

## Price Inflation: Are the Statistics Lying?

*The rate of price inflation remains moderate, according to the official CPI data. However, some economists believe that, due to new statistical adjustments, the CPI may be understating price inflation. The debate over these adjustments has political overtones, because increases in the CPI have a huge impact on the Federal budget.*

The Consumer Price Index (CPI), the most widely followed barometer of price inflation, increased by 3.2 percent over the past 12 months. That the official data suggest the rate of price inflation remains moderate may seem like welcome news, yet many readers may find it difficult to reconcile the reported figures with their personal experience.

The price of regular gasoline has increased by 40 percent in the past year. Heating oil is up 70 percent. Tuition at public universities rose an average of 10 percent this year, and private universities and community colleges increased their tuition by six percent and nine percent, respectively. The premiums, copayments, and deductibles for many health insurance plans have increased by double digits, and in January the monthly Medicare premium will increase by 17 percent.

Why is there such a gap between the CPI data and personal experience? And are the official figures accurate?

The answers matter a great deal, because the CPI is used to make cost of living adjustments to wages and private contracts, and it also influences the Government's monetary and fiscal policies. If the reported rate of price inflation is low, the Federal Reserve can follow a more expansionary monetary policy and keep interest rates low. And a smaller increase in cost-of-living adjustments to Federal programs and the tax code has a multi-billion dollar impact on the Federal budget. It slows the growth of spending and raises more tax revenue, which, in turn, reduces the budget deficit and slows the growth of the national debt.

Given the high stakes, can the Government be trusted to measure price inflation accurately?

### *Are They Cooking the Books?*

Some people think the reason the official data seem too low is that the Government intentionally understates the rate of price inflation. 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.

However, the calculation of the CPI recently has taken on a political overtone. This politicization began in the mid-1990s, when Federal Reserve Chairman Alan Greenspan testified to Congress about price indexes. He said that most price indexes tend to overstate inflation, and that the CPI probably overstated it by at least one percentage point annually. He added, "I can think of no better area for additional research than in the construction of price indexes, in part, because of the widespread extent of indexation in the Federal government's accounts."

The Senate then held hearings on the accuracy of the CPI and appointed a commission to investigate the extent of any statistical bias in the index. From the start, however, the deck was stacked in favor of a finding that the CPI overstates price inflation. The Boskin Commission (named for commission chair Michael Boskin, the former head of President George H.W. Bush's Council of Economic Advisors)

was established with the goal of finding ways to reduce upward bias. The economists chosen to serve on it had already testified that the CPI was strongly biased upward. Economists who questioned whether the CPI overstates price inflation (admittedly a minority) were not asked to serve.

The Boskin Commission concluded that the CPI overstates price inflation by about 1.1 percentage points per year—in other words, just about what Greenspan had suggested. The Commission also projected that correcting this overstatement could reduce the projected future level of the Federal debt by over \$1 trillion over 12 years.

The Commission also recommended that if the CPI could not be made more accurate, Congress should reduce cost-of-living adjustments to correct for the bias. For example, if the CPI increased by 3.2 percent, Social Security benefits and tax brackets might be increased by only 2.2 percent.

Congress did not formally act on any of the Commission's findings. However, the statisticians responsible for calculating the CPI did ramp up their efforts to improve the index. The net effect, according to most economists, has been to reduce the CPI's upward bias. Indeed, according to some economists, the CPI may now have a *downward* bias.

### *When a Price Increase is Not a Price Increase*

The CPI measures the average change in the prices of goods and services purchased by urban consumers. Because the goal is to measure the effect of *price change only*, the quantities and qualities of the items in the CPI "market basket" are supposed to remain the same from one pricing period to the next. In other words, if you pay more for something because you are buying more of it—either a greater quantity or a better quality—then the price increase should not affect the CPI. For example, if the price of a car increases by \$200, but the car now includes \$200 worth of air bags as a standard feature, this should not count as a price increase in the CPI.

The problem for statisticians is that

*Season's Greetings and Best Wishes for the New Year*

estimating the dollar value of quality changes is a tricky business. Suppose the price of a television increases by \$100 but the new model offers a clearer picture and better sound. Are the improvements worth \$100? If so, the price of a “constant quality” TV—what the CPI measures—is unchanged. But how do you put a price on that kind of quality change?

Most economists believe that the quality adjustments used in the calculation of the CPI have long been inadequate, and that as a result the index has overstated the rate of price inflation for many years. The amount of the overstatement, however, is all but impossible to quantify. As the above examples suggest, placing a value on quality improvements requires more than statistical rigor. It requires judgment, which is often very subjective.

The new twist on this problem is that over the past decade the statisticians have become more aggressive about making quality adjustments. Some observers think they have gone overboard. If so, the CPI may now be *underestimating* the rate of price inflation.

The new “hedonic” adjustments (from the Greek word for pleasure) require statisticians to view an item in terms of the characteristics that give it value. They then “unbundle” these characteristics and estimate their dollar value, using sophisticated statistical models. For example, an increase in the processing speed of a computer would be assigned a dollar value. If the market price of a computer stayed the same when its processing speed increased, this would translate into a comparable reduction in its “constant quality” price.

The value of a faster processor is not easy to measure, however. It depends on how a person uses the computer. Are you typing text or are you running the latest video and audio software? The Bureau of Labor Statistics apparently assumes the latter. As financial writer James Grant puts it, a computer “like a piano depends on the individual at the keyboard: He may play the ‘Moonlight Sonata’ or ‘Happy Birthday.’ The implication of hedonic adjustment is that the computer-using workforce studied at Julliard.”

### ***The Impact of Quality Adjustments on the CPI***

Accurate or not, some of the hedonically-adjusted prices in the CPI have plunged: computers (down 70 percent in the past five years), television (down 46 percent), video equipment (-55 percent), audio equipment (-18 percent). Quality-adjusted prices for women’s apparel have decreased by nine percent since 1999, and the quality-adjusted price of a new car

## **How to Introduce Bias by Reducing Bias**

Economic data are always subject to revision, either because better data become available or due to improved estimation methods. Unlike other data, however, changes in CPI methods are only applied on a *prospective* basis – the previous data are not revised. This reflects the difficulty of doing so, as well as the fact that the CPI is widely used to make cost-of-living adjustments in private contracts and public programs.

This may lead to a bias in the reported trend of price inflation, even as the index is “improved.” Consider the following simple example. In period one, no adjustment for quality improvement takes place. The CPI increases by ten percent, but half the increase is due to quality improvement. Therefore, the reported CPI overstates price inflation, and the increase in a more accurate CPI would have been only five percent. In period two, the CPI is “improved.” The CPI would have increased 15 percent, but statisticians estimate that quality improved by eight percent, thus the reported CPI increases by only seven percent. As a result, the reported data show a decline in price inflation from ten percent in period one to seven percent in period two. However, the reported data show a decline in price inflation at a time when it is really accelerating. In this example, the “real” inflation rate increased from five percent to seven percent.

In practice, statistical refinements in the CPI do not always lead to lower estimates of price change; sometimes they result in higher estimates. Nonetheless, the risk seems to be rising that the CPI may be understating a pickup of inflation in recent years, even as the index is being improved.

has fallen by five percent. These decreases have helped offset large price increases for other items, such as health care (up 24 percent in five years) and college tuition (up 40 percent).

Health care prices are among the fastest growing components of the CPI—and, not coincidentally, many of them are not adjusted for quality changes, largely because it is so difficult to do so. Suppose the price of a pain-relieving drug increases by 10 percent but the new version has fewer side effects. Has its “constant quality” price increased by 10 percent? Or by somewhat less? Or has it actually decreased? In the 1950s, cataract surgery required a seven-day hospital stay. Now it is performed on an outpatient basis. How does one put a price on that kind of quality change?

The Labor Department is looking into changing the way it calculates health care price indexes. Given the enormous advances in the quality of medical care, the new indexes might show that the quality-adjusted prices of some health care goods and services actually have been falling.

### ***Implications***

Quality adjustments are one reason the CPI often differs from the price changes that people observe in the markets. After all, you still have to pay \$200 more for the car with standard air bags. The increase may not show up in the price index but it still shows up on your bill. This raises questions about using the CPI and

other price indexes to make cost of living adjustments. Cars, health care, and everything else that people buy still have to be paid for with money, after all. If the dollar price of an item increases but its quality-adjusted price index falls, would it make sense to reduce people’s money income based on this quality improvement?

There will never be a perfect price index. The deficiencies in the CPI reflect the enormous difficulty of constructing an accurate index, rather than any intentional effort to distort the numbers. The vast majority of statisticians and economists have no hidden agenda behind their efforts to improve the index, even if they disagree about the more subjective nature of some changes.

Policy makers and the economists who advise them, however, *do* have an incentive to push for a certain type of statistical change—namely, anything they think will reduce upward bias in the CPI. They know that any such reduction can potentially save the Government billions of dollars in outlays and borrowing. They have less incentive to encourage changes that might reduce any downward bias in the index.

If the CPI inflation rate continues to creep up, expect more calls for such adjustments and more proposals to use “alternative” indexes to measure price inflation and make cost-of-living adjustments. If this happens, the gap between the official numbers and the prices that you observe in daily life is likely to widen. □

## YEAR-END TAX MOVES FOR 2004\*

*The end of the year provides an opportunity to make investment and tax decisions that will minimize your 2004 taxes and set the stage for making the most of tax-saving opportunities in the new year.*

As the end of the year approaches, many people become too tied up in the bustle of the holidays to think about tax planning. Yet even with the New Year around the corner, you still have time to take steps to help minimize your tax bite for 2004 and plan for the year ahead.

### **Weed Out Investment Losers**

If you are thinking of unloading some stock or fund shares that are worth less than you paid for them, doing so before the end of the year could help reduce your tax bill. First, use long-term losses to offset long-term gains, and short-term losses to reduce short-term gains. Apply any remaining long-term losses toward reducing short-term gains, and vice versa. If losses exceed gains, you may deduct as much as \$3,000 of losses against ordinary income this year, and carry over any losses you do not use this year into future years.

Under the Internal Revenue Service's "wash sale" rule, the loss deduction will be disallowed if you sell a security, then purchase another one that is the same or "substantially identical" to the one you sold. The rule applies to a 61-day period that spans from 30 days before to 30 days after the sale.

### **Maximize Retirement Savings**

The end of the year is a good time to review savings plans and retirement goals. Those with some extra cash on hand might wish to consider making last-minute 401(k) contributions for 2004 (assuming the employer permits it), while individuals planning for 2005 might increase salary deferral elections to reflect the new contribution limits.

In 2004, the maximum annual contribution for 401(k), 403(b), and 457 plans is \$13,000. It rises to \$14,000 in 2005. Investors that reach age 50 before the end of the calendar year can make additional "catch-up" contributions of up to \$3,000 in 2004, and \$4,000 in 2005.

The Individual Retirement Account (IRA) contribution limit is \$3,000 for 2004 and \$4,000 for 2005. The catch-up contribution limit for IRAs is \$500 for 2004 and 2005. Although IRA contributions for any given tax year can be made up until April 15 of the following year, you will

benefit most from the tax-free buildup of investment earnings if you invest earlier rather than at the last minute.

### **Delay Income and Accelerate Deductions**

If you expect to be in the same or lower tax bracket in 2005 as you are in 2004, it is usually advisable to defer income into next year and accelerate deductible expenses into 2004. You can do this in a number of ways:

- If you run a business, delay customer and client billings. By sending out bills in late December or January, you do not have to pay taxes until you collect the money next year. (Of course, you should not consider this strategy if you have reason to believe that such a delay would jeopardize timely payment.)
- Cut checks before year-end for deductible expenses. You can claim deductions for 2004 even if the checks do not clear until 2005.
- Pay deductible expenses by credit card. Payments made by credit card are deductible in the year they are charged, not the year they are paid. You can take the deduction for this year even if you do not pay the charge card bill until 2005.
- Prepay the balance of your estimated state tax liability before year-end, rather than waiting for the January 18, 2005, deadline, to secure the deduction on your 2004 tax return.
- Make a charitable donation. If you want to do this but do not have the cash, you can charge your gift to a credit card.
- Defer year-end bonuses to 2005.

Taxpayers should weigh any decision to delay income and accelerate deductions against other factors, such as the forfeiture of any investment earnings you may have made on amounts used to pay expenses. Anyone subject to the alternative minimum tax (see box) should also evaluate their strategy in a different light than those who are not.

### **Donate Wisely**

If you donate long-term appreciated stock or mutual fund shares instead of cash to a charity, you get to deduct the full market value of the shares. If you sell the stock first and donate cash, your contribution (and deduction) will be lowered

by the amount of the capital gains tax.

You can deduct your contributions only if you make them to a qualified organization. Ask any organization whether it is qualified, or check IRS publication 78, which lists most qualified organizations. Keep written acknowledgement of your gift, which is required for contributions of \$250 or more.

### **Time Mutual Fund Purchases**

Mutual funds are required to distribute their income annually and in the case of capital gains, funds typically distribute by December 31 at least 98 percent of their gains for the 12-month period ending October 31. Capital gain distributions are subject to federal income tax unless the fund shares are held in a tax-deferred account, such as an IRA or employer-sponsored retirement plan.

When a fund makes a distribution, its net asset value decreases by an equal amount. If you buy shares for a taxable account just before the distribution, you are liable for current federal income tax on those gains. Because mutual funds commonly make distributions toward the end of the year, investors are often advised to postpone late-year purchases of fund shares until after the fund has distributed its annual gain.

This rule-of-thumb is not cast in stone, however. Even if a shareholder purchases shares just before the distribution and pays taxes on the gains, the reinvested distribution increases his or her cost basis. In effect, this amounts to a prepayment of future taxes. Additionally, many mutual funds have distributed minimal gains since 2001, and are expected to do so again this year. Before you make a decision about a year-end purchase, check the fund's web site, which is likely to have information on distribution dates and amounts.

### **Make "Annual Exclusion" Gifts**

Under federal gift tax guidelines a donor may make non-taxable gifts of up to \$11,000 each year per recipient. These gifts are called "annual exclusion" gifts because they do not count against the donor's lifetime exemption from the gift tax (currently \$1 million). The annual exclusion is not cumulative from year to year, so it disappears after each calendar year.

If you have children or grandchildren who are 14 or older, you may wish to consider giving stock or other appreciated assets to them. Assuming the child is in the two lowest tax brackets, he or she will pay a five percent tax on long-term gains generated from the sale of the appreciated asset in 2005 through 2007. In 2008, the capital gains tax for the two lowest tax brackets falls to zero, then rises

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to 10 percent in 2009.

### Avoid Income Caps

Try to avoid exceeding the various income thresholds for tax breaks. This strategy is important if you are hovering around an income limit for certain tax credits, exemptions, or deductions. This year, for example, a deduction for college tuition is available to married couples filing jointly with modified adjusted gross incomes up to \$160,000, and single filers earning as much as \$80,000. Since the deduction vanishes if income exceeds the \$160,000/\$80,000 limits, "borderline" taxpayers paying for college expenses for themselves, a spouse, or anyone claimed as a dependent on a tax return might consider additional charitable contributions or other ways to reduce income so that they do not lose the deduction. (For more information on education credits and deductions, see IRS Publication 970.) Similar income caps that affect eligibility for tax benefits come into play for other items, including Roth IRAs, traditional IRAs, and Coverdell Education Savings Accounts.

### Buying or Donating Cars

If you are thinking of buying a car, consider a "green" one. A new Federal tax law allows individuals to claim a one-time deduction for the incremental cost of buying a motor vehicle that is propelled by a clean-burning fuel. The clean-burning fuel deduction is up to \$2,000 for certified vehicles first put into service in 2004 and 2005. The deduction will be limited to \$500 for vehicles placed in service in 2006 and no deduction will be allowed after that year. The Toyota Prius, Honda Insight, and Honda Civic Hybrid are all eligible for the deduction.

If you are thinking about donating a used car to charity, consider doing so in 2004 instead of 2005 or after. Until the end of this year, taxpayers who itemize their deductions may deduct the fair market value of a donated automobile. Beginning in 2005, they can only deduct the amount the charity receives once the car is sold.

### A New Sales Tax Deduction

Taxpayers who itemize deductions will have a choice of claiming a tax deduction for either state and local sales taxes or state and local income taxes on their federal tax returns for 2004 and 2005. The sales tax deduction was eliminated in 1986, and only income taxes have been deductible since then. Under the new rules, taxpayers cannot deduct both and must decide which of the two methods benefits them most.

The change will mean a nice tax bonus for individuals who live in states with no state income taxes, such as Florida, Wash-

ington, and Alaska. Taxpayers in states with low state income taxes, or who have made some major purchases, may also come out ahead by deducting the sales tax. To figure out which deduction works best for you, you can rely on receipts to determine how much sales tax you have paid over the course of the year. Alternatively, you can use IRS tables that will be included in tax return instructions. Sales tax paid on certain purchases, such as cars and boats, can be added to the amounts listed in the IRS tables.

### The Educator-Expense Deduction

A new tax law reinstated the educator expense deduction, which had expired at the end of last year, for both 2004 and 2005. Out-of-pocket expenses that educators paid for books or school supplies any time this year may qualify for a deduction of up to \$250. To be eligible, a person must work at least 900 hours during a school year as a teacher, instructor,

counselor, principal, or aide. The deduction is available whether or not the taxpayer itemizes deductions on Schedule A.

### Flexible Spending Accounts

Spend down your health-care flexible spending account balance at a drug store. The "use or lose" provisions of employer-sponsored FSA plans require that you spend every dollar you have set aside during the year for medical, dental, and other eligible expenses, or forfeit any money in the account that remains after December 31. Last-minute FSA spenders should note a Treasury Department ruling last year that makes many over-the-counter medications and drugstore items used for "medical care" eligible for flexible spending account coverage. Those deemed "merely beneficial" to someone's health are not. Allergy and sinus medicines, pain relievers, and cold medicines qualify, while dietary supplements or toothpaste usually do not. □

## Beware the Alternative Minimum Tax

The classic year-end strategy of delaying income and accelerating deductions may not apply if you are subject to the alternative minimum tax, or AMT. In fact, the opposite—accelerating income and postponing deductions—usually makes more sense for the increasing number of individuals and families subject to the tax. In 1987, only 140,000 taxpayers were subject to the AMT. Recent estimates suggest that around three million taxpayers will fall into its clutches in 2004, and if no further changes occur, 14 million people will be hit with the AMT by 2006.

The alternative minimum tax was created over 30 years ago, when wealthy individuals could effectively wipe the tax slate clean through liberal use of tax torpedoes such as questionable tax shelters. To close the loopholes, Congress introduced the alternative minimum tax. It was supposed to hit the rich by making them figure out their taxes the regular way, and then a second time at a lower rate without many of the deductions and exemptions otherwise available. They paid according to whichever method resulted in the highest tax.

The problem is that the rules governing the tax have been revised only sporadically and do not account for inflation and changes in regular income taxes. With lower income tax rates and over three decades of inflation, many middle-class taxpayers could well find themselves in alternative minimum tax territory soon. Those most susceptible include taxpayers who make ample use of federal tax deductions, credits, and favorable long-term capital gains rates on their regular tax returns. Another vulnerable group are individuals who have exercised an incentive stock option, since the difference between the exercise price and the market price of the stock must be recognized for AMT purposes in the year of exercise. If you think you may be subject to the alternative minimum tax, ask your tax advisor to do a projection for this year and next so that you can plan accordingly.

### PRICE OF GOLD

	2002	2003	— 2004 —	
	Dec. 12	Dec. 11	Dec. 2	Dec. 9
Final fixing in London	\$326.40	\$404.10	\$454.20	\$437.10

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