



Isle of Man
Government

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Consultation on the Future of the Manx Retail Prices Index (RPI)

Economic Affairs
Cabinet Office

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Consultation on the future publication of the Manx Retail Prices Index ("RPI")

1. About the consultation

The purpose of this consultation is to invite comments on the options available to Economic Affairs in the publication of information in respect of prices in the Isle of Man, and in particular the future of the Manx Retail Prices Index.

Economic Affairs currently publishes a monthly inflation report, where around 1,000 prices are recorded and are weighted to be representative of a typical basket of goods and services. The eventual inflation figure is normally expressed as a percentage increase or fall in the price of goods in this basket, compared to the same period a year ago.

The international landscape for the publication of price indices has changed dramatically in the last few years with the adoption of the Consumer Prices Index (CPI) as the main measure of inflation in the UK, and the delisting of the Retail Prices Index (RPI) as a UK National Statistic (2013). This was done in order to bring the United Kingdom in line with European and International norms.

Recently, wide gaps between CPI and RPI have emerged locally leading to newspaper headlines questioning whether prices in general are actually going up or down. As such Economic Affairs would like to consider options for change that –

- a) Help public understanding of what the general level of price inflation is;
- b) Conform to international standards for the collection and publication of information; and
- c) Acknowledge existing examples where Manx RPI may still be used to set prices, pay agreements or other inflationary uplifts.

This consultation is not a referendum, it is there for interested parties to comment and for the expression of views. Submission of a response does not necessarily guarantee a change to that which is proposed. Paper copies of the consultation are available, as are the Guidance notes and Code of practice on consultations.

Responses will be published unless specifically requested otherwise. A list of all responders will be attached to the consultation response document. Responses should clearly indicate if the response is on behalf of an organisation rather than an individual.

Responses are required to be submitted by **18th May 2016**.

Please direct any queries to:

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Responses

Respondents are asked to consider which of the below 3 options they favour in respect of changing Isle of Man inflation reporting, or to indicate that they prefer no change with reasons for this view.

Please send responses, in writing and preferably by email, to:

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2. Importance of Inflation

Currently Economic Affairs publishes two inflation measures, the Retail Prices Index (RPI) and the Consumer Prices Index (CPI).

In simple terms, inflation measures the falling purchasing power of money. As an example, if inflation is 2% over a 12 month period, this means that should a product cost you £100 in month 0, it would cost you around £102 in month 12. It is a vital statistic as it can be used for setting benefit payments, contractual price increases and setting tax allowances, amongst other things.

Inflation is measured by tracking the prices of a fixed basket of goods. The coverage of goods to be included in the basket is compiled using the recorded expenditure of households in the Household Income and Expenditure Survey. Currently, around 1000 prices are collected each month for around 500 products in the basket. Goods in the basket range from food, to petrol, to clothing, to travel costs and are weighted according to expenditure of each.

Prices for various products are collected from around 70 stores. Individual product prices are averaged and these average prices are used to compile individual product indices. As an example, the price of sliced brown bread may be collected from 6 stores, but these prices will be averaged and compiled into a brown bread index, which is then aggregated into the bread index, which is then aggregated into the food index.

RPI

The RPI was the first inflation measure for the Isle of Man. The basket of goods and weighting of products are compiled based on the majority of Isle of Man households, but exclude the top earners and pensioners whose income is at least 75% derived from state benefits. It includes expenditure both within the Isle of Man and abroad by the relevant households. The RPI clearly does not have full coverage of the spending of Isle of Man households.

There are some products included in RPI which are not included in CPI, including mortgage interest payments, council tax, estate agent fees and the television licence.

The formula used to average the individual prices is known as the Carli formula. The Carli formula is the sum of all prices, divided by the total number of price. There are many problems with it as an average, however one is that it tends to overstate price increases by giving more weight to items with a higher price. A movement from 80 to 90 in a range of 1-100) would be weighted higher in this average than similar movements of smaller numbers which actually represent a greater percentage change (e.g. a movement of 3 to 4 in a range of 1-5). A large percentage change movement in the price of a pint of milk would have a lower impact than a smaller percentage change movement in the price of a piece of furniture, for example. This impact is known as the "formula effect" and results in artificial upward bias to the inflation rate. It is this impact which is of most concern to Economic Affairs. An example of the "formula effect" is given below.

RPIJ

The RPIJ is a measure of inflation which is exactly same as the RPI in terms of coverage and items, but it uses a different formula to average the prices, known as a Jevons formula. This uses the rooted product of the prices to calculate the average and is considered to be a better statistical average as it is not prone to the formula effect. Whilst it is not a perfect measure due to the limitations in consumer coverage, it is far more reliable than the RPI. Jersey already uses a geometric mean in its compilation of its RPI, making it directly comparable to United Kingdom RPIJ.

CPI

CPI has been calculated since 2008 and tends to be lower than the RPI. The household coverage is better in that it includes all households and spending by visitors. In this respect it may be thought of as being more representative. There are some additional products included in CPI which are not in RPI, mainly university accommodation fees and tuition fees. The CPI uses the Jevons formula (explained above) to average prices, meaning it is not prone to the same upward bias that the RPI is.

Example of difference in inflation caused by the “formula effect”

A simple example of how the formula effect works in practice can be shown below. There are two coats, one costing £100 and one £125. If the cheaper coat increases by 25% and the more expensive reduces by 20% the combined cost remains unchanged, but inflation under the Carli method (which averages the two percentage movements) is 2.5%. The same occurs if the coats then return to their original prices.

	Coat A		Coat B		Arithmetic average of price increases 'Carli' method	Geometric average of price increases 'Jevons' method
	Price	Increase	Price	Increase		
Initial price	£100		£125			
Price after 1 year	£125	+25%	£100	-20%	+2.5%	0%
Price after 2 years	£100	-20%	£125	+25%	+2.5%	0%

If both coats had increased by 25% in the first year then both methods would have shown a 25% overall increase. Assessing inflation on percentage movements tends to overstate levels of inflation when prices are moving up and down.

Formula Effect in Isle of Man inflation.

Given the above, it should be clear that the “formula effect” is primarily a result of price volatility (i.e. the more that prices move up and down, the bigger the “formula effect” is). One of the changes introduced following the 2013 Household Income and Expenditure Survey was to expand the number and range of items collected, in order to more accurately measure the general level of inflation. As a result, however, the formula effect has widened, primarily as more prices go into and out of special offers. We have also recorded more volatility in prices of air fares based on more price collections and seasonal demand variations.

In the UK these factors would have less of an impact as there are many more prices collected for each product. Discussions with the UK Office for National Statistics in February 2016 concluded that this is the main reason for the large gap between Manx RPI and Manx CPI at present. It is for this reason that Economic Affairs feels the Isle of Man RPI statistic cannot be seen as a true representation of the state of overall inflation in the Island.

Issues with multiple inflation measures or removing Manx RPI.

The stark differences between the RPI and CPI measures currently allow for agreements to be agreed based on whichever inflation measure suits. For example, linking a rental agreement to RPI would allow for higher rent increases. In February 2016 the RPI was measured as being 3.3%. As explained above, the RPIJ is the exact same as RPI with only a different way of averaging prices, however the RPIJ was measured as -0.7%. This in itself shows how RPI is very likely to be overstating inflation.

A number of long term agreements are based on Manx RPI, for example the price control within the 1995 Isle of Man Steam Packet User Agreement. We also believe that legal agreements and commercial rental agreements may be linked to Manx RPI. Economic Affairs is interested in other examples where Manx RPI is used as the benchmark and where the removal or recalculation of Manx RPI would cause issues, alongside information on the length of such agreements.

The Office for National Statistics, in its 2013 review of RPI, faced similar challenges. It concluded that it should not alter the calculation method of RPI and this decision was widely reported as being influenced by the likelihood of legal action from holders of UK public debt where the rate of interest was linked to RPI. These investors would have seen the value of their debt reduce if inflation expectations were lowered. As such, the UK is committed to producing RPI until such time as these debts are repaid. The Isle of Man does not have this issue, but there may be agreements linked to Manx RPI that would be impacted by any change and we would like to understand these before making any changes.

Finally, a number of statistics are deflated by Manx RPI to present "real" increase. GDP and average salaries are examples where changing the inflation assumption will change the level of growth reported, although it will make our reporting more consistent with elsewhere.

Options available

Economic Affairs consider there to be three broad options for changing the existing publication of CPI and RPI

- 1) Stop publishing RPI due to the limitations above and rely solely on CPI.
- 2) Continue to publish RPI but calculate it in line with UK RPIJ to remove the "formula effect"
- 3) Continue to publish RPI but publish UK RPIJ alongside it so that the formula effect can be clearly identified.

Option 1) would be clearest in terms of public understanding but may require re-negotiations of current agreements linked to Manx RPI.

Option 2) would remove the formula effect but would still disadvantage those who rely on the previous calculation methodology of Manx RPI, and would mean two indices continue. The "new" and "old" Manx RPI would not be directly comparable, but "new" Manx RPI would be comparable with Jersey RPI and UK RPIJ.

Option 3) could potentially increase confusion around the general level of prices, but would allow those linking to current Manx RPI to continue to do so.

The following organisations have been contacted directly in regards to this consultation. If you believe we should contact additional persons or organisations, please contact us.

Tynwald Members

Attorney General

Isle of Man Government Departments, Statutory Boards and Offices

Isle of Man Local Authorities

Isle of Man Creameries

Isle of Man Meats

Isle of Man Law Society

Isle of Man Chamber of Commerce

Isle of Man Employers Federation

Isle of Man Society of Chartered Accountants

Unite Union

Businesses supplying prices for use in the inflation statistic

Estate Agents based in the Island



This document can be provided in large print or audio tape on request