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Observations on *Moving away from Direct Payments* (Defra, 2018a)

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The Agriculture Bill (2018) was published in September 2018 (House of Commons, 2018). At about the same time Defra published an evidence report *Moving away from Direct Payment: Agriculture Bill: Analysis of the impacts of removing Direct Payments* (Defra 2018a). This viewpoint article argues that this document does not clearly define Farm Business Income (FBI), the measure of income chosen in the analyses, and that this makes it harder for the reader to understand the possible impacts of the withdrawal of Direct Payments on returns to "farmer, spouse and unpaid labour" for their labour and managerial input into the business: an issues of key concern for the future structure of the sector.

The use of Farm Business Income as a measure of "net profit" or "profit"

The Summary section of *Moving away from Direct Payments* (Defra, 2018a) states:

> "Farm Business Income (FBI) is a measure of *net profit*, calculated as Farm Business Outputs (revenue) minus Farm Business Inputs (costs). Between 2014/15 and 2016/17 the average *profit* for all farms was £37,000" (p 5, italics added).

Immediately below this statement is this comment:

> "Across all farm types, over the period 2014/15 to 2016/17, Direct Payments were equivalent to 61% of Farm Business Income (*profit*), but this varies greatly by sector, being most significant for Grazing Livestock and Mixed farms" (p 5, italics added).

Therefore, early in the document, and indeed in the very same paragraph, and on the very same page, FBI is described as a measure of both "net profit" and "profit". This raises the question, what does FBI really measure? Page 19 informs the reader that:

> "FBI equals farm business output less farm business inputs" (p 19).

And that farm business inputs include:

> "feed, materials, labour and machinery, measured in physical or financial terms" (p 19).

Why an input cost might be measured in physical terms is not explained. However, this statement implies that all labour costs are paid, but a further statement on the same page states that:

> "FBI is the amount that a farm business has left after costs to invest, pay taxes and pay salaries" (p 19).

In fact, *Moving away from Direct Payments* does not *explicitly* stated which labour costs are deducted to arrive at FBI and whose salaries need to be paid out of FBI. To answer the question, the reader needs to look elsewhere. For example, Defra (2018b) defines FBI as representing:

> "the financial return to all unpaid labour (farmers and spouses, non-principal partners and their spouses and family workers) and on all their capital invested in the farm business, including land and buildings" (p 11).

This makes it clear that FBI does not represent "profit" in the sense a layperson would understand the term: total revenue less total costs. Defra also defines and uses another measure of farm income, Farm Corporate Income (FCI). FCI subtracts an imputed value for 'farmer, spouse and unpaid family labour' from FBI (Franks, 2009) to give an alternative measure of income, and one that better reflects "profit" as it is more commonly understood. *Moving away from Direct Payments* makes no reference to FCI.

The choice of income measure used to analyse the impacts of the withdrawal of Direct Payments is important because, as Table 1 shows, the difference between FBI and FCI can be large. For example, the average charge made for 'farmer, spouse and unpaid manual labour (excluding unpaid managerial labour)' for farms in England (2015/16) was £28,452, and for hill farms in England (2016/17) £25,726/farm.

This viewpoint presents two examples that shows how the misrepresentation of FBI as "profit" makes the impacts of the withdraw of Direct Payments on farm businesses presented in Defra (2018a) more difficult to understand. This is important because, as argued, it will have a significant influence on the future structure of farm businesses.

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Table 1: A comparison of the values of FBI and FCI

Sample	England (£)	Hill Farms (£)
Year	(2015/16)	(2016/17)
Farm Business Income (FBI)	31,482	18,972
Adjustment for unpaid "farmer, spouse and unpaid manual labour"*	28,452	25,726
Farm Corporate Income (FCI)	3,030	-6,754

*Note that this imputed value does not make a deduction for managerial input of "farmer, spouse and unpaid family labour". (Source: Rural Business Research (2018) and Harvey and Scott, 2018).

Impacts of the withdrawal of Direct Payments on input prices and farm incomes

Moving away from Direct Payments presents several analyses of the financial challenges farm businesses may face following the withdrawal of Direct Payments. To give one example, it calculates that half of the loss making Less Favoured Area Grazing Livestock farms will need to reduce costs by more than 16% to breakeven without Direct Payments (p 25—27). It is estimates such as this that lead Defra to conclude that withdrawing Direct Payments:

> "may encourage more rapid structural change" (page 9).

As the rate of structural change is typically measured by the rate of change in the number and size of farm businesses it is clearly an issue of interest to the farming population.

Moving away from Direct Payments argues that the size and scope of any adjustments a farmer may need to make following the withdrawal of Direct Payments will, in part, be related to how input prices change. An example provided is farm rents:

> "as Direct Payments have led to an increase in rents, their withdrawal will see the reversal of this impact" (p 15).

This is because:

> "Direct Payment is indirectly paid to the landowner through inflated rent prices" (p 15).

This raises the question, if Defra are confident of the link between Direct Payments and land values, why has it apparently been happy to allow the link to exist when agricultural policy is principally aimed at supporting farmers' incomes? Putting this question to one side, and given that there is a link between Direct Payments and land values, and most economists would agree that there is, what will be important to the adjustments farmers need to make is the rate at which rents fall and the level to which they fall. This will, in part, depend on when rental agreements are due to be renegotiated:[2]

> "rental agreements may not be up for a renewal immediately after the withdrawal of Direct Payments. Rent reviews will vary by type of farm and tenancy." (p 28).

Farm Business Tenancy rents are typically more changeable than other tenancy agreement rents, in part because they tend to be negotiated more frequently, which makes them more responsive to changes in farm profitability. Unfortunately, economic theory is silent on the rate at which input prices in general may change. However, as this example shows, the rate at which prices change generally reflects the contractual terms, and therefore the relative market power of buyer and buyer of their produce. For most inputs, an individual farmer has less market power than a seller. Because of this input prices are likely to be 'sticky', that is, to remain constant or fall more slowly than they had previously increased.

Given sticky input prices, the first "hits" of the loss of the Direct Payment will be the amount available to compensate 'farmer, spouse and unpaid family' for their manual labour and managerial input: because FBI is not clearly defined, this consequence of withdrawing Direct Payments in not transparently clear in *Moving away from Direct Payments*.

The use of depreciation to support "farmer, spouse and unpaid labour"

Moving away from Direct Payments suggests that farmers could use depreciation to support 'farmer, spouse and unpaid family' labour when Direct Payments are withdrawn. It notes that accounting standards allow profit to include a deduction for machinery and building depreciation, but because these costs are not cash costs:

> "In the short term [they] do not need to be paid out" (p 24).

Consequently:

> "Depreciation ….. does not alter the day to day cash flow of a business. Therefore, in the short term, when looking at the impact of instantly removing Direct Payments, depreciation costs can be excluded so only 19% of farms [across England] would not be able to cover their production costs" (p 24).

Which is an interesting use of the word "only". Nevertheless, the principle underpinning this statement is correct. For example, Harrison and Tranter (1989) stated:

> "Because depreciation is an incoming cash flow item it need not necessarily be used to replace the capital items which are notionally giving rise to it" (p 63).

Undoubtedly farmers do use this "incoming cash flow item" to help tie them over during hard times. But the annual value of depreciation depends on previous investments: a farm already in financial difficulties prior to the withdrawal of Direct Payments may already be using this strategy, and if they have been using it for several years there may be little or no depreciation "incoming cash flow item" remaining to draw on. Moreover, as Harrison and Tranter (2089) point out,

[2] But also, on other factors, such as transition arrangements put in place as we move from full to no Direct Payments, the details of which are not yet decided (see possible options in Defra 2018a, Section 5, p 42-45).

such an adjustment strategy relies on existing capital stock being made to:

> "keep going at some acceptable level of performance" (p 63).

This is not always possible, but even when it is, it is likely to lead to an increase in repair and labour costs, outcomes which are not referred to in the calculations presented on page 24 (Defra 2018a), but which will nevertheless further reduce the cash available to compensate 'farmer, spouse and unpaid labour' for their manual and managerial labour.

The use of depreciation in this way has a direct implication for future increases in efficiency - an adjustment strategy discussed in *Moving away from Direct Payments*:

> "Removal of Direct Payments may be offset in a number of ways, including farm efficiency improvements (reducing inputs or improving outputs) ...." (p 31).

No doubt efficiency on some farms can be raised further by the use of some or all of the best practices discussed in *Moving away from Direct Payment* (see Box 1). However, if the depreciation allowance is spent supporting incomes rather than banked it cannot later be used to finance capital investments. This will reduce efficiency and competitiveness in the medium- and long-term, and thereby merely delay rather than reduce the number of farmers who leave the sector.

Box 1. Suggestions put forward as to how farm performance can be raised

Improve farm efficiency by increasing the value of outputs (p 34).
Improve farm efficiency by reducing costs (p 31), for example,

- Feed livestock more efficiently to improve feed conversion ratios;
- Nutrient management plan (50% of relevant holdings do not have a NMP);
- Manure management plan (33% of relevant holdings do not have a MMP);
- Test the nutrient content of soil (33% of relevant holdings do not do this);
- Selective breeding, using estimated breeding values (p 33);
- Improved animal and crop health (p 37).

Switch land use into new Environmental Land Management System (p 3 & p 39).
Diversify the use of farm assets (p 31).*
Reduce waste (p 36).
Gain a better understanding of the market;

- Vertically integrate where appropriate (p 36);
- Secure more favourable contracts for produce (p 36).

Undertake financial management practices (p 40), such as

- Produce budgets, gross margins and cash flows, and benchmarking (done on only 33% of farms).

* Though it is noted on page 31 that "if more farms diversity, for example into tourism, this would increase the supply and thus in turn may lower the return to the farmer" (Defra 2018a).
(Source: Defra (2018a))

Conclusions

This viewpoint does not offer any comment about the decision to remove Direct Payments, nor does it offer any advice on how that process should be conducted. Rather it argues that the text used in *Moving away from Direct Payments* to examine the consequences of moving away from Direct Payments fails to properly define FBI. As a result, the way FBI is used as a measure of "profit" is misleading – FBI is not a measure of profit in the way a businessperson or an informed layman would understand the term.

As a direct consequence of this misuse, *Moving away from Direct Payments* gives misleading implications on farmers' short-, medium- and long-term incomes and business competitiveness. For example, if input prices are either slow to fall, or do not fall at all, the first "hit" will be taken by the cash available to compensate 'farmer, spouse and unpaid labour' for their manual work and managerial input during the year. If this happens, farmers may well chose to support their incomes by diverting depreciation – a cash inflow item – away from reinvesting in their business. But this can only provide a temporary lifeline for a proportion of farm businesses, and doing so will have adverse medium- and long-term impacts on farm efficiency and therefore the sector's competitiveness.

The rate of structural change across the sector – which is typically measured by the change in the number and size of farm businesses – will depend on many factors, but ultimately the most important of these will be the level of income at which farmers are prepared to continue to farm, i.e. their own "supply price". The willingness of farmers to accept lower private drawings during hard times is described as the "traditional belt tightening exercise" associated with family farming (Harrison and Tranter 1989, page 63), and Harrison and Tranter (1989) comment that identifying a farmer's "supply price":

> "Is a notoriously hard [question] on which to shed empirical evidence" (p 27).

Identifying the impacts of withdrawing Direct Payments on the structure of farming would have been helped by the use of FCI rather than FBI because FCI provides a clearer measure of the profit farm businesses currently deliver after deducting reasonable drawings to support the living of farmers and their families. As such, FCI would provide a better guide of the current strength of the sector, and of the profit/losses farmers would enjoy/need to face following the withdrawal of Direct Payments. This in turn would provide a better guide to the rate at which farmers are likely to leave farming – an issue clearly of importance to farmers and policy makers alike.

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