The Daily Dish

Measuring Inflation and Poverty

DOUGLAS HOLTZ-EAKIN | MAY 7, 2019

Eakinomics: Measuring Inflation and Poverty

The Bloomberg headline is eye-catching — "Trump May Redefine Poverty, Cutting Americans From Welfare Rolls" — and suggests that the Trump Administration is pursuing a radical new anti-poverty initiative. Suppose instead the headline had been "Trump to Improve Accuracy of Federal Inflation Data." Would you have felt the same level of policy interest and intensity? As it turns out, these are the same thing, as the actual request was for comments on "Consumer Inflation Measures Produced by Federal Statistical Agencies."

At the heart of the issue is the possibility of moving from a conventional consumer price index (CPI) to the "chained" CPI to measure inflation. In a conventional CPI, inflation is calculated using a fixed basket of purchased items. Suppose that I consume only Diet Coke and Twizzlers, spending $63 to buy nine 12-packs of Diet Coke at $7 a piece and $63 to buy 14 2-pound bags of strawberry twists at $4.50 a pop. I spend equal amounts on Diet Coke and Twizzlers, so my CPI would apply equal, 50 percent weights to the prices of those products. My CPI would be (0.5 x $7)+(0.5 x $4.50) or $5.75.

But the real issue is measuring price increases. Suppose that the price of Diet Coke rises to $9 per 12-pack. My new CPI will be $6.75, which is 17.4 percent higher than before. Inflation is measured at 17.4 percent.

But when Diet Coke gets expensive, I'll be likely to shift away from Diet Coke to other products. Suppose that I react to the price increase by buying only seven 12-packs of Diet Coke and using the $18 to buy four more bags of Twizzlers. Now I'm no longer spending equal amounts on Diet Coke and Twizzlers. Instead, I'm spending 44 percent of my money on Diet Coke and 56 percent Twizzlers. The calculation of my CPI becomes (0.44 x $9) +(0.56 x $4.50) = $6.48.

A chained CPI inflation measure comes from "chaining together" the expenditure pattern for the base year ($5.75) with the new expenditure pattern for the current year ($6.48), yielding an increase of 12.7 percent. Simple enough, but here comes the politics.

A chained CPI approach shows lower rates of inflation because it places less emphasis on those goods and services whose prices are rising the fastest, because people are moving toward substitutes for those products. If inflation is measured to rise more slowly, the threshold for being in poverty will rise more slowly, and fewer people will be deemed to be in poverty. This is exactly the phenomenon highlighted by the Bloomberg headline. But it goes further than that. Any government benefit indexed to inflation — most importantly Social Security checks — will also rise more slowly. So using a chained CPI approach is simply an assault on the welfare state, right?

Not so fast. It turns out that the tax brackets are adjusted for inflation as well, and the Tax Cuts and Jobs Act (TCJA) moved to the chained CPI approach for measuring inflation. As a result, the cutoffs for new tax brackets will rise more slowly. For the same increases in income, more people will move into higher brackets and pay more taxes. So, in addition to gutting the welfare state, the chained CPI is a machine that feeds the insatiable progressive desire for taxpayer funds, right?

This is just silly on both sides of the ledger. The reality is that the chained CPI is simply a more accurate measure of inflation, not a political weapon. If the federal government is going to index its activities for inflation, there is no excuse for not measuring inflation to the best of its ability.