Bulletin

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Up on the farm?

CREATING A PROSPEROUS FUTURE FOR AGRICULTURE

Although UK farm income has improved a little since 2000, it is still at less than half the levels of the mid-1990s. And the modest recovery can largely be attributed to factors beyond farmers' control, particularly the movement in exchange rates. In this bulletin Frontier, which has recently carried out a study for the Department for the Environment, Food and Rural Affairs (Defra), looks at how the sector can try to overcome its underlying economic challenges.

In 2000, the UK's Total Income From Farming (TIFF) was approximately £1.8 billion (in 2004 prices), compared with close on £7 billion in 1995. Over that period, the UK also lost ground dramatically against its European Union (EU) competitors, falling from second place in 1996, in terms of TIFF, to ninth by 2000.

Since then, there has been some improvement. In 2004 TIFF was just over £3 billion, and the UK ranked third amongst the EU (excluding the new entrants).

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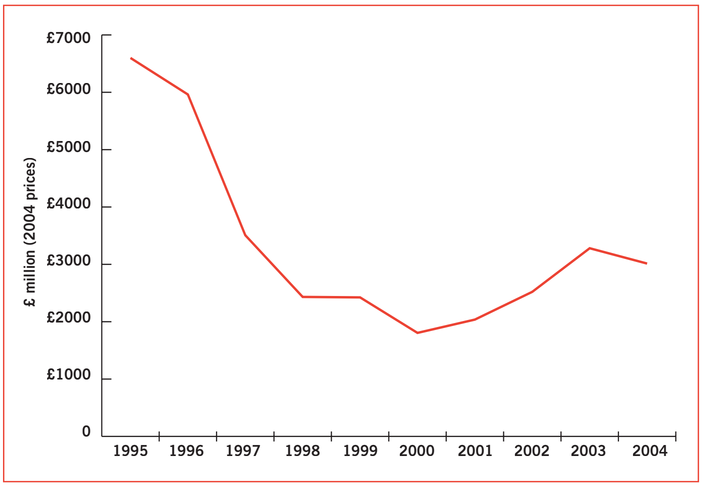

Figure 1: Total Income from farming 1995-2004

Source: Defra, Agriculture in the UK 2004

However, the industry is still focused on the production of low-margin commodities, and is reliant on subsidies. Even after three years of recovery, subsidies accounted for 90% of TIFF in 2003. To become self-sustaining, the sector will have to go through radical change.

HIGH SUBSIDIES…

Industry subsidies come at a price, not just to taxpayers and consumers but also to the producers themselves. This cost to the industry comes in terms of the difficulty of making rational business decisions. Subsidies leave farmers dependent on factors beyond their control – European policies and exchange rates, as well as international negotiations on tariffs and trade barriers. These constraints make it hard to operate efficiently in the short term or to make informed investment decisions for the longer term.

Major reforms of the Common Agricultural Police (CAP) were agreed in 2003 with the aim of reducing market distortions by "decoupling" subsidies from the level of production. From 2005, all EU countries were required to shift some subsidies from market price support (what is known as Pillar I) to rural development and environmental measures (Pillar II).

The British Government believes that in the future all farm support should be from Pillar II, and is moving faster than others in that direction under the Single Payment Scheme (SPS). The aim of the SPS is to pay subsidy according to the amount of land held (not the amount of farm output produced), provided certain basic standards for care of the land are met.

Although these reforms reduce the incentive to produce at a cost above market prices, the new land-based subsidy will still distort the market. The SPS may well maintain in existence farms of a size below the efficient scale – to some extent such rural support schemes are intended to do precisely that. Moreover, farmers will continue to be heavily dependent for income on political decisions and compliance with official schemes rather than on market forces.

… LOW MARGINS

Too great a proportion of UK farming and food production consists of low-margin commodities. The following examples illustrate the problem.

- In 2003, the UK exported just over £5.5 billion of highly-processed food products, but imported just over £7.1 billion.
- In 2003 the UK was a net exporter of unprocessed cereals, but a net importer of highly-processed cereals, to the tune of £3 spent for every £2 earned.

- In horticulture, the imbalance is even greater. For every £1 earned from the export of processed fruit and vegetable products in 2003, we spend £4-6 on imports.

To compete successfully in the production of low-value agricultural commodities, one must be able to combine favourable climatic conditions, large scale and low costs. While the UK has created larger and more efficient farms than many parts of the "old" European Union, on world markets it is vulnerable to competition from lower-cost, larger-scale and more climatically favoured regions.

Unless farmers are to subsist only as rural park-keepers, therefore, UK agriculture must change direction. To become part of a self-sustaining industry, farmers must:

- identify advantage;
- reduce costs; and
- add value.

IDENTIFYING ADVANTAGE

The sector as a whole, including policy-makers, needs to focus on identifying and reinforcing UK farming's advantages. Any new policies must focus on supporting efforts to maximise the opportunities for UK farming.

The following are just some of the advantages that the sector could seek to maximise.

- **Ability to deliver traceable high-quality product.** Consumers are demanding higher-quality produce, whose provenance and safety are assured. The UK has one of the best food safety regimes in the world.

- **Proximity to large and wealthy consumer markets.** For some products, this provides an automatic advantage because of transport costs. More importantly, there is also increasing consumer demand for locally-sourced produce.

- **Skilled labour.** While this is less important for large-scale commodity production, if the sector seeks to focus on higher-value-added products, a skilled workforce will become an increasingly important asset.

- **Strong biotech base.** A recent report comparing the biotech sectors in the US and Europe found that the UK is the clear leader amongst European countries, in terms of companies, financing, products in development and revenue growth.

CUTTING COSTS

Although UK agriculture has become steadily more efficient, there is no question that the minimum efficient scale of production is larger than many operating units, and that it is rising. In the dairy industry, for example, milk production costs in 2004 averaged 29p per litre for herds of 10-40 cows, and under 17p for herds of over 150 cows. This compares with farm-gate prices in the summer of 2005 of under 20p per litre.

Consolidation may be the obvious answer, but it is not the only one. Other countries have proved more adept at increasing horizontal co-operation, through:

- buyer groups, where farmers come together to purchase in greater quantities, and therefore take advantage of the discounts available to larger purchasers;
- seller groups, which help to reduce transaction costs and allow farmers to provide large-scale purchasers with greater security of supply; and
- co-operatives, which have been created and run more successfully in other countries and deserve some reappraisal in the UK.

There are also opportunities to improve co-ordination, with firms up and down the supply chain. The difference in scale between farms and major supermarkets has made it difficult for farmers to see this as a partnership of equals, but new opportunities need to be assessed all the time. For example:

- if farmers could tap into the energy cost savings achieved by food retailers, with their huge purchasing power, farm production costs could be greatly reduced;
- with greater co-operation between farmers, processors and retailers investment in UK facilities could take place that would enable farmers to seize the opportunity presented by a growing demand for bio-fuels;
- if the integrated distribution networks from the factory gate to consolidation centres, and on to retail outlets, could be extended from processors to the farm gate, this would help to reduce farm costs and increase efficiency.

ADDING VALUE

UK farming needs to shift from the production of commodities to higher-value products. A number of strategic lessons have to be learnt.

- **Follow the customer.** Market signals have been so blunted by agricultural policy that farmers have not acquired the skills needed to understand and respond to changing customer demands. However, other parts of the food sector collect huge amounts of information on customer behaviour and trends. The industry needs to work together to share consumer insights.

- **Be number one for new.** Markets distorted by subsidy also blunt the incentive to innovate. Changing this requires co-operation between farmers and others in the supply chain. This could help with faster identification of new and growing markets, with other parts of the chain providing farmers with advice and support on how to develop new products.

- **Inform the customer.** Improved marketing of British farm products has often been suggested as a means of improving outcomes for farmers. However, consumers show little response to generic campaigns to buy British, unless these convey some perceived health or taste benefit. What may be more effective is supporting and encouraging farmers or groups of farmers to develop and promote their own brands, particularly in areas with distinctive products.

- **Identify niche export markets.** Farmers in other EU states have built export markets for added-value cheese, meat and other products. These markets are protected by accrediting either a geographic area of production (e.g., Parma ham), or the traditional production process (e.g., Jamon Serrano). For example, France now has many more products (119) covered by Protected Designation of Origin than does the UK (19).

There is a growing and important role for Defra to play in encouraging and supporting these moves towards more sophisticated understanding of customer needs, innovation, and the differentiating and marketing of farm products.

CONCLUSION

The CAP has helped to blunt price signals in agriculture. While UK farmers have been more efficient that many others in Europe, they are too concentrated on the production of low-margin commodities. In shifting the focus of subsidies from production to the environment, it is important that policy-makers do not miss the opportunity to encourage the food industry to work with UK farming to move its ambitions towards the high-value-added products that will enable the UK to sustain a viable industry.

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