OD(81)18
9 March 1981

COPY NO 45

CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

CAP: 1981 PRICES AND ECONOMIES PACKAGE

Note by the Chancellor of the Exchequer

This memorandum examines the Commission's prices and economies proposals primarily in relation to our objectives for CAP reform and budget restructuring. On prices I propose a negotiating position, which is more restrictive than that in the Minister of Agriculture's memorandum. I recognise the strong pressures we shall be under from our own Agricultural industry. But I do not believe that the approach outlined below, which follows that we agreed to put to the Commission in December last year, would imply a degree of hardship for the farming community out of line with that we are asking the rest of the country to bear. In my view some of the farm income statistics quoted exaggerate the difficulties of the industry. The evidence set out in Annex A below shows that over the present recession net trading profits in the manufacturing sector have fallen much more steeply than has net farm income.

2. The Commission's proposals are disappointing and fall well short of our immediate objectives for budget restructuring and CAP reform. The price increases are well above the 4-5% we told the Commission we regarded as appropriate and show insufficient regard to the problem of surplus products. No guidance is provided on a financial framework which in the future will be needed if the budgetary costs of the CAP are to be kept within manageable bounds. In our approach to the Agriculture and Eco/Fin Councils on 16 March we should concentrate our efforts on remedying these defects. We

need also to consider our position on the green pound in the context of the price fixing.

Prices

3. The Commission's proposals involve average price increases of about 8½% in a full year. Price increases for products in surplus are in general little lower than the average except in the case of cereals, but even here are too high.

4. The Commission's proposals will tend to be regarded as a starting point. Our starting point therefore should be for lower price increases than the Commission are suggesting - on average not much more than 5%. We can argue along the following lines:

- There is no dispute that farm incomes have been hit by rising costs and the effects of recession. This is the case amongst our partners as well as in the United Kingdom. But manufacturing industry throughout the EC has come under similar pressures, and farmers cannot expect to be insulated from these conditions.

- Price inflation also is common to our economies and in the effort to control inflation it is especially important to keep food price rises to the minimum.

- Price increases of the order proposed will make no significant contribution to the elimination of surpluses. A rigorous price policy is the key to our strategy for getting rid of these surpluses and bringing the level of Community agricultural expenditure under control. This is especially so given the static level of EC demand for food and the continued 2-3% a year growth of agricultural productivity.

- More specifically something near a standstill on cereal prices is justified by the surpluses in that sector. The same consideration would also support the case for a low price increase for milk products (for which cereals are a significant input.) But in view of the pressures on our dairy farmers a somewhat higher figure for milk than for cereals would be appropriate, but not more than the 5% average referred to above.

5. It is also important that the economy measures, especially the super-levy on milk, proposed by the Commission should be welcomed as a means of holding expenditure in check and as a first step towards CAP reform.

Financial framework

6. The Commission's estimates put the gross cost of the price increases at over 1200 million ecu in a full year. The cost falling in 1981 is less and can be easily accommodated. But the figures imply an increase of some 10% in 1982 FEOGA expenditure (gross) compared with the 1981 Budget provision.

7. While any forecasts in this sector inevitably have a wide margin of error, the Commission's most recent projections for 1982 suggest that, if agricultural spending rises by more than 6% over the 1981 budget provision and non-agricultural spending rises in line with past trends, the 1% VAT limit could well be reached. The Commission's "savings" proposals could reduce the gross cost of the price increase in a full year by about one-third. But most, if not all, of these savings measures will encounter strong opposition from other Agricultural Ministers. If, however, price increases of the order proposed by the Commission were to be accepted without offsetting economy measures and the 1% ceiling was in consequence threatened, this could lead to the provision for our 30 May agreement refunds in the 1982 budget being challenged by other member states. At the very least, agricultural spending would continue to absorb an excessive share of the budget and the budget restructuring exercise would thus be undermined in advance.

8. It is essential therefore that the outcome of this year's price review negotiations should be consistent with our policy for restructuring the Community budget and with safeguarding in future years budget refunds to the UK, on at least the scale of the 30 May agreement. This is underlined by the fact that we still have to negotiate the size of the refund in respect of 1982. We must therefore make it clear that our agreement to this year's price settlement will be dependent on the acceptance of a formula for containing the growth in agricultural expenditure both in 1982 and in subsequent years to a rate markedly below the underlying growth of own resources. A more precise form of words is set out at Annex B. It would not be satisfactory to accept that agricultural spending could rise fully in line with own resources. A ceiling set in these terms would not bite and the CAP would continue to take up 70% of the budget.

9. A formula on the lines suggested in paragraph 8 above can make a real contribution to CAP reform. But it must operate as a genuine constraint and not just as a pious expression of hope by the Agriculture Council that their price increases should not result in the limit being exceeded. In other words, it would have to be accepted that, as the ceiling approached, the Commission would have the responsibility for taking the necessary management measures to keep within it. The Council would then have to decide on the more fundamental policy changes required, including, if necessary, reductions in intervention prices. The German Cabinet and Chancellor Schmidt in particular have said that they favour a formula for containing agricultural spending similar to that described above. I therefore propose to seek German support in the Eco/Fin Council for the adoption of a Resolution embodying such a formula. We should take the same line in the Agriculture Council on the same day.

Green pound

10. The Commission's proposals include a revaluation of about 6% in the green pound. If price increases are contained to within 5%,

we are agreed that the green pound should be left unchanged. In my view if we are forced to concede an increase in common prices going beyond 5% then we should revalue the green pound by sufficient to keep the effect on domestic food prices to 5%. It should be borne in mind that if the green pound is maintained at recent levels, (15%), our positive MCA would add something like £300m to our net contribution to the Community Budget in 1981, compared with the situation if the MCA was entirely eliminated (broadly the assumption in the 1981 budget). Even with the operation of the 30 May agreement, the net cost would probably not be less than £75m, though the theoretical possibilities range between zero and the full amount.

11. In the meantime, so long as we resist price increases above 5%, on the grounds deployed in paragraph 4, it would be reasonable for us to question the case for a green pound revaluation. But this should in no circumstances be the main focus of our efforts, and there should be no question of compromising on the objectives set out above in order to avoid a revaluation.

Conclusions

12. I recommend that at the Agricultural Eco/Fin Council on 16 March the UK line should be:

(i) Challenge the Commission's price proposals as incompatible with the objectives of reducing CAP surpluses and restructuring the budget.

(ii) Suggest average price increases of no more than 5% with a significantly lower figure in the cereals sector.

(iii) Support the economy measures proposed by the Commission, especially the super levy.

(iv) Make it clear that as an essential element in this year's price agreement the Council must adopt a formula which will contain agricultural expenditure within definite limits in 1982 and subsequent years. A form of such a formula is in Annex B. Together with the economy measures this would represent a useful first step towards CAP reform.

(v) Reserve our position on the green pound.

(G.H.)

HM TREASURY
9 March 1981

CONFIDENTIAL

The memorandum by the Minister of Agriculture argues that the agricultural industry is facing very severe difficulties primarily on the basis of the data for "net farm incomes". In particular it has been suggested that there can be few other occupational groups which have suffered a similar erosion of income in the recent past. While it is common ground that net farm income has fallen sharply in real terms in the last 4 years compared with the record level of 1976, the Treasury view is that the MAFF presentation in terms of farm income, net of interest payments is both misleading in itself and exaggerates the steepness of the fall in recent years. Nor does the evidence bear out the contention that the farm sector has suffered a more acute erosion of its profits than the main body of private sector manufacturing industry.

Definition of net farm income

2. The definition of "net farm income" used in the Minister of Agriculture's memorandum is the "income of farmers and their spouses after providing for depreciation and payment of interest and excluding stock appreciation".

3. It is thus a hybrid statistic, which aggregates together a farmer's personal income and his return on capital. This in any case makes comparisons with other sectors of the economy difficult. But, if such comparisons are made, the definition quoted above is unsatisfactory in two respects:

(a) It is a poor measure of the farm family's personal income for three reasons. First, it is a purely accounting concept, which makes allowance for depreciation on a full replacement cost basis and not in any sense a cash flow figure. Second, it excludes unrecorded income in kind and from other sources such as tourism. Third, it explicitly excludes the salaries paid to members of the farmers' own family (other than spouse). Indeed these salaries are imputed as a cost in arriving at the figures quoted in the Minister of Agriculture's memorandum.

(b) It is unsuitable for comparisons with the company sector because of the way in which interest payments are treated.

It is questionable whether interest should be shown as a cost in measuring real farm incomes. At a time of high inflation interest charges are largely or, wholly, offset by the fall in the real burden of the farmers' capital debt. This factor is reflected under current cost accounting by the "gearing adjustment", but such an adjustment is not made in the MAFF statistics for net farm income. For this reason comparisons with the rest of the company sector are better made pre-deduction of interest, not post-deduction of interest. This conforms with the presentation adopted in the UK national income accounts, where interest is treated as a distribution out of profits.

4. Tables 1 and 2 accordingly show farm income on four different definitions, which take account of some, but not all of the problems mentioned above. Table 1 shows that on two out of the four definitions farm money income has increased both between 1979 and 1980 and over the last 3 recession years 1978-80. Table 2 shows that the fall in real farm income between 1979 and 1980 is in all cases substantially less steep than the 24% figure shown in the Minister of Agriculture's paper.

Comparison with the rest of the economy

5. For the purposes of comparing the farm sector with other sectors in the economy, it seems most appropriate to regard the "net farm income" series as comparable with net trading profits in the rest of the private sector. Table 3 below compares aggregate net farm income with the net trading profits of manufacturing companies excluding oil companies over the last 10 years. Both indices measure income after charging for depreciation at current cost, but before charging interest, but the figures for net farm income still exclude the salaries paid to the farmer's own family and partners. It was agreed by the Minister of Agriculture in his letter of 5 November last year that this was an appropriate basis of comparison. The table shows that if 1980 is compared with 1970 farm income has fallen in real terms by 35%, while real manufacturing profits have dropped by 46%. Between the peaks reached in 1973 and 1980 farm incomes fell by 49% and company profits by 55%. Over the last 3 recession years (1978-1980) farm income fell by 22% and manufacturing profits by 58%. Thus the squeeze on manufacturing profits has been more severe in recent years than the fall in net farm income.

6. Other indicators also suggest that the farm sector's position is at least no worse than that of manufacturing industry in general. The level of bankruptcies has remained relatively stable in farming during the present recession and bankruptcies in agricultural industries have fallen as a percentage of total bankruptcies in recent years. The downward trend in the level of the farm labour force over the decade to 1980 was about 2½% per annum and there has been no apparent acceleration in recent years. The unemployment rate in agriculture is very similar to that in manufacturing and to that for the whole economy. As regards investment the relative performance in agriculture and manufacturing is shown in the table below:

	Manufacturing Investment (£m 1975 prices)	Agriculture GFCG
Average of 1969-71	3984	563
1976	3873	567
1977	3511	556
1978	3773	601
1979	3872	583
1980	3557	523

Thus the 10% fall in agricultural investment in 1980 compares with a drop in manufacturing of 8%. Comparing 1980 with the averages for 1969-71 shows a fall of 7% in agriculture and 11% in manufacturing.

DCW

TABLE 1

ALTERNATIVE FARM 'INCOME' SERIES

Concept	Income Recipients	Treatment of Interest	Estimates for 1975-80 £m						% change	
	i. Farmer and Spouse ii. Farm family ie. not treating imputed labour earnings, or associated NI contributions as a cost	i. as a cost ii. not as a cost	1975	1976	1977	1978	1979	1980	1977-80	1979-80
Net Income (MAFF Definition)	(i)	(i)	995	1283	1256	1243	1145	1025	- 18	- 10
Alternative Measures of Net Income	(i)	(ii)	1119	1422	1409	1431	1461	1485	+ 5	+ 2
	(ii)	(i)	1224	1540	1518	1556	1490	1432	- 6	- 4
	(ii)	(ii)	1348	1679	1671	1744	1806	1892	+ 13	+ 5

TABLE 2

ALTERNATIVE FARM 'INCOME' SERIES REAL TERMS INDICES 1975=100

Concept	Income Recipients	Treatment of Interest	Indices of real 'income' 1975=100						% change	
	i. Farmer and Spouse ii. Farm family ie. not treating imputed labour earnings or associated NI contributions as a cost	i. as a cost ii. not as a cost	1975	1976	1977	1978	1979	1980	1977-80	1979-80
Net Income (MAFF Definition)	(i)	(i)	100	111	94	85	69	53	-44	-23
Alternative Measures of Net Income	(i)	(ii)	100	109	93	87	79	68	-27	-14
	(ii)	(i)	100	108	92	87	73	60	-35	-18
	(ii)	(ii)	100	107	92	89	81	72	-22	-11

Table 3

Comparative Income Trends Indices 1975 = 100 Real Terms

	Aggregate* Net Farming Income	Net Trading Profits* of Manufacturing Profits
1970	105	158
1971	105	165
1972	104	182
1973	133	193
1974	102	86
1975	100	100
1976	109	104
1977	93	140
1978	87	150
1979	79	100
1980	68	86 ‡

* Excluding stock appreciation, after charging depreciation (at current cost) but before charging interest.

‡ Forecast

CONFIDENTIAL

PROPOSED FORMULA FOR LIMITING GROWTH OF AGRICULTURAL EXPENDITURE

Beginning with the 1982 budget the provision made for the increase in agricultural expenditure in the budget for each year, compared with that in the budget adopted at the beginning of the previous year, should not exceed half the rate of growth in the own resources base between the two years. Agricultural expenditure will then be contained within that budgetary limit.