



Inflation: the Standard of Living, Real and Imagined.

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It is not hard to define inflation, as an economist would use that term. Inflation is depreciation in the purchasing power of the currency. It is present when a constant stream of nominal income, or a constant nominal net worth, will not secure as high a standard of living as it previously did. If Standard of Living comprises the goods and services that this world provides for us to use and consume, then inflation is the Cost of Living.

There is a tradition that prevails amongst those who purport to measure inflation – the Bureau of Labor Statistics – that their job is to measure a certain price index which is not and does not claim to be a measure of the cost of living. That disclaimer is quite accurate. The Consumer Price Index is not a cost of living index. To the degree that they diverge, however, the CPI is to that degree an irrelevant artifact because the only concept of inflation that has any economic significance is the cost of living. I raise this point because the CPI has become increasingly irrelevant and misunderstood. Let me expand on this theme.

What is the Standard of Living?

The standard of living is the sum total of all those goods and services that this world affords us mortals. Most of them could be classified under the broad heading of “Consumption opportunities.” The services that an automobile provides to a busy modern family, for instance, is one such consumption opportunity. The cost of living naturally includes the money cost of everything that goes into a given pattern of driving. Any increase in the money cost of the vehicle or the fuel or of repairs is inflation. On the other hand, driving more or driving a nicer car are not inflation. How that family actually uses its cars is not the Cost of living, it is the Standard of living.

There are other goods that we provide to ourselves that could not be classified as consumption, but whose cost belongs in the cost of living. Through our taxes we collectively cover the expenses of the public schools. This can not be counted as consumption because the tax levy is not a fee for service. The elderly, who no longer have need of or use for public schools, pay their share while the children who obtain all the services pay none. The cost of the schools is nonetheless part of the cost of living because the schools, and the education that they provide, are an integral part of the standard of living. However people wish to spend their money, as long as the money itself actually buys something, is a legitimate part of the standard of living. What I mean by saying “actually buys something” has to do with the logic of the allocation of resources. Since the schools have real costs – the teachers must be paid and the schools heated in winter – the public outlay is buying real resources, and the school system competes with all other economic activities for them. In effect, then, the standard of living comprises all those things and those activities that the households allocate money for. This allocation is a reality, but it is by no means entirely voluntary. Items that are financed by tax dollars impose an involuntary – though admittedly not necessarily unwelcome – allocation through the tax collections. The relevant definition of the household budget is pre-tax income, or pre-tax nominal wealth.

## The Paradox of Creative Destruction.

The paradox of creative destruction has tripped up nearly everyone who spends any time thinking about how we measure the National Income. It is simply this annoying question: We properly count new construction of homes in national income. More homes being erected equals more income being earned. If, therefore, our goal is to have high income, why don't we each year single out 20% of all existing homes to be demolished? The owners would have to rebuild them and that would generate more building activity. That is more income, isn't it? Or to put this in another context, why don't we cheer for tornadoes and earthquakes? While neither you, dear reader, nor I would be guilty of such shoddy thinking, a detailed analysis of the matter provides insight into what we mean by the Standard of living.

Our natural reaction is to deny that tearing down existing homes would actually increase national income, but that is not right. Other things being equal, the families whose homes were destroyed would attempt to build anew, and doing so would actually increase measured national income. There is no paradox here.

The paradox comes from confusing national income with the standard of living. Consider a family that has been rendered homeless. The services of their home were part of their standard of living; they were a consumption opportunity that the family formerly enjoyed. After the wreckers leave the premises however the opportunity is no longer available as it was. The family must instead dip into its current income or – more likely – its wealth, to regain what they already had. Thus we would judge that their Cost of living had increased with no corresponding increase in their Standard of living. Alternatively, if they do not rebuild, their standard of living has declined with no corresponding reduction in their cost of living. That for them is inflation.

Obviously, any single event and any single family do not have a measurable impact on any statistic that is intended to reflect what is going on in the society as a whole. The concept of inflation that matters to us is an average over the whole society. Casualty losses from natural causes do in total have a measurable impact. We do not ordinarily concern ourselves with accidental casualty losses because they occur at a rate that is fairly constant over time and that is in any case beyond our control, but in any case the national income accounts actually do adjust for losses. The money cost of casualty losses is deducted from income. In case the loss is insured, the sum received by the insured is not counted as income, while the outlay from the insurer is treated as an expense. Thus the income accounts do not overstate the standard of living.

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