



Hidden Inflation

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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, are 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 is 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 nothing. 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. In whatever way 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 in account of natural casualty losses.

## Inflation and Prices.

The Bureau of Labor Statistics does not attempt to measure the cost of living. Their brief is to track an index of the prices of goods and services that households purchase. That task has become increasingly difficult, and even problematic, over time.

Chairman Greenspan has addressed this issue many times, and my conclusion is the same as his.

There are some goods the definition of which remains fairly constant over time and that are sold directly to the public. Most foods are of this type. Some more modern conveniences are also easily priced. Kilowatt hours of electricity are in practice homogeneous, because regulation of the industry has standardized the terms of service. The average household spends only a very small portion of its pre-tax income to purchase such goods however. For many other goods, the price paid is also an indication of quantity or quality. The luxurious mansion and the humblest cottage may actually provide housing at the same price, defined as price per unit of effective service. Their selling prices are primarily an indication of quantity of service rather than economic price per unit of service. The B.L.S. is well aware of this, and it takes care to compare over time prices of equivalent versions of a thing. Since they are primarily interested in tracking change in the price level, it is not hard simply to monitor price changes of standardized units.

It is much easier for the economist to describe how prices should be measured than it is for the statisticians to actually implement it. There is no perfection in government statistics. Any residual deficiencies of the price indices are not however serious enough to raise the specter of hidden inflation. We do a tolerable job of monitoring the trend of the cost of that part of our living that are bought and sold in markets. The larger problem is that this is a shrinking part of our standard of living. Taxes, which pay for a variety of goods that are provided through government at all levels, consume about the same share of household income as what we spend on goods that we buy.

#### Inflation in Public Goods.

Since goods and services that the government buys for the public are not priced they do not appear in any price index. They are nonetheless fully as susceptible to cost inflation as are private goods. Whenever the cost of public goods and the tax levy needed to finance them rise without a corresponding gain in the amount of service or in its quality there is inflation. More broadly, an increase in public outlays that has no commensurate increase in the standard of living is to that degree an increase in the cost of living.

While the prices of goods we purchase have been very steady for years, public outlays on goods like education have skyrocketed. It is obviously necessary to adjust for simple measures like the number of children being educated, but in fact that number has declined over time. Per pupil outlays have grown even faster than has the total expense. If we are not getting more education per pupil, the cost of education has risen. Hardly anyone would argue that our schools are significantly better than they were in the past. Our president would undoubtedly argue that they are not nearly as good, and many would rise to second him. It is not my purpose here to critique all the public services that we

receive from state and local governments, but I think few would assert that the quantity of public service has risen anywhere near as fast as has the cost, and that the difference is hidden inflation.

The entire ledger of public goods presents, it seems to me, rather less gloomy reading. Improvements in public safety, especially in cities, and the positive explosion of public amenities all have added immensely to our standard of living. The public outlays to pay for them have added to the cost of living. Where we collectively net out is something that I can not say.

### Money and Taxes.

In the days when most goods were private goods purchased in markets, prices were a good measure of the cost of living. Inflation was in those days a matter of too much money chasing too few goods, and that in practice it was caused by rapid and sustained growth in the money supply. Inflation was in those times purely a monetary phenomenon. The same holds true today for that part of household outlays, but the causes of public sector inflation are not as fully understood.

We know at least where to look. Assuming for simplicity that there is no change in the amount or quality of the public services provided, inflation is caused or permitted by whatever permits taxes to rise systematically over time.<sup>1</sup> As long as taxes merely grow at the same rate as price inflation – as long as the cost of public services rise only as fast as a price index – then we really have the usual sort of inflation. Certainly, as prices and wages grow in the private sector, wages will grow in the public sector and the cost of goods that the government buys will also increase. A tax increase that simply passes that cost squeeze along to the ultimate payer is only a byproduct of the price inflation. There is no problem of hidden inflation in that circumstance. By the same reasoning, the cause of systematic inflation is still excessive money stimulus.

Uniquely public sector inflation can arise only when taxes can rise faster than the rate of price inflation, or in other words, when the cost of public goods is rising faster than the cost of private goods. When the cost per pupil in school rises without any corresponding improvement in education, that is a symptom of mismanagement of the schools. In the 1960's, public education was hijacked and made to serve as a vast public works project. While educational goals were not consciously compromised, they were in effect subordinated to the higher goal of employing the maximum number of persons and of paying them as well as possible, subject to the public's willingness to pick up the tab.

Under what circumstances, therefore, can tax levies rise faster than the price level? Although our income tax is nominally progressive, with the result that the average

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<sup>1</sup> One special situation that must be allowed for as a transfer of some consumption opportunity from the private to the public sector. If the states were to begin to purchase medical drugs and to distribute them to the public at no cost or at a subsidized cost, taxes would rise but there would not necessarily be any increase in the cost of living.

tax rate should rise as money income rises, in reality the effect of progressivity is very small. The total levy from income and payroll taxes is nearly proportional to national income. Progressivity applies at the level of the individual taxpayer: those at the top of the income ladder pay the lion's share of all income taxes. It does not follow in practice, however, that if everyone got a raise, the average tax rate would rise. Many taxes are not progressive, social security being the most obvious example. The public at large, moreover, is sure to protest any broad tax rate increase, and to demand relief which returns the average tax rate to where it started. As a first approximation it is fair to say that taxes of activities, taxes of flows of income or spending, rise only as fast as income, and that they track price inflation rather than leading or causing it.

This leaves another entire category of taxes: taxes on wealth or on assets. The capital gains tax is one case of this. The real property tax that local government levies is another. The tax effect of price inflation is a third. Since the tax effect of price inflation is itself tied to the rate of price inflation, I will not dwell on it here, but will focus on the real property tax. The real property tax is a tax on the market value of land and structures. When market values rise, properties are reassessed, and unless the tax rate is lowered the tax levy rises. This dynamic is the only significant way in which taxes can rise faster than price inflation of goods, and rise faster than the money supply. This nation has experienced in recent years a rather astounding building boom, both for residences and for retail and commercial developments. At the same time, monetary policy has been fairly conservative and price inflation tame. The boom has in this case been financed by massive borrowing from overseas. The availability of money from outside the country drives real estate prices higher, without needing any contribution from domestic monetary policy. The logical sequence of events is therefore: foreign lending raises property values, higher property values result in higher property taxes, higher taxes pay for a high cost of public goods.

There is another, supplementary link between borrowing from foreign sources and public sector inflation. Since governments at all levels borrow from foreigners, the capacity to spend is not limited to the current flow of taxes. Domestic borrowing is not inflationary, because the purchasing power of the citizen who has bought a government bond is reduced by the cost of the bond. The result could be to shift the incidence of inflation from the private sector, where it is tracked by the B.L.S., to the public sector, where it goes unnoticed. In that case, the overall level of inflation would in fact stay the same, but measured inflation would fall because household expenditures would fall. Borrowing from foreign sources permits a net acceleration of inflation because it does not directly reduce household expenditures on private goods, while but the cost and the quantity of public goods increases.

Now, as I implied earlier, I do not assert that the total dollar cost of public goods has risen faster than the value of the public services. I do not know if there has been public inflation. Speaking as a committed curmudgeon, I am inclined to suspect that is the case, but it is purely a prejudice on my part. What we can conclude however is that inflation is Not merely or entirely a monetary phenomenon anymore. We have an example of a process by which the cost of living can increase – we can collectively spend

more on some goods – without any concomitant increase in the money supply. Any resulting inflation will necessarily, moreover, be hidden inflation because we simply do not track the cost of public services.

As I suggested above, the need to rethink inflation and its causes has arisen only because public goods now account for such a large component of total household outlays. In the laissez-faire economy of the 1920's, when our methods of tracking inflation were put in place, private expenditures were large and public ones small. Price inflation was essentially synonymous with inflation. That is no longer the case. If we as a nation are serious about measuring trends in our standard of living – which goes by the highly apocryphal name of “Real GDP” – we need to broaden our observations to include all goods and to assess their unit costs to the public.

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