly regarded by them as the most important objective of the Community's agricultural policy.

The basic difficulty is that measures to deal with one of these problems make, or seem likely to make, the other worse. Ministers are, therefore, forced to decide which problem is most important to them.

/3. These

3. These problems are, of course, not unique to the EC. The United States, for example, currently has a "farm crisis" which stems in essence from the same two factors; but the difficulties in the EC are in some respects particularly acute.

4. The surplus problem (paragraph 2(a) above) shows no sign of diminishing. Indeed the prospects are that the rate of technological change may if anything increase, so that on constant policies output and hence the cost of the CAP will increase even further. And recent US actions indicate that the cost of disposing of a given surplus on third country markets could increase. Reputable recent studies suggest that by the end of the decade some 15% of UK farmland may be surplus to requirements and could be allowed to go out of production. The effects of such a development on the agricultural economy as a whole would be so profound that it would constitute a major political problem.

5. However, I have no doubt, as is explained in the paper, that much the best response to the surplus problem is to seek to move towards a more market orientated policy and in particular to act on the price level. However, though the inevitable adverse long-term effect of over-generous increases in EC common prices has long been apparent, it has proved difficult to get the Council of Agricultural Ministers to take account of this in its decisions. Short-term political needs have been given greater weight.

6. Against this background we have sought ways of forcing the Council to take a more realistic view. We have had considerable success in achieving the agreements on the financial guideline for agriculture and on guarantee thresholds. These are, in essence, devices to force the Council to take account of financial and market realities by reducing expenditure and lowering prices. However, the experience of this year's price fixing is that, whatever the rules say, it is very difficult to get Ministers to agree to price cuts if it causes them political problems. Nevertheless these two measures have undoubtedly strengthened our hand in negotiations. A few years ago any price cuts would have been virtually unthinkable, while this year and last significant cuts in common prices for some products have been agreed. Price cuts in real terms have of course been much greater.

7. Other prescriptions for reforming the CAP involve either imposing measures such as quotas or co-responsibility levies which are intended as alternatives to a restrictive price policy, or income aids, which are regarded as a complement to price policy. As the attached paper shows there are distinct disadvantages to all of them.

8. I propose therefore that we should continue to make a restrictive price policy our first objective in the CAP. We should continue to give strong support to the financial guideline and the concept of guarantee thresholds. We may be obliged to consider other ideas such as coresponsibility levies, quotas or income aids. It would

/not be sensible

not be sensible to decide categorically now that in no circumstances could we accept any proposal of these types. But it is clear that such policies would not be our first preference; and that if we were seriously to consider them there would need to be definite other advantages for us in an overall package.

9. I am copying this to Geoffrey Howe, Nigel Lawson and Sir Robert Armstrong.

M J

20 June 1985

CONFIDENTIAL

PERSPECTIVES FOR THE CAP

Introduction

1. In putting forward their proposals for this year's CAP price fixing the Commission announced their intention to carry out a further review of the operation of the CAP under the title "Perspectives for the CAP". The Commission have been undertaking the review under six headings:-

(1) agriculture in society;
(2) new uses for agricultural products;
(3) alternative production;
(4) agriculture and the environment;
(5) external trade;
(6) cereals.

2. Clearly, not all these are equally important. Some are no doubt included to meet the political need to be seen to explore possible areas where an expansion of agricultural output might be possible. For example, all the evidence is that in the short term there is very little scope for finding economic new uses for agriculture products (cf the mandate for Working Group 2). Heading (1) is the most important since it has been defined to include the possibilities of income aids to supplement a restrictive price policy.

Recent Developments

3. Andriessen reported on the progress made so far at the Informal Agriculture Council in Sienna on 27/29 May. He referred to all the areas of work the Commission have been investigating, but on the vital issues he stressed that there was an urgent need to ensure a better balance in agricultural markets and to eliminate structural surpluses. Supply must be brought more in line with demand and support prices should take full account of technical progress and productivity. Only in this way could a further extension of quantitative controls be avoided. Such an approach would affect

agricultural incomes and employment, and some form of direct income support might need to accompany a restrictive price policy to make it socially and politically acceptable.

4. The response of member states reflected their well-known views. For example, the French emphasised the need to maximise export opportunities, while the Germans and others stressed the desirability of maintaining social objectives for the CAP, by which they meant predominantly the preservation of small or family farms, preferably through price support. I spoke in accordance with our established position, but only the Dutch gave strong support to the UK line for a market orientated price policy.

5. Andriessen said that the Commission would publish what he called a "green paper" setting out the Commission's thinking in greater detail by the end of June. After consulting the interests concerned he would put the Commission's conclusions to the Council in the autumn and it is intended that these be taken into account at the 1986 price fixing.

Analysis

6. The principal alternative methods of controlling EC production and containing the costs of the CAP are:-

(a) Price

7. Economically action on price is by far the best means of bringing supply and demand into balance. Reducing prices eventually brings about a decrease in production (despite occasional claims to the contrary), and an increase in consumption. At the same time it lowers the cost of disposing of any remaining surpluses (eg by export refunds) by reducing the gap between Community and world prices. These results are achieved without any of the bureaucratic complexities and economic inefficiencies that attend other measures.

8. Productivity in agriculture in the EC increases by some 1½ - 2% per annum and this may, if anything, increase over the next few years. Accordingly, real prices need to be reduced by this amount per annum if they are not, in effective terms, to increase.

9. Recent events have confirmed how very difficult it is to secure agreement on a really restrictive price policy especially if this involves reductions in common prices. Nevertheless, agreement was reached on the principle of guarantee thresholds and most have been applied properly (though not of course that for cereals). Some account has also been taken of budgetary discipline. As a result of these factors some common prices have been reduced over the past two years and most have been reduced substantially in real terms over this period. For example, in the last 3 years real milk and beef prices have been reduced by about 8% and (assuming a 1.8% price cut for cereals for 1985/86) the real price of wheat by well over 10%. But this action over a few years only is much less than is required to get the CAP onto a proper footing. In effect reform via the price mechanism has not yet been fully tried.

10. The need for a restrictive price policy is fundamental and the UK will need to continue to battle hard on this front. This will be the case whether or not alternative measures to control output/expenditure are considered or even agreed.

(b) Quotas

11. Quotas can take various forms. One form, for example, is set-aside whereby producers are paid not to plant a proportion of their land. However, as my Department's note (my letter of 5 December 1984 to Patrick Jenkin copied to you) showed there would be very real problems and potential costs in such a system. Production of milk and sugar in the EC is already limited by quota. Technically these are the commodities most suited to direct supply controls (because virtually all production passes through a few processing factories). As the experience with milk showed it is very difficult and costly in administrative terms to establish from scratch a satisfactory quota regime. It would be even more difficult to impose quotas at the farm level for other commodities since these would presumably need to be based on some historic performance related to output or acreage and in general detailed individual records do not exist in most member states. The milk and sugar examples show that there is a tendency for quotas to be set at too high a level and that once set it is very difficult to reduce them

in line with market needs. Thus a substantial surplus can in effect be institutionalised. Quotas are likely to act as a deterrent to improvements in efficiency since they impose a straightjacket on development. Moreover, the very existence of quotas is used to justify claims for large price increases.

12. For these reasons an extension of quotas to new commodities would be unwelcome and very much a second best solution. However, given the difficulty of tackling the Commission's cereals surplus by other means it would not be surprising if at some stage the idea of limitation by quotas were to be seriously put forward for this commodity at least. Our precise attitude would have to depend on the circumstances at the time, including the extent to which it had proved possible to make progress via price policy.

(c) Coresponsibility Levies and Oils and Fats Tax

13. Although the Commission has so far shown no disposition to argue for increases and/or new coresponsibility levies or an oils and fats tax in the "perspectives" context, the suggestion is very likely to come forward. Co-responsibility levies are undesirable since in practice they result in increased consumer prices thereby reducing consumption and do nothing to tackle the central issue of surpluses. Moreover they are manifestly a device for avoiding financial discipline (since such levies count in the EC budgetary process as "negative expenditure"). The milk coresponsibility levy contains significant exceptions for "small" producers and there would undoubtedly be strong pressure for similar provisions to be included in any new levy. Because of the nature of our farming structure, such levies are likely therefore to bear disproportionately on the UK. We should therefore continue to oppose them. The arguments on an oils and fats tax have been well rehearsed and we should remain opposed to it.

(d) Income Aids

14. The Commission are clearly giving considerable thought to the case for supplementing the incomes of individual poor farmers by direct income aids as a means of mitigating the effects of a restrictive price policy on the most disadvantaged. However, there

are a number of serious questions as to whether such a policy could be effective at the Community level and whether it would be in the UK interest including:-

(a) it is highly doubtful if as a corollary to the introduction of a scheme a sufficiently restrictive price policy would in fact be adopted and sustained to ensure that there was a net financial benefit for the EC budget. An increase in Community expenditure would clearly be highly unwelcome;

(b) it would be difficult to decide on the criteria for eligibility given the very different economic conditions in different member states. In practice it would seem that different qualifying income levels would be needed in different member states, but this would present severe problems of presentation;

(c) most small farmers in the Community do not have the reliable records that would be necessary to confirm eligibility;

(d) the absence of records presents a risk of abuse to any scheme. This need not (only) be fraudulent. It might be difficult, for example, to prevent the rural unemployed in some member states from taking steps to allow themselves to be redefined as producers. In general there could be enormous administrative problems;

(e) if only very low incomes qualified for aid there would in effect be little mitigation in the political pressure to increase prices to help producers with low incomes (but not low enough to qualify). If relatively high incomes qualified for aid the cost of a scheme would be very high;

(f) aids would act as a disincentive to structural rationalisation thereby perpetuating the CAP's problems into the future;

(g) there would be a risk of conflict and/or overlap with member states' social security policies;

(h) a scheme would be costly and since its main impact would necessarily be in the poorer Mediterranean countries, it would be very difficult to avoid a substantial EC contribution to it;

(i) assuming (h) is correct then, mainly because of our farm structure the UK could be a substantial net contributor to any scheme.

15. Annex I shows the very different farm structure in the UK compared to the EC as a whole. Annex II gives a crude example of how a scheme might actually work taking account of the farm structure shown in Annex I. Necessarily Annex II contains some fairly heroic assumptions. I should emphasise in particular that the example quoted is a very favourable one. In practice it would be very difficult indeed to achieve the 10% across-the-board price cut envisaged; it is likely that it would be claimed aids were needed to compensate for much less restrictive price decisions than that. The example also envisages that prices will be sustained after the initial cut 10% lower than they would otherwise have been; this would be even more difficult to achieve. We could also be very hard-pressed to achieve 50% national financing. So we could certainly not expect to achieve the result set out in paragraph 8 of Annex II.

16. We should therefore be distinctly unenthusiastic about the concept of income aids (as we have always been in the past). We cannot judge the negotiating position in which the idea might be discussed, and it would therefore be premature to rule out the possibility of such a measure entirely. But at the very least we would need to make it very clear from the outset of negotiation

that we could only contemplate any scheme which would have net beneficial effects on Community expenditure and/or had other advantages for the UK in the "package".

(e) Budgetary Discipline

17. One of our major objectives over the coming years will be to ensure compliance with the financial guideline for agriculture. At this year's price fixing we have been successful in maintaining pressure on the Commission and others to recognise that budgetary costs must be kept within the 1985 budget provision and must respect the financial guideline for 1986. However, it is already clear that the difficulties of staying within the guideline is unlikely to ease over the following years. Precisely how difficult this will be depends of course, on market factors which cannot now be foreseen with precision. A measure of what is involved can, however, be provided by comparing the trend of CAP expenditure as it has developed under existing policies with what we expect to be permissible under the financial guideline. This comparison is shown in Annex III, which shows a gap of some 3.5 becu in 1989 between the trend figure and the guideline. Although a major step towards changing the trend has, of course, already been taken by the adoption of milk quotas the gap is one measure of the difficulties of negotiation that the Minister of Agriculture will face in the Council over the coming years. In some respects the position may get worse. The trend of expenditure on cereals and oilseeds in the base period was held down by strong world market prices due, in part, to the strength of the dollar by comparison with the ecu and to particular US pricing policies, and we cannot rely on these favourable influences persisting.

18. These figures take no account of enlargement and decisions have yet to be taken on how the additional revenues and expenditure generated by enlargement are to be taken into the guideline calculations. Substantial extra expenditure will arise from enlargement and we must expect there to be strong pressure from the enlarged block of Mediterranean countries for the adoption of further policies of particular benefit to them.

Conclusion

19. A restrictive price policy remains by far the best means of controlling the CAP. This will certainly not be easy to negotiate, but no other potential policies offer advantages sufficient to justify adopting them as our first preference. There are serious doubts as to whether any scheme of direct income aids which could be negotiated would, overall help to contain CAP costs or be of net benefit to the UK; but we cannot rule out the possibility entirely at this stage.

Ministry of Agriculture,
Fisheries and Food

June 1985

ANNEX I

FARM STRUCTURE IN THE EC 10 AND UK

I. Total Number of Agricultural Holdings by size

Size	EC 10 (1979/80 data) Number of Farms	EC 10 (1979/80 data) Prop of total agric. area %	UK (1984 data) Number of Farms	UK (1984 data) Prop of total agric. area %
1 - 20 ha	4,500,000	28	84,000	5
20 - 50 ha	860,000	29	65,000	13
50 +	340,000	42	72,000	82
	5,700,000	100 (89 m ha)	221,000	100 (17 m ha)

II. Cereal Production: Number and size of production units (1977 data for EC 10 and UK*)

	EC 10 Number of Holdings	EC 10 Prop of Cereals Area %	UK Number of Holdings	UK Prop of Cereals Area %
Up to 3 ha	2,100,000	9	22,000	1
3 to 20 ha	1,480,000	40	49,000	11
20 ha +	290,000	51	44,000	88
	3,900,000	100 (27.5 m ha)	115,000	100 (3.96 m ha)

* 1984 data for the UK records 95,000 holdings growing cereals.

ANNEX II

Hypothetical Allocation of Income Aid as Compensation for Price Cuts

Basic Assumptions

1. Assume a once for all price cut of 10% averaged over all commodities. Prices are maintained thereafter 10% below what they would otherwise have been.

2. Loss of revenue to producers in EC 10, 12 billion ecu.

3. Assume agricultural production ceases to expand and therefore stabilises for some years.

4. The FEOGA budget would not rise, since surpluses would no longer be growing in volume, but would actually decline due to lower unit costs of surplus disposal. The budget might be about 3 billion ecus lower per annum than it would otherwise have been.

Income Aids

5. If the 4,500,000 holdings of between one and 20 ha are paid 750 ecus per annum income aid (100% EC financed), the cost would be about 3 billion ecus. This would broadly compensate for their share of revenue lost from the price cut.

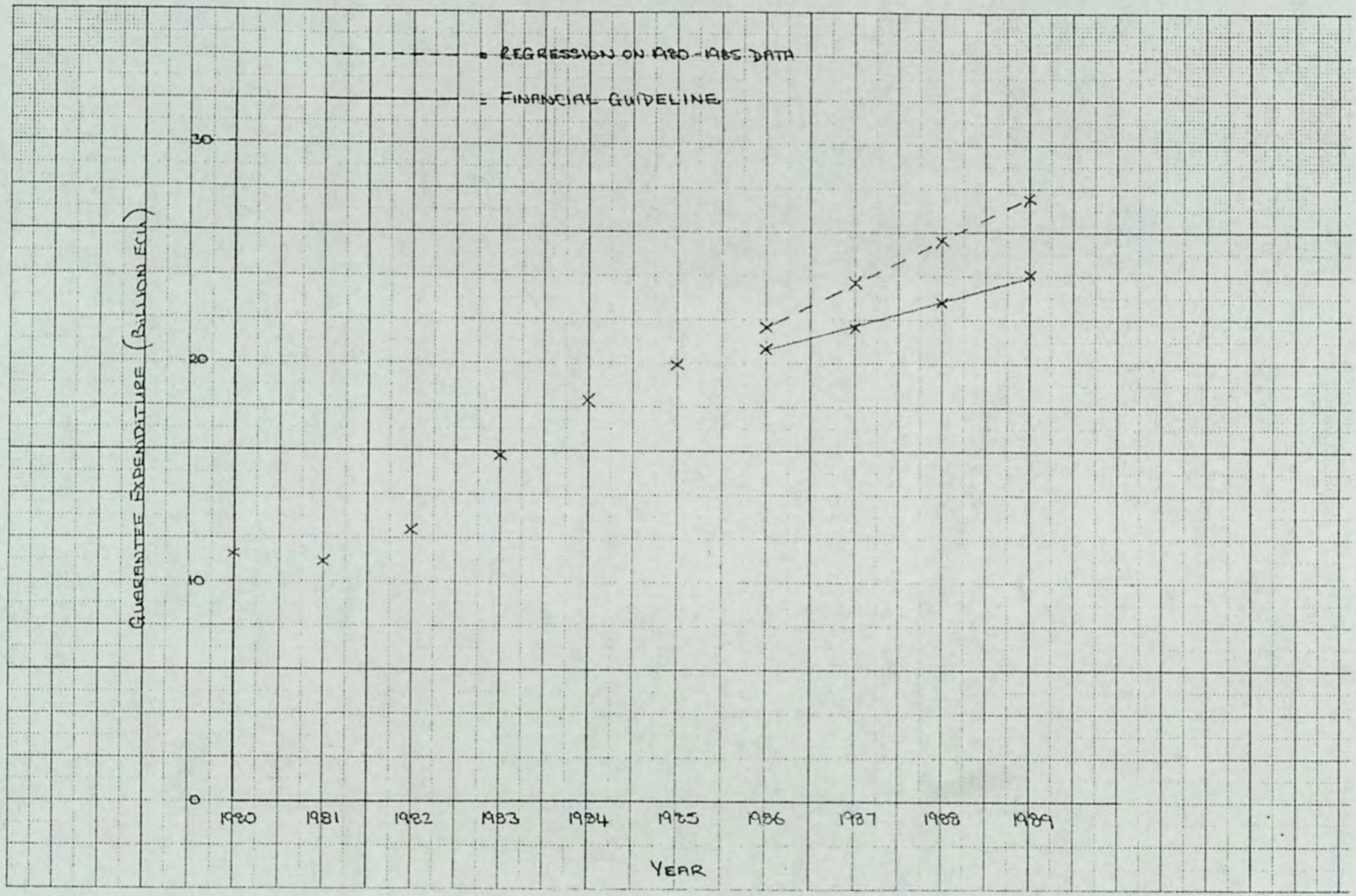
6. The UK, having relatively few small farms, would receive only about 2% of the 3 billion ecu income aid. This contrasts with the UK's overall share of EC 10 agricultural production of 13½%; this latter figure is almost the proportion of the UK receipts from the agricultural side of the Community budget which would be reduced due to a cut in price support.

7. As a consequence:-

   (i) Excluding the effect of the Fontainebleau mechanism the UK would find its net contribution to the budget rising by about 250 mecus.

   (ii) Including the effect of Fontainebleau the net contribution would rise by about 100 mecus.

8. If 50% of income aids were financed by member states then the effect on the UK's net contribution would, in very broad terms, be neutral (but the UK's total contribution to the budget would be reduced by about 300 mecus).


= REGRESSION ON 1980-1985 DATA
= FINANCIAL GUIDELINE
GUARANTEE EXPENDITURE (BILLION ECU)
30
20
10
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
YEAR

ANNEX III

CAP - European policy
pt 13