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The AIER Cost-of-Living Guide

After moderating somewhat in 2006, the overall rate of price inflation accelerated in 2007 to its highest rate in 17 years. The Consumer Price Index (CPI) increased by 4.3 percent, compared with a 2.5 percent increase in 2006 and 3.4 percent in 2005.

The CPI has now increased every year since 1955. Looking further back, the purchasing power of the dollar has fallen dramatically—according to the CPI statistics, by over 95 percent—since 1913. That is the same year that Congress created the Federal Reserve System, which, as the Nation’s central bank, is supposed to “fight” price inflation.

In our view, this long-term erosion in purchasing power is likely to continue as long as the United States retains a fiat currency. All the currencies of the world today are fiat currencies—that is, currencies that promise to pay nothing except more of the same currency and that are legal tender (usable to extinguish debts and obligations) because their issuing governments say so. This system stands in sharp contrast to a gold standard, in which currencies are defined as

or redeemable in specific weights of gold. Fiat currencies derive their value solely from a government “fiat,” or decree, that they are legal tender.

The problem with fiat currency systems is that they lack the self-correcting mechanisms of a gold standard; if prices increase too much, there is no market mechanism to bring them back down. The historical evidence over many centuries and around the world suggests that governments tend to follow fiscal and monetary policies that foster higher prices. In the absence of a gold standard, there is little to restrain them from printing fiat money to excess. All the fiat currencies of the world have lost value over the years, and none is immune from the rot of officially-sponsored inflating.

Taking a Long View

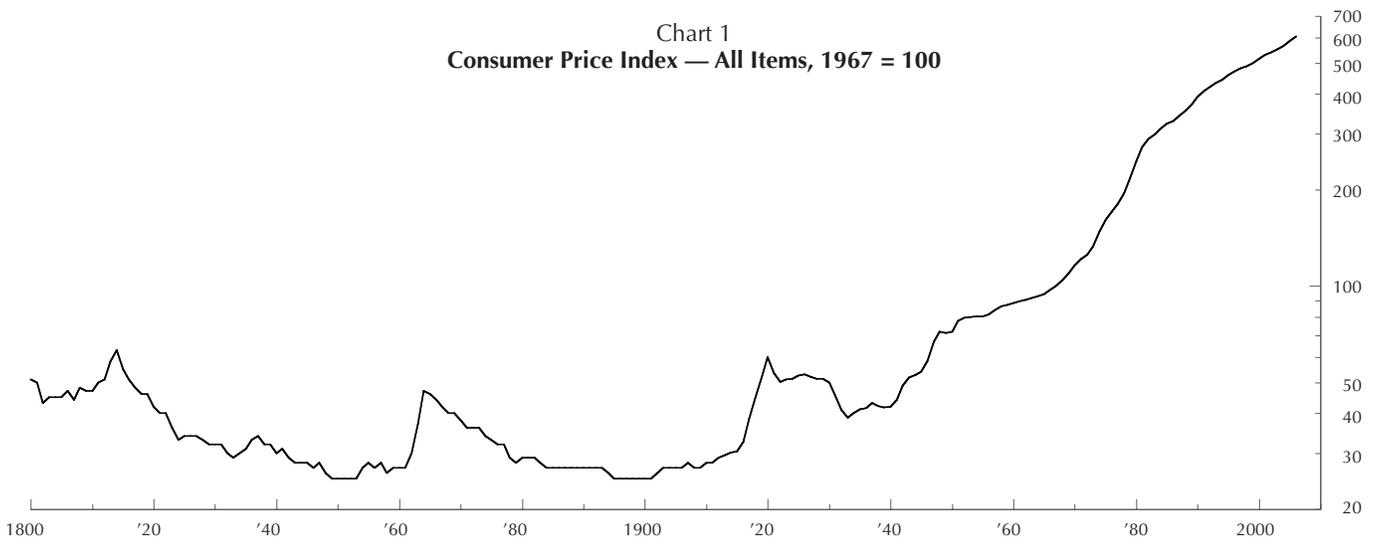
A review of the historical record provides a stark reminder of how ineffective the U.S. government has been at preserving the purchasing power of the dollar. As shown in Chart 1, for more than a century the general price level in the United States fluctuated

periodically in response to a series of wars and panics. From the Revolutionary War through World War I, wartime monetary excesses were followed by postwar decreases in prices. The sharp upturns in prices preceding the three peaks shown in the chart coincide with the War of 1812, the Civil War, and World War I.

During each of those episodes when the dollar’s purchasing power plunged, the currency’s redeemability into monetary commodities (gold or silver) at fixed rates was impaired. After convertibility was restored, prices began to return to their prior levels. From the perspective of modern experience, it may seem astonishing that *the price index in 1930 was exactly the same as it had been in 1801, 130 years earlier.*

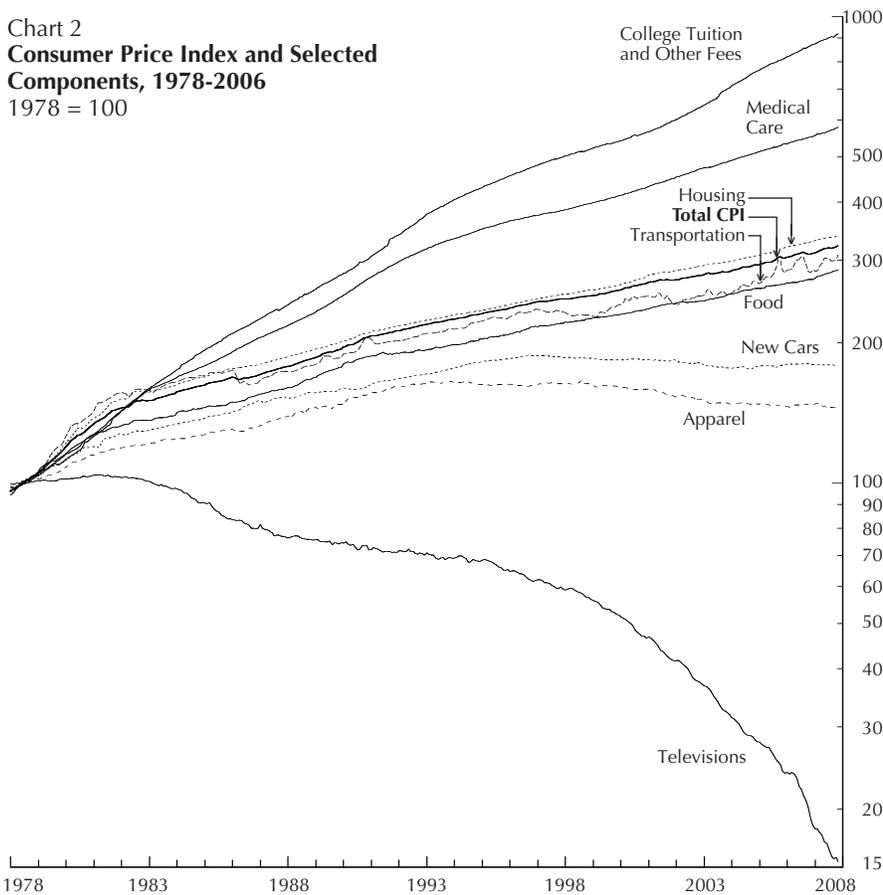
A sea change in the movement of the general price level followed the abandonment of the domestic gold standard in 1933 and the subsequent suspension of gold redeemability in 1971. As Chart 1 shows, the purchasing power of the dollar has eroded almost continuously since the early 1930s. There has been no reversal of the price trend

Chart 1
Consumer Price Index — All Items, 1967 = 100



Note: Prior to 1913 index largely is based on prices for goods rather than goods and services, and on wholesale rather than retail prices.

Chart 2
**Consumer Price Index and Selected
 Components, 1978-2006**
 1978 = 100



such as occurred previously when the dollar returned to convertibility.

Measuring Price Changes

There is, of course, no such thing as a “general price level.” Price indexes attempt to summarize the prices paid by millions of different individuals for the myriad goods and services produced in the overall economy. The CPI, the most widely used barometer of overall price inflation, was developed during World War I, when the unprecedented economic mobilization that was undertaken to meet the urgent demand for arms, munitions, and equipment led to rapid increases in prices, particularly in shipbuilding cities. This created the need for a cost-of-living index to use in wage negotiations. In later decades, as price inflation became chronic, the CPI was increasingly used to make cost-of-living adjustments to a wide range of contracts and payments, including wages, Social Security benefits, other government programs, and the tax code.

The CPI measures the change in the price of a “basket” of goods and services. The first step to calculating the index is to find out what people buy. The Census Bureau does this by surveying consumers. The survey currently used is believed to represent the

spending habits of about 85 percent of the population.

Hundreds of items are included in the CPI, covering spending on food, transportation, household operation, education, recreation, etc. When the prices of all these items are combined to construct a “general price level,” the price of each item is weighted according to the proportion of income that consumers spend on it. For example, people spend more on housing than they do on clothing, thus housing costs are given more weight than clothing in the CPI.

In actual experience, of course, people do not spend the same proportion of income on the same items every year. Tastes change. Moreover, in a dynamic economy such as that of the United States, new or improved products continually become available, while others become obsolete. To account for this, the CPI basket of goods and services is changed every few years to reflect new information on what people are buying. Even so, the index can have difficulty keeping up with innovations and changing tastes. Furthermore, the prices of new items often drop sharply after they are introduced (for example, iPhones) but, because new items are not added to the CPI for some time, the index misses these decreases, a factor that works to make the

CPI overstate price inflation.

In addition, shoppers often juggle their purchases to take full advantage of “good buys,” and thus are able to reduce their total expenditure. The index does not always capture this so-called “substitution effect.” It probably also fails to fully account for special pricing practices, such as rebates, senior or student discounts, frequent-flyer miles, and cash-back plans. Moreover, CPI price data are not collected on weekends or holidays, when stores have sales and many consumers shop. All these shortcomings tend to cause the CPI to overstate the impact of price increases on the cost of living.

Perhaps most important, however, the CPI may not be adequately adjusted for quality improvements. In theory, the index measures the prices of items whose quality remains constant over time. In other words, if a price increase for a good is accompanied by a comparable quality improvement, this increase should not affect the CPI. In practice, putting a price tag on quality changes can be tricky. If a new medicine costs \$10 more but it causes fewer side effects, how much of the price increase is attributable to this improvement? If the answer is “all of it,” the “constant quality” price has not increased at all.

Many economists believe that, on balance, the quality of goods and services has increased more over the years, especially over the very long term, than indicated by these quality adjustments. To the extent this is so, the CPI has overstated price inflation. However, the degree to which this has happened is still an open question.

Despite its shortcomings, the CPI is the best available statistical measure of changes in the cost of living, if that is described as the dollar outlays required to reach a given level of consumer satisfaction.

Some individuals contend that the Government intentionally understates the CPI. However, hundreds of Government economists, statisticians, and other number crunchers collect and process the price data that go into the CPI. A conspiracy to “cook” the data would be difficult to organize and impossible to conceal.

Recent Price Changes

Chronic price inflation even at “moderate” rates leads to significant losses of buying power over time, a fact often obscured by media reports that focus on comparatively small monthly or annual price changes. For example, during the past decade, the rate of price inflation averaged 2.6 percent per year—but this means that over the entire ten

years, the dollar lost roughly one-fifth (22 percent) of its purchasing power.

A breakdown of the CPI into broad categories of goods and services, as shown in Chart 2, reveals where price pressures were greatest during the past three decades. The prices of higher education and medical care have increased considerably faster than the overall price level, while prices for items such as clothing and, more dramatically, televisions have increased more slowly, or fallen.

The accompanying table shows a detailed breakdown of consumer prices, revealing the cumulative price changes in goods and services from the beginning of 1990 through the end of 2007. An eclectic mix of items leads the list, including energy products and educational and medical care services. At the other extreme, the prices of personal computers and related equipment have plummeted by 89 percent.

Those consumers who purchased relatively more of the items near the top of the table suffered a larger increase in their cost of living than that implied by the increase in the aggregate CPI. Those who spent more on the items shown near the bottom experienced a relatively smaller increase.

Prices are influenced by countless forces of supply and demand including technology, demographics, changing tastes, product innovation, international competition, and even the weather. However, government policies are another important source of price pressures, and it is notable that prices have increased the most for items that are heavily influenced by such policies: tobacco is heavily taxed, and large subsidies for education and health care have increased demand for them and thereby helped push prices upward.

The relationship between government policy and the costs of obtaining goods and services is not as simple as these examples might suggest. Myriad policies distort prices, and it is all but impossible to identify the relative impact of different, sometimes conflicting, policies.

In addition, government policies affect not only the prices of items but their availability. Policies that artificially limit price increases also tend to limit supply. When this happens, low prices do not necessarily reflect a lower cost of living, or a higher standard of living. Witness the long lines in the old Soviet Union for “cheap” goods, and the long waiting lists for medical services in countries with “low-cost” national health insurance.

In turn, rising prices do not always imply a corresponding increase in the cost of liv-

PERCENT CHANGES IN SELECTED PRICE INDEXES 1990 — 2007

<i>Item</i>	<i>% Change</i>	<i>Item</i>	<i>% Change</i>
Household fuel oil.....	258.4	Spices, seasonings, condiments, sauces....	51.8
College tuition and fees.....	229.2	Coffee.....	51.2
Cigarettes & other tobacco products.....	224.6	Bread other than white.....	50.2
Elementary & high school tuition & fees... ..	215.3	Eyeglasses & eye care.....	49.8
Hospital services, nursing homes, adult day care.....	206.3	Ham.....	48.9
Gasoline (all types).....	206.1	Distilled spirits at home.....	48.2
Educational books & supplies.....	163.1	Snack foods.....	48.1
Dental services.....	144.4	Sugar & sweets.....	47.3
Housing at school, excluding board.....	143.9	Frankfurters.....	46.7
Cable/satellite television & radio service... ..	141.8	Frozen vegetables.....	46.2
Oranges & tangerines.....	140.4	Wine at home.....	46.1
Tomatoes.....	139.0	Nonprescription medical equipment & supplies.....	39.4
Bank services, tax return preparation, other financial services.....	131.4	Pets & pet products.....	38.8
Funeral expenses.....	125.8	Housekeeping supplies.....	37.4
Legal services.....	125.1	Breakfast cereal.....	37.4
Water & sewer maintenance.....	119.3	Bananas.....	37.3
Lettuce.....	117.8	Stationery supplies & gift wrap.....	32.9
Motor oil, coolant, & fluids.....	117.1	Nonprescription (over-the-counter) drugs..	32.9
Garbage & trash collection.....	117.0	Pork chops.....	31.0
Prescription drugs.....	116.9	Shampoo, cosmetics, perfume, & other personal care products.....	27.2
Utility natural gas service.....	116.7	Sports vehicles including bicycles.....	23.3
Apples.....	115.2	Carbonated drinks.....	23.2
Out of town lodging, incl. hotels & motels	112.7	Frozen & freeze dried prepared foods.....	20.0
Bacon & related products.....	107.9	New trucks.....	17.5
Fees for lessons or instructions.....	107.3	Vehicle parts & equipment other than tires	15.1
White bread.....	98.6	Used cars & trucks.....	14.6
Physicians' services.....	98.5	Jewelry.....	14.4
Airline fare.....	97.4	Tires.....	14.1
Motor vehicle insurance.....	95.5	Women's footwear.....	13.8
Alcoholic beverages away from home.....	92.4	New cars.....	12.2
Public transportation within city.....	88.2	Laundry appliances.....	10.0
Potatoes.....	88.0	Public transportation between cities excl. airlines.....	9.5
Fresh whole milk.....	83.7	Furniture & bedding.....	9.2
Motor vehicle maintenance & repair.....	77.3	Boys' and girls' footwear.....	8.0
Fresh sweetrolls, coffeecakes, doughnuts..	76.9	Watches.....	6.2
Fresh cakes & cupcakes.....	76.0	Sports equipment.....	5.5
Rent of primary residence.....	76.0	Haircuts and personal care services.....	2.8
Beef and veal.....	75.0	Admissions to movies, theaters, and concerts.....	2.2
Crackers, bread, and cracker products.....	73.0	Infants' and toddlers' apparel.....	0.3
Butter.....	67.7	Men's suits, sport coats, & outerwear.....	-1.1
Postage.....	67.0	Men's footwear.....	-4.1
All-Items CPI.....	66.6	Men's pants & shorts.....	-6.4
Frozen and refrigerated bakery products...	63.8	Women's dresses.....	-7.5
Eggs.....	63.4	Women's outerwear.....	-13.1
Soups.....	63.3	Boys' apparel.....	-13.4
Food away from home.....	61.6	Girls' apparel.....	-14.5
Cheese & related products.....	59.5	Long distance in-state phone calls.....	-20.8
Cookies.....	57.5	Long distance out-of-state phone calls.....	-26.3
Newspapers, magazines, books.....	57.3	Clocks, lamps, and decorator items.....	-36.5
Telephone services, local charges.....	54.3	Photographic equipment & supplies.....	-37.3
Electricity.....	54.3	Toys.....	-40.0
Fish & seafood.....	53.9	Audio equipment.....	-43.3
Beer, ale & other malt beverages at home.	53.7	Televisions.....	-78.8
Margarine.....	53.1	Personal computers & other information processing equipment.....	-89.0
Ice cream & related products.....	53.0		
Poultry.....	52.3		
Rice, pasta, cornmeal.....	51.9		

ing. In this regard, the sharply higher prices that typically arise when countries abandon central planning can overstate the impact on their standard of living. The higher prices are offset, at least to some extent, by the freeing of time formerly spent waiting in line and a greater selection of goods and services. Similarly, in the United States, when the government removed price controls on petroleum in the 1970s, the long lines to buy gas disappeared.

Be that as it may, the larger point to be gained from the table is simple: no matter

what the politicians and monetary authorities say, the buying power of the dollar continues to decrease. Chronic price inflation even at “moderate” rates leads to substantial losses of buying power over time. In 1978, Federal legislation first explicitly directed the Federal Reserve to conduct monetary policy with a goal that included “stable prices.” Yet the CPI has tripled since then, suggesting that the purchasing power of the dollar has decreased by two-thirds. How much more purchasing power will our money lose in the years ahead? □

PURCHASING POWER CONVERSION FACTORS

To Convert:			To Convert:			To Convert:		
Past Dollars to 2007 Dollars use		2007 Dollars to Past Dollars use	Past Dollars to 2007 Dollars use		2007 Dollars to Past Dollars use	Past Dollars to 2007 Dollars use		2007 Dollars to Past Dollars use
Year	Multiplier A	Multiplier B	Year	Multiplier A	Multiplier B	Year	Multiplier A	Multiplier B
1920	10.3549	0.0966	1949	8.7016	0.1149	1978	3.1763	0.3148
1921	11.5697	0.0864	1950	8.5933	0.1164	1979	2.8526	0.3506
1922	12.3272	0.0811	1951	7.9653	0.1255	1980	2.5133	0.3979
1923	12.1110	0.0826	1952	7.8150	0.1280	1981	2.2783	0.4389
1924	12.1110	0.0826	1953	7.7565	0.1289	1982	2.1461	0.4660
1925	11.8341	0.0845	1954	7.6988	0.1299	1983	2.0793	0.4809
1926	11.7004	0.0855	1955	7.7275	0.1294	1984	1.9932	0.5017
1927	11.9022	0.0840	1956	7.6139	0.1313	1985	1.9247	0.5196
1928	12.1110	0.0826	1957	7.3700	0.1357	1986	1.8896	0.5292
1929	12.1110	0.0826	1958	7.1660	0.1395	1987	1.8230	0.5485
1930	12.4011	0.0806	1959	7.1168	0.1405	1988	1.7506	0.5712
1931	13.6248	0.0734	1960	6.9965	0.1429	1989	1.6701	0.5988
1932	15.1166	0.0662	1961	6.9263	0.1444	1990	1.5845	0.6311
1933	15.9306	0.0628	1962	6.8575	0.1458	1991	1.5205	0.6577
1934	15.4550	0.0647	1963	6.7679	0.1478	1992	1.4761	0.6775
1935	15.1166	0.0662	1964	6.6806	0.1497	1993	1.4332	0.6977
1936	14.8991	0.0671	1965	6.5745	0.1521	1994	1.3974	0.7156
1937	14.3818	0.0695	1966	6.3919	0.1564	1995	1.3589	0.7359
1938	14.6878	0.0681	1967	6.2005	0.1613	1996	1.3199	0.7576
1939	14.8991	0.0671	1968	5.9511	0.1680	1997	1.2903	0.7750
1940	14.7927	0.0676	1969	5.6430	0.1772	1998	1.2705	0.7871
1941	14.0883	0.0710	1970	5.3376	0.1874	1999	1.2431	0.8045
1942	12.7054	0.0787	1971	5.1135	0.1956	2000	1.2027	0.8315
1943	11.9710	0.0835	1972	4.9545	0.2018	2001	1.1694	0.8552
1944	11.7669	0.0850	1973	4.6644	0.2144	2002	1.1512	0.8687
1945	11.5054	0.0869	1974	4.2008	0.2381	2003	1.1255	0.8885
1946	10.6204	0.0942	1975	3.8494	0.2598	2004	1.0963	0.9121
1947	9.2869	0.1077	1976	3.6397	0.2747	2005	1.0604	0.9430
1948	8.5933	0.1164	1977	3.4175	0.2926	2006	1.0273	0.9735
						2007	1.0000	1.0000

How to Convert Past and Present Values

The table above provides a simple way to convert values from the past into their equivalent value today (or vice versa). To convert a value from a particular year in the past to its 2007 equivalent, simply multiply the original price by the conversion factor **Multiplier A** shown in the table for the appropriate year.

For instance, say you want to know if

the value of your house has “kept pace with inflation.” Multiply the original price of the house by the Multiplier A factor shown for the year you purchased it.

Example: A house was purchased in 1965 for \$25,000. Adjusting for price inflation, this price in terms of 2007 dollars is $\$25,000 \times 6.5745 = \$164,363$. This is approximately how much the house would have to sell for today just to keep up with

price inflation.

To convert 2007 dollars into past dollars, simply multiply today’s dollar amount by the conversion factor **Multiplier B** shown in the table for the appropriate year.

Example: If the price of a movie ticket is about \$7.00 today, what was the constant-dollar equivalent in, say, 1974? Today’s \$7.00 purchase price in terms of 1974 dollars is $\$7.00 \times 0.2381 = \1.67 .

Use the
Cost-of-Living Calculator
at our website:
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