Why it's so hard to measure inflation. By Tim Harford

The official inflation rate tries to compare the price of a typical bundle of goods today with that of a typical bundle of goods in the past. But we do not consume the same goods today as we did in the past. How many Walkmans in an iPod? The question has no sensible answer, but an answer, nevertheless, is codified in the official inflation rate.

You can be forgiven for thinking that this is an irrelevant intellectual game. You will not, of course, be thinking that if your pension or salary is linked to the inflation rate.

In recent years, received wisdom among economists has been that the inflation rate has been overstated because of unmeasured improvements in quality. Home computers have not only become cheaper but dramatically better, and failure to fully adjust for the quality improvements would overestimate the inflation rate and underestimate how much better off we are compared with previous generations.

A highly influential paper by Yale economist William Nordhaus made the point forcefully. He studied not commodities like bicycles or...
spoons but a service: light. By tracking lighting technology from campfires to oil lamps to today's energy-saving light bulbs, he estimated that the real price of light had fallen 10,000-fold in 100 years. Partly because of Nordhaus' work, many economists believe that the official statistics on wages underestimate how much richer we have become.

Light and computers are getting better at a rate unmeasured by inflation figures, but perhaps those figures err on the other side for different products. Economic historian Robert Gordon thinks that the focus on high-tech goods has distracted attention from two very important products for which inflation is higher than the official figures show. Women's clothes, for example, command high prices at the beginning of every season, before finishing the season in the bargain bin and being replaced by new fashions, once more at high prices. It would be easy for a statistical analysis to mistake that pattern for a year-in, year-out dramatic fall in the price of women's clothes. My wife testifies that they are not as cheap as I seem to think. Gordon, a little more scientifically, used detailed listings from catalogs to measure both price and quality of clothes.

Many economists still think that inflation is overestimated and we have therefore been getting richer faster than the official statistics show. But Gordon must have a point: If we have been getting rich that quickly, then our ancestors were impossibly poor. Gordon calculated that if the recent estimates of price bias are projected backward, Bruegel's peasant household would have had an income of less than $6 a year and been able to afford less than an ounce of potatoes a day back in 1569. That would have made for a different picture.

The Undercover Economist appears on Saturdays in the Financial Times Magazine.

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Last year, Daniel Gross argued that rich people are inflation's true victims and last month he found that globalization is actually driving inflation these days. In 1999, Steven E. Landsburg cursed grade inflation while Jordan Ellenberg came to its defense in 2002.

Tim Harford is a columnist for the Financial Times. His latest book is The Undercover Economist.
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Remarks from the Fray:

The inflation rate differs greatly by socio-economic class, and the government makes no attempt to consider this. Coming up with a consumer price index mean selecting a "basket of goods" and tracking what happens to the cost of buying that basket over time (with various statistical tricks used to tinker with the makeup of the basket, based on the relative prices of the individual items in it). But the obvious question is WHOSE basket do you work with. The basket of the average consumer will differ from that of the median consumer, and the basket of someone at the 10th percentile will differ greatly from the basket of someone at the 90th.

I'm an upper-class guy, so, for me, inflation hasn't been too bad in recent years. The percentage of my total income eaten up by healthcare costs, gas and heating costs, food, clothing, and energy is relatively low, compared to what one might see for a much poorer person. Meanwhile, I spend a fair amount on the luxuries and vices of the rich: high tech toys, big-screen TVs, exotic cruises, and personal services (like having other people plow my driveway). The prices for those things has mostly been falling in recent years -- I can get a much better big-screen TV today for what I would have paid in 2001, and income stagnation for the working class means I can hire them a bit more cheaply than in the past. For me, the inflation rate might actually be negative... or, at least, fairly low.

But, if I were a much poorer American, inflation would have been eating me alive in recent years. Healthcare costs have been spiking dramatically. If that were a big component of my overall purchases in a year, as it is for poorer people, it would be a huge driver of my own inflation rate. Same with gas prices -- if figuring out how to pay to fill up the car were a major component of my budgeting challenge, then having gas prices jump from $1 to $3 in a decade would be a brutal challenge. Meanwhile, all those drops in the price of electronics wouldn't mean nearly as much in my personal inflation rate: if I'm still using a TV I bought in the mid-90s, because I can't afford to upgrade, it doesn't much matter to me what has happened to TV prices and quality in the intervening years. And, of course, the falling cost of personal services is no advantage to me if I'm more likely to be the provider of such services than the consumer of them.

In some situations it makes sense to come up with an "average" inflation rate. But in others, it would make a lot more sense to tailor the "basket of goods" to what is actually being bought by the poor or the rich, rather than by your typical American. For example, when the thresholds for the poverty rate is calculated, they use an average CPI, rather than one that's relevant to the poor, which is just silly. Whether or not the "basket of goods" of a typical American is getting more expensive or less isn't terribly relevant to the question of what's happening to the "basket of goods" of an atypical American in the 10%-20% range of incomes, who might be falling into or out of poverty.

We'd be better served if the government came up with several CPI rates, not just urban/rural (as currently), but in five percentile increments by income class. Then apply the right inflation rate in the right situation. For example, if you index the estate tax exemption to inflation, use the inflation rate for the class that will actually be impacted by the estate tax, not the inflation rate for average people who aren't impacted in the least.

--Arkady

(To reply, click here.)

Let's all remember that a huge part in pursuing happiness for the average human is attempting to find good sex and/or fun/"meaningful" relationships. The problem is that regardless of how "rich" we get as a whole, that fact per se does not affect the cost of finding and engaging in sex/good/fun relationships.
You will always compete with other humans for this, and, if the average human is richer, then the humans you're competing with in general will also be richer, so richness per se becomes irrelevant to what is a big part of what humans view as pursuing happiness.

--Bouje

(To reply, click here.)

While economists might think we’re overestimating inflation, I think that people living and working in the contemporary American economy would probably differ with them on the point. Wage growth in America has been horrible for decades now and it’s been especially bad during the last five or so years. We’ve got record low unemployment but still not tightness in the labor market that is driving wages higher. The notion that we’re richer than we think seems like a bit of trickery that doesn’t jive with the real world.

--destor23

(To reply, click here.)

I recall a British saying about gin; Something like, "drunk for a penny, dead drunk for tupney." With the price of a good martini around $5.00 nowadays, THAT'S inflation. [...] I doubt that Bruegel's peasants even HAD any income, let alone $6.00/year. Most of the trade was barter, home-grown food, hunting, etc. Without a record of time spent on acquiring the necessities of life (food, shelter, clothing, energy) the comparison doesn’t make any sense.

--portorchardkid

(To reply, click here.)

No one cares how rich they are compared to their great great great great grandparents. I care how rich I am to how rich I was when I was 20, 30, or 40 years younger than I am now. That, I would argue, is what actually matters to humans - not economists, but real living humans.

In the last 25 years, higher education has become much more expensive. Housing has become much more expensive. Retirement has become much more expensive, etc. Although manufactured goods have become cheaper, and some have even become higher quality for less money, the big ticket items through life look like they have increased in cost at a much faster rate than the stated rate of inflation. When a single low level civil servant can support 5 people in 1970, and someone working at a similar level (buying old used cars, few clothes, cheap vacations) today cannot because of the high cost of housing and the high cost of college education and the high cost of health insurance, what happened? Did wages go down or did prices go up? Isn’t that the definition of inflation?

--Answer_grape

(To reply, click here.)

(5/27)