Published as “How to Re-write Economic History: The Boskin Commission,” Atlantic Monthly, April 1997.

HOW TO REWRITE ECONOMIC HISTORY: THE GREAT CPI FIX

Thomas I. Palley
Assistant Director of Public Policy and Economic Research
AFL-CIO
Washington, DC 20006

EXECUTIVE SUMMARY

The Boskin Commission reports that consumer price index (CPI) overstates inflation by 1.1 percentage points. This conclusion is based on the claim that the CPI suffers from sample selection bias. The Commission's findings themselves suffer from such bias, since all its members were already on record claiming the CPI was overstated, and the Commission failed to take account of evidence indicating CPI understatement of inflation. If accepted, the Commission's findings will impose lower wages and higher taxes on working Americans, and will lower social security benefits for the elderly. The Commission's popularity amongst politicians reflects the hope that it provides a technical and invisible means to deficit reduction.

Keywords: Boskin Commission, consumer price index, sample selection bias, deficit reduction.

HOW TO REWRITE ECONOMIC HISTORY: THE GREAT CPI FIX

In December of last year (1996) the Boskin Commission released its long awaited report on the consumer price index (CPI). The Commission reported that it believed the annual rate of inflation, as measured by the CPI, to be overstated by between 0.8 and 1.6 percentage points: its best estimate was that inflation is overstated by 1.1 percentage points. Oscar Wilde wrote "The only duty we owe to history is to rewrite it." In line with this aphorism, with one fell swoop, the Boskin Commission has rewritten the entire economic history of the last twenty five years. This is because their claim that inflation has been overstated means that the growth of the economy and real wages has been much higher than previously reported. In this fashion, the Commission has solved the problem of stagnating wage income which is now revealed to be a mere fiction. Far from experiencing a "silent depression", the Commission implicitly claims that American families have actually been experiencing a steady expansion of prosperity. Though they may not think it or know it, the average American family is far better off than a generation ago, and the prospects for generation X-ers are even brighter.

The political implications of this rewriting of history are enormous since it serves to defuse the criticism surrounding the American economy's miserable performance. In addition, the Commission's findings are being actively used to promote an economic agenda that will injure lower and middle income households. This agenda involves reducing wages and social security benefits, and increasing taxes on lower and middle income households. Given these implications, it is imperative that the Commission's findings be substantively examined before being accepted.

Unfortunately, the majority of the American economics profession appears to have uncritically accepted Boskin's findings. This is despite the fact that these findings implicitly make a mockery of the profession's own intellectual accomplishments. The fact that inflation, wages, and income have all supposedly been misstated, means that twenty five years of research has been conducted using incorrect data. This in turn means that much of this research, which purportedly confirmed the profession's theoretical claims, is no longer valid. Presumably, the profession is therefore now in need of a theoretical re-tooling.

Contesting the Boskin Commission's conclusions is a difficult task, and it has been rendered more so by the wave of headlines and sound bites that have touted Boskin as received truth. Moreover, it involves addressing some technical issues that can quickly strain the average person's interest. However, the matter is too important to be left undone. Put simply, the Commission's "cooking of the books" threatens to promote policies that will harm working Americans, and undermine the dawning consciousness that the American economy is no longer delivering prosperity for huge segments of society.

Some technical issues made simple

In arriving at their conclusions, the Boskin Commission cited four reasons for the CPI's mis-measurement of inflation. These were (1) Product substitution bias, (2) Outlet substitution bias, (3) Quality change bias, and (4) New product bias. The CPI is an index that measures the cost of a given basket of goods in which the quantity of each good is based on the amount that the average consumer was purchasing at the date the index was started. "Product substitution bias" emerges because over time consumers change the bundle of goods that they purchase, and consequently the bundle of goods that the CPI is tracking becomes no longer representative of consumer spending patterns. The Boskin Commission claimed that consumers have been substituting toward cheaper goods, and the CPI was therefore over-sampling expensive goods.

"Outlet substitution bias" arises because consumers have been changing the places at which they shop, and have been shifting from buying at high price department stores to lower price outlet stores. As a result the CPI over-samples high price department store purchases and understates lower priced outlet purchases.

"Quality bias" reflects the fact that products tend to improve in quality over time, and this means that consumers are effectively getting "more" product for their money. Not only may the CPI fail to capture this improvement in quality, but since improving quality sometimes adds to cost, it may also register quality improvements as price increases.

Lastly, "new product bias" arises because new products come onto the market, and are only gradually incorporated into the CPI basket of goods. Since prices of new products tend to fall rapidly shortly after they are introduced, this price decline is not captured by the CPI since new goods are not in the CPI basket at this early stage of their product life.

Why Boskin is wrong

The cornerstone of the Boskin Commission's findings is "sample selection bias" in the construction of the CPI: that is, the CPI basket of goods over-samples high price goods, and under-samples low price goods and goods whose prices are falling. There is a delicious irony in this claim of sample selection bias in that the Commission is itself the perfect example of such bias. This is because all of its members were already on record prior to the establishment of the Commission as saying that they believed the CPI to be overstated. At the same time, the Commission took no evidence from such well known economists as Janet Norwood, former head of the Bureau of labor Statistics (BLS), and Dean Baker of the Economic Policy Institute, both of whom believe the CPI to provide a correct reading of inflation. In effect, the Commission took account of all the evidence of over-statement, and ignored all the evidence of potential understatement of inflation by the CPI.

One of the more pernicious aspects of the Commission's report is its implication that the government's official statistics have been incompetently prepared. The reception that has been given to the Commission's findings makes it seem as if it has discovered a series of biases that the government's statisticians have overlooked. Nothing could be further from the truth. The BLS, which has responsibility for maintaining the CPI, has long been openly aware of all the different biases that Boskin has identified. Indeed, on the basis of its professional research, BLS already carefully and scrupulously makes adjustments to the CPI to try and root out these biases. Whereas the Boskin Commission conducted no new research, BLS has an on-going agenda promoting frontier research on the CPI.

There are two important implications from these observations. First, Boskin seeks to make adjustments to the CPI that will come on top of adjustments already made by the BLS. These supplementary adjustments push the claimed level of bias to levels which are simply implausible. Second, the Boskin Commission's findings have been reported in a fashion that creates a political climate in which the government's statistical agencies appear to be compromised. These agencies have a history of producing the finest statistical work possible, and continue to do so. If the economy is not producing the results we would like, cooking the books will not fix this objective reality.

Both the public and economists need quality data to comprehend what is happening within the American economy. Making the government's statistics the object of attack represents an attempt to fracture and cloud the nation's political and economic understandings. Obviously Boskin does not do this openly: however, this is the sub-text, and it fits with a conservative agenda that has long targeted government monitoring of the economy. Thus, in the 1980s, the Reagan administration cut funding for the collection of labor market statistics, and this led to the suspension of many data series the BLS maintained. The Reagan administration also cut back on regulatory supervision of the saving and loan industry, thereby contributing to the S&L crisis which has cost the nation a half trillion dollars. Many conservatives want to shrink government and take it out of the business of monitoring the economy. The resulting gap would be filled by business and TV, and it is not hard to see the direction of the bias in information and statistics production that would result.

With regard to the technical details of Boskin's arguments, Dean Baker has pointed out that the CPI may understate inflation. Some examples of understatement include the following. With regard to substitution bias, it fails to take account of the greater contributions for health care premiums and doctor co-payments that have increasingly been forced on American households as a result of the changing health care delivery system. With regard to quality bias, it fails to take account of increased traffic congestion which raises the cost of commuting. The CPI also fails to include the effects of increased crime which have lowered the quality of life for many.

Numerous examples of understatement are available, and given that the CPI already adjusts for almost all the biases identified by the Boskin Commission, one is forced to the conclusion that the Boskin's findings are implausible. However, tit-for-tat regarding what is included and excluded misses the real point, which is that the Boskin Commission has fundamentally misunderstood the economic information contained in the CPI.

Consumers do substitute across products as new products come into being and lifestyles change. However, the noticeable feature of current trends is the systematic substitution to cheaper products. This substitution is the outcome of the now widely recognized squeeze on ordinary household incomes. For example, suppose your child has just been accepted by Yale University, but you find you are unable to afford the fees; instead, she must attend Erewhon State College which is a lot cheaper. The Commission would point to this as an example of substitution bias, and claim that the CPI is overstating inflation.

Exactly the same argument applies to the issue of outlet bias, where consumers have switched from high price department stores to outlets because they can't afford department store prices. Indeed, ironically, the Commission may have completely misread the inflationary nature of outlet bias: to the extent that outlet stores provide inferior service, there is an argument that consumers have suffered a loss of quality so that outlet shopping has contributed to an understatement of quality inflation.

The Commission's reading of new product bias is also indicative of its misunderstanding of the purpose of the CPI. There are good reasons why the CPI does not immediately include new products. Such products are often extremely expensive when they first come out, and beyond the range of ordinary households. These products only become widely consumed when their prices fall. The CPI is intended to provide a measure of the cost of living for an ordinary household, and as such it should only include new products when they get widely adopted. To include new products before they are widely adopted as sugested by the Commission would be a step backward, and would actually make the CPI less useful as a measure of the ordinary household's cost of living.

The economic consequences of the Boskin Commission

So much for the technicalities of the Boskin Commission's findings. What would be the substantive consequences of adopting its recommendations? Aside from rewriting economic history (which is no small feat), a decision to restate the CPI to show lower inflation would have profound consequences for American families. Many employment contracts have explicit cost of living adjustment (COLA) clauses that link wages to CPI inflation. Lowering the CPI inflation rate would have an immediate negative affect on wage growth for workers with such contracts. Compounding this damage is the fact that rate of CPI inflation serves as a focal point for setting wages for workers who do not have employment contracts with automatic COLAs. Consequently, these workers would also receive lower wages. In this fashion, up and down the breadth of the nation, workers would suffer lower wages.

The economic harm to workers would not be restricted to wage cuts. Income tax brackets and the earned income tax credit (EITC) given to low wage workers are both indexed to the CPI. Lowering the CPI inflation rate would therefore lower income tax exemptions and push many middle class families into higher tax brackets. In effect, adoption of the Boskin Commission's findings would be tantamount to imposing a tax hike on lower and middle income families.

Another group that is particularly affected by the CPI are retirees. This is because social security payments are indexed to the CPI, so that lowering the CPI inflation rate would lower their social security income. The effects would be significant: social security is the principle source of income for 66% of the elderly, while it is the only source of income for 16%. Punishing the elderly in this fashion would be particularly cruel, since the CPI understates the inflation that they actually experience. This is because the elderly are large consumers of health care, and costs in this sector have gone up faster than the rest of the economy. Moreover, the elderly tend not to be consumers of new products such as computers which have trended down in price and lowered the CPI. In effect, from an elderly person's standpoint, the CPI under-weights health related spending and over-weights new products, thereby significantly understating the inflation they experience.

The politics behind the Boskin Commission

Given the questionable intellectual foundation of the Boskin Commission's findings, explaining its high standing in Washington D.C. requires a political perspective. Both Democrats and Republicans have been keen to see its recommendations adopted as they provide a potentially easy way to achieve deficit reduction. The fact that further deficit reduction is probably unneeded doesn't matter: the reality is that both politicians and the public think it is. In this case, the problem becomes how to achieve it. Raising taxes is unpopular, while government spending has now been so cut that there is little discretionary spending left. Spending on Welfare has already been raided: interest payments on the national debt can't be cut, and the public refuses to accept further cuts in government services which it values. Restating the CPI therefore offers an easy way out since it will lower social security payments via reduced COLAs and raise tax revenues through reduced exemptions. It doesn't matter that such a fix would harm lower and middle income households: the hope is that the CPI can be presented as a boring technical apolitical issue that voters won't notice.

For the Democrats, a CPI fix gets them off the hook of deficit reduction, but at the cost of another shameful desertion of the constituency they claim to represent. The Republicans are more fortunate: they are let off the hook of deficit reduction, while simultaneously advancing the interests of business at the expense of working Americans and the elderly. A CPI fix therefore fits with their wider objectives.

Whereas the deficit reduction dimension is clear and openly acknowledged, this other dimension is not. The debate over the accuracy of the CPI has been presented as technical and apolitical, and the Commission's recommendations have been presented as addressing a particular problem. When viewed in this light, its findings can appear restricted to a narrow problem. The reality is that the push to revise the CPI is part of a coherent policy agenda that seeks to lower wages, increase profits, and shift the distribution of income in favor of America's most wealthy. This agenda includes supply side economics, the accelerated development of globalized capital markets, the balanced budget amendment, welfare reform, and the withering of social security on the vine. Each of these policy measures can be made to appear as a self-contained response to a particular problem: in fact, they and the CPI fix are part of a unified strategy.

Further reading

Baker, D., "Revising the Consumer Price Index: The Changing-the-Yardstick Approach to Deficit Reduction," Economic Policy Institute Issue Brief, No.105, March 1995.

----------, "The Inflated Case Against the CPI," The American Prospect, Winter 1996.

----------, "The Significance of the CPI in Government Statistics," Economic Policy Institute, 1996.