

The Rise of Undocumented Inflation

Quality deterioration, not factored into inflation statistics, means that we spend the same amount for inferior products.

BY MAROUN MEDLEJ, DONALD L. LOSMAN JANUARY 3, 2023



LIM HUEY TENG/AP PHOTO

A Honda technician works on an airbag during a free airbag replacement event in Kuala Lumpur, Malaysia, November 20, 2016.



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*This story is part of a Prospect series called **The Great Inflation Myths**, which takes on the dominant orthodoxies mainstream economists and the Federal Reserve have been*

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inflation calculations contain an understating bias, making inflation, at least in the manner it's commonly described, worse than the numbers suggest. University of California, Berkeley economist Emi Nakamura once noted that while economists “use these statistics, we don't always know very much about how they are constructed.” It is time to wake up. The economics profession and the Bureau of Labor Statistics (BLS), which produces the official inflation numbers, have missed the elephant in the room: massive quality degradation.

Conventional Wisdom

Toward the end of the 1960s, economists came to what is now an obvious conclusion. There has been a continuum of beneficial quality change for all sorts of products. The profession correctly embraced the notion that if the price of an auto rises by \$1,000, that is not necessarily inflation because now there is air-conditioning, seat

belts, and other amenities. More money for a better car does not confirm inflation. Inflation occurs when the same products and services cost more. To the profession's credit, economists both at the BLS and elsewhere have done an admirable job in researching and estimating quality improvements.

Alas, not so with quality improvement's evil twin—quality degradation, a process as overlooked as quality advances were in the early 1960s. Inflation means getting less for your money, which happens either when prices rise or when quality deteriorates. Either way, there is less bang for the consumer buck.

New Production Realities

Two long-standing forces—globalization and an increasingly service-oriented economy—strongly suggest that quality deterioration has been with us for some time, and is both extensive and increasing.

In a globalized world of intense price competition, one road to profits is to reduce quality. For buyers, quality is often hard to perceive until a product is purchased and used. And even then, if no fire has resulted from a low-quality heater or no furniture has crashed to the floor, consumers may be satisfied, but ignorant of the vulnerabilities until an issue occurs. Recalls of consumer products have been massive, in children's toys, pajamas, generators, mirrors, footwear, rugs, and food products carrying pathogens such as listeria and salmonella.

Imports from Asia, particularly China, have been found to be low-quality and often fraudulent. This past July, the Food and Drug Administration warned about tainted sexual enhancement products, weight loss items, bodybuilding pills, sleep medicines, and dietary supplements. Other examples include farm-raised Chinese seafood, lead paint on train toys, contaminated

Chinese seafood, lead paint on children's toys, contaminated pet food, and toxic toothpaste, not to mention Unilever's October 25 recall of shampoo products.

Longer global supply chains involve more participants, less supervision, and political vulnerabilities. Increased speed of operations and reduced inventories mean fewer opportunities for quality inspections. Low import prices do help keep official price indices down, but few adjustments are made for reduced quality.

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The same holds true for big-ticket items like automobiles, for which the number of recalls and the number of vehicles involved have mushroomed over the past 15 years. Indeed, on average every car on the road today has suffered a recall at least once. But with the exception of reduced auto warranties, almost no negative quality adjustments are made.

In mid-September 2015, the “Dieselgate” scandal was discovered, wherein Volkswagen purposefully installed devices that falsified emissions control numbers. Other European companies did likewise. And who can forget the Takata airbag debacle? Roughly 70 million Takata airbags have been recalled because they can explode when deployed (or cause harm by failing to deploy). Honda's September 2022 warning is clear: “Defective airbags can KILL or seriously injure you.”

Inflation means spending more for the same product or spending the same amount for an inferior product. In either case, buyers get less, often dangerously less, but quality failures are virtually ignored in official inflation calculations. This is what we call undocumented

inflation. And no one is spared. Last July, the Air Force announced that it was grounding all F-35 planes due to ejection seat problems. Quality deterioration is everywhere and must be incorporated—just as qualitative improvements are—in all calculations.

Products not only have a “use” value, but a time value as well. Price index calculations do not include time value. If the price of a car is \$40,000 and remains so in the next year, no price increase is recorded. However, if one must now wait two to five months for delivery, the real consumer cost is higher. Waiting for “out of stock” drug prescriptions is now also common—and could be fatal.

The Service Sector

The service sector reflects similar trends. Cost-cutting in services is widespread, especially in the recent inflationary environment. There is often no bread at restaurants unless requested; brokerage companies urge or mandate electronic statements and confirmations instead of mailing paper; supermarkets now charge for paper or plastic bags. Seating space in airlines has progressively and significantly declined, and the Postal Service has removed thousands of sidewalk mailboxes. Some major retail drug chains that had pharmacists seven days a week have now closed pharmacies on weekends, a 29 percent drop in prescription availability. None of these costs are reflected in price level measures. This is the time value issue once more.

Similarly, in the Washington, D.C., area, the typical wait time to get an appointment with an ocular plastic surgeon is two to three months. In Orlando, the waiting period is closer to five months for many specialists. Indeed, wait times for all sorts of American medical specialties have been increasing for years. And how about the nearly agonizing telephone waiting times for

customer service: “Press 1, press 2 ...” Rather than hiring more phone operators, wait time costs are imposed on users.

In the travel industry, for the first half of 2022 more than 128,000 airline flights were canceled, all unrecognized in official price level data. And a careful 2016 study found that “on average, hospitals with lower costs had lower quality and worse outcomes.” In finance, many banks have shuttered drive-in tellers, thus forcing longer wait times inside. Similarly, the Washington, D.C., metro system has for years experienced closed stations due to construction or repair, costing riders time as well as dollars for taxis. Once again, none of our price indices reflect such costs.

Conclusion

From 2010 to 2019, roughly 70 percent of the companies tracked by the American Consumer Satisfaction Index had “declining or flat customer satisfaction scores. Since then, American customers have become even more dissatisfied.” Clearly, quality degradation has been increasing and is everywhere, except in our official price level data. Accordingly, as bad as inflation seems, corrected calculations would make it even worse.

This type of inflation through quality deterioration is not new since the pandemic, nor is it something that the Federal Reserve can wipe away with higher interest rates. It is structural, and needs to be dealt with through more innovative BLS methodologies that incorporate quality degradation.

Without accurate numbers, important measures of productivity and economic growth cannot be properly assessed. In late November, the Social Security Administration, responding to recent official inflation numbers, raised payments to millions of pensioners. But

those increases may be seriously understated. It is far past time for correction: The elephant in the room must be exposed.

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