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Denying Inflation: Who, Why, and How

by Mason Gaffney

Henry George foreboded that landowners might take a growing wedge of the national "pie", or product. Labor's wedge might grow absolutely, as the whole pie grows, but still fall as a fraction.

It might even shrivel. In our times, George's grimmer scenario is coming true. Since about 1975, labor's wedge of the pie is shrinking as an absolute. "Real" wage rates have been falling since then. "Family wage" used to mean a breadwinner's wage high enough to support a family; now it means the combined wages of two adults. Many of these are "DINKS" (Double Income, No Kids) because that is all they can afford without cutting their customary material and educational standards.

The "real" wage rate is a ratio: the nominal money wage rate, divided by an index to the Cost of Living (COL). The higher the COL, the lower the real wage. Landowners cut into labor's share from both the top and the bottom, because the COL includes many products of land (like building materials and energy) and land itself (like homesites). Shelter costs are by far the largest part of household budgets.

The standard index to the COL is the Consumer Price Index (CPI), calculated and published regularly by the Bureau of Labor Statistics (BLS). This index is, we will see, a political football.

Henry George said little about inflation because it was not a threat in his day. That was a time of "hard money" and the gold standard. Prices were stable or falling; deflation was the great bugbear. Today, though, to check on George's forecast, we have to distinguish between nominal money wages and real wages.

An old folk song offered the following wisdom about survival in The Everglades: "If the skeeters don't gyitcha then the gators will." If the skeeters of life are nicks taken from money wages, the big gator is the price of buying and owning a home.

Why deny inflation? Those in power have several reasons to understate rises in the cost of living (COL), measured by the CPI.

To mask the fall of real wage rates. This is supposed to placate working voters. It is supposed to support orators declaiming that our standard of living is ever-rising, and we should all feel good. Actually, real wage rates have fallen steadily since peaking in about 1975. That is using the official Consumer Price Index (CPI) to measure rises in the COL. If the CPI understates rises in the COL, real wage rates have fallen even faster than the data show.

As a by-product, this denial of inflation supports those who like to dismiss Henry George as a false prophet of doom.

To mask the fall of real interest rates, making savers and lenders feel better, and more willing to lend to governments. In this age of massive and growing federal debts, the US Treasury depends on willing lenders more and more, to stay solvent.

To cut the real value of social security payments. This point is straightforward. These payments are also indexed to the CPI. If the CPI understates the COL, real social security benefits fall every year. Congress gets to spend the savings on wastes like Alaska's "bridge to nowhere", redundant imperialistic ventures, tax cuts for major campaign contributors, and no-bid contracts for the well-connected.

To cut rises in labor union and other wage contracts that are indexed to the CPI. The Federal minimum wage, like most state minima, is also indexed to the CPI.

To give the Federal Reserve Bank credit for having "tamed inflation", when in fact inflation of land prices is running wild.

A lesser point today, but important before Congress leveled out the rise of tax rates with income, is to slow the rise of income tax brackets, which are indexed to the CPI. Congress, briefly in a reasonable mood, enacted this sensible provision when enough people became aware that they were victims of "bracket creep". Bracket creep is when inflation boosts your money income into a higher tax bracket, although your real income has not risen.

However, if the true COL rises by 10%, while the CPI rises by only 5%, this provision no longer protects us against bracket creep. It just gives a talking point to those who claim to protect us. Sneaky! That is why you, dear reader, may have had a hard time following the bean under one of the three shells. Politicians are good at withdrawing promises. The sneakier the method, the easier it is for them to cover their tracks.

That is the "Why" of veiling inflation. Now let us look at the "How". There have been two major steps in recent decades.

First was removing the costs of buying and owning homes from the CPI. The Bureau of Labor Statistics (BLS), the agency that calculates the CPI, did this from 1983 onwards. They didn't remove it altogether; that would have been too transparent. Instead they substituted the "rental equivalent" of housing. This is supposed to be what your house would rent for, or what you would pay to rent a similar house. It is a hypothetical and casual figure — sloppy and unverifiable, in other words — based simply on questionnaires to a sample of homeowners. It takes no account of the fact that some people will, and therefore everyone must, pay a premium to own, because of expected higher future rents and resale values.

The "rationale" (cover story) for doing this is that a home is both an investment and a residence, and only the residence cost belongs in the cost of living. In fact, the annual economic cost of owning a home is the market value times the interest rate (plus the property tax rate, homeowners' insurance, depreciation, etc.). When prices are rising we may deduct annual gain from the cost, but when prices are falling we then must add the annual loss to the cost of ownership, and now that losses are becoming current, there is no thought of adjusting the CPI for that. If the BLS were constructing a true measure of the COL they would be on top of this point; but they do not balance their act. They seize on reasons to lower the CPI, not to raise it.

Thus the land boom of 1983-89 was mostly blanked out of the official published CPI of those years. The CPI rose gently as though the land boom never happened. Again, in 2004 housing prices rose by 13%, while these "rental equivalents" rose only by 2%.

*And can we believe that the price of access to recreational lands has advanced as slowly as other prices? In 1946 a summer family membership in the Dorset Field Club, Vermont, cost $100, giving access to the links, tennis courts, and clubhouse privileges for three months. Today there is no access for non-members. A membership costs about $30,000, by private negotiation, and annual dues were $3,000 in 2003. Meantime, in the big leagues, Donald Trump is asking $300,000 or so for a membership in Ocean Trails C.C.; and even Rupert Murdoch is complaining about the green fees at Pebble Beach, $450 for one round. I am grateful that I got my fill of golf when I was young and dad could afford it.

The CPI also takes no account of the price of extra land around some houses. It takes inadequate account of recreational lands, which now have displaced farming and forestry over whole counties and regions.*

The second major step was the Boskin Commission Report of 1995 (Newt Gingrich was dominating Congress), and its acceptance and implementation. Michael Boskin of the Hoover Institution was called upon to legitimize allegations that the CPI overstated inflation. He and his Commission obliged, and supplied the rationale for several rounds of trimming down the CPI even more.

The Boskin Commission's advanced methodology included a lot of old-fashioned cherry-picking. They accumulated evidence supporting the foregone conclusion, and omitted contrary evidence. Most tellingly, they were silent about the biggest factor by which the CPI understates inflation: that is the use of "rental equivalence" in place of home prices. Now, shelter costs are about 40% of consumer budgets, and hence of the true COL. To accept an extreme understatement of shelter costs, while distracting us with lesser factors and arcane methodology, shows bias.

Most professional economists, sad to say, treat Boskin's report as holy writ. They come on like preachers, salesmen, or just cheerleaders, not like scientists exercising independent judgment. I have recently surveyed 20 current texts in Macroeconomics. They all list the same four "biases", in the same order, that they allege make the CPI overstate inflation. These are:

Substitution bias. When the price of something rises, you use less of it, so it should be weighted less in the index.

Quality improvement bias. Products of the same name keep getting better, so they say.

New product bias. The CPI lags in showing how new gadgets raise our welfare. Microchip products, of course, are the example of choice.

"Discount bias". The CPI scriveners assume that products sold in discount stores are of lower quality, when they really are just as good, according to Boskin et al.
As to "a", above: when the price of food rises, elderly pensioners turn to cat food. Now the cost of fresh fruits and veggies counts for less in their cost of living. They have shown a preference for cat food, whose weight in the CPI should rise, and they are as well off as ever. Hmmm — something fishy there.

Let's examine point "b", above, quality improvement bias. The texts give some examples, but not a single counter-example. Here are a few of the latter.

1. Two-by-four dimensional lumber is no longer 2×4, but 15-20% smaller in cross-section, and of lower grade stock.

2. Salmon is no longer wild, but farm raised in unsanitary conditions, and dyed pink (ugh).

3. “Wooden” furniture is now mostly particle-board; “wooden” doors are now mostly hollow.

4. New houses have remote locations, far from desired destinations.

5. Ice cream is now filled out with seaweed products.

6. Airline travel is no longer a delight but a series of insults and abuses.

7. Gasoline used to come with free services: pumping the gas, checking tire pressure and supplying free air, checking oil and water, cleaning glass, free maps, rest rooms (often clean), mechanic on duty, friendly attitudes and travel directions. They served you before you paid. Stations were easy to find, to enter and exit. Competing firms wanted your business: now most of them have merged.

8. Cold fresh milk was delivered to your door.

9. Clerks in grocery and other stores brought your orders to the counter; now, many clerks, if you can find one, can hardly direct you to the right aisle.

10. Suits came with two pairs of pants and a vest, and they fitted the cuffs free. Waists came in half-sizes.

11. Socks came in a full range of sizes; shoes came in a full range of widths; the clerk patiently fitted the fussiest of customers.

12. Public telephones were everywhere, not just in airport lobbies. Information was free; live operators would often give you street addresses.

13. Public transit was frequent, and served many routes now abandoned.

14. Autos used to buy “freedom of the road”; now they buy long commutes at low speeds and rage-inducing delays. One must now travel farther and buck more traffic to

reach the same number of destinations. Boskin et al. dwell on higher performance of cars, and the bells and whistles, but rule out taking note of the cost-push of urban sprawl.

15. Classes keep getting larger, with less access to teachers and top professors, and more use of mind-numbing “scantron” testing.

16. Before World War II, an Ivy-league college student lodged in a roomy dorm with maid service and dined in a student union with table service, and a nutritionist planning healthy meals. All that, plus tuition and incidentals, cost under $1,000 a year (or, about $14.5K in CPI-adjusted 2007 dollars). Now, to maintain your children’s place and status in the rat race, you’d put out $40,000 a year for a claustrophobic dorm and junk food. On top of that, a B.A. no longer has the former value and cachet. Now you need time in graduate and professional schools to achieve the same status. Many students emerge with huge student loan balances to pay off over life, with compound interest.

17. Warranties on major appliances cost extra, aren’t promptly honored, and expire too soon. Repair services and fix-it shops used to abound to maintain smaller appliances. Now, most of them are throwaway.

18. Replacement parts for autos are hard to find, exploitively overpriced, and are often ersatz or recycled aftermarket parts

19. Musical instruments are mass-produced and tinny instead of hand-crafted and signed

20. Many new “wonder drugs”, if you can afford them, have bad side-effects, while old aspirin still gets the highest marks

21. A rising array of taxes and other payroll deductions stand between one’s nominal income and what it might buy. Income and social security taxes are not counted as part of the CPI.

22. Medical doctors once made house calls, in the dim mists of history. Since then, access has become progressively more difficult, until today … well you know, you’ve been there. In many small towns there is no doctor at all.

23. In 1998 the BLS dropped auto finance charges from the CPI. And certainly the largest cost of consumer credit, mortgage interest, has been removed by use of the "rental equivalent" substitute, with never a squawk from Boskin.

24. In 1995 the BLS eliminated an "upward drift" in the "rental equivalent" index, with no explanation. It is probably relevant that Congressman New Gingrich was in the saddle.

One could go on. Boskin et al. seem not to have considered counterexamples to their foregone conclusions. The BLS, succumbing to political pressure, keeps modifying the CPI to show less inflation, even while our daily experiences and shrinking savings tell us there is more. A 1999 study of the changes in the 20 years between 1978 and 1998 showed the cumulative effect of many changes had been to lower the CPI substantially (*Monthly Labor Review*, 6-99, p.29).

George warned that landowners might take most of the fruits of progress, leaving labor barely enough to survive. Critics have urged us, instead, to don rose-colored glasses. The rosiest of these is the CPI as manipulated to screen out bad news, especially news about soaring land prices. Let us be aware of who is manipulating the news, why, and how.