Episode 1,005: Are We Richer and Better Off Than We Think?

Guest: Jeff Herbener

WOODS: I read this article. I thought, *Herbener. He's got to tell me what the rights and wrongs of this thing are.* Feldstein was my economics professor for a couple of courses when I was at Harvard. He's still there. I'm not, of course. But I, you know, have still read him over the years, and I'm not really in sympathy with him most of the time. But this article I thought did raise some legitimate points. He's arguing that people's standard of living is actually better than government statistics make it appear, because you can buy new and better products at little or no extra cost, and the way the government measures real incomes doesn't take proper account of precisely what you can buy with your take-home pay. So he says when you're dealing with quality improvements, it's hard to incorporate a qualitative factor like that.

Now, in fact, I don't know if he mentions this, but he may. There are a lot of things in the age of the Internet that are given away for free, services that are free. Like apps you use on your phone that would have cost you a fortune to do, you can do for free on an app today. There's no way to capture that. Or he gives that example — I love this — the graphic from the Radio Shack newspaper ad from 1991 advertising 25 products or something. And every one of those products is something that a smartphone now does. You don't need this huge array of products. You have one smartphone that does all those things and more. So therefore, we ought not to be so pessimistic, because things are actually a lot better than the statistics would indicate.

So I think that's a reasonable overview of what he's saying, so let's start in — I know that that can be critiqued, but I'd like to hear if you can amplify any points in there that you think are valid.

HERBENER: Oh, sure, yeah. Like you, I agree with this basic thrust of his claim, but of course what he's done is he's picked out the production of particular goods where the market is much freer than in other areas. So here in consumer electronics where the market is much less regulated and interfered with by the state, we see this kind of progress. And of course we would see this kind of progress in other areas if the government would just keep their hands off in these areas. So he's being a bit selective, overly selective, but with respect to the set of goods that he's chosen, this is obviously true.

In fact, I think it's safe to say that the only way that we can get sort of objective evidence of what's happening to the standard of living, we can't rely upon government statistics. That's quite correct. But what we can do is just look at the way people live.

We just have to kind of have a general sense of what consumer goods people have to enjoy. Like you mentioned the free apps and so on. We just sort of have to list these things out and make a judgment as to what has happened to our standards of living because of these improvements that we're enjoying.

WOODS: I seem to recall there's something called — is it hedonics, where —?

HERBENER: Yeah, that's correct.

WOODS: Yeah, explain what that is, because that's a way to try to quantify quality improvements.

HERBENER: Yeah, this is one of the places where Feldstein's article in *The Wall Street Journal* is truncated. He really doesn't go into this in sufficient detail. He mentions one way in which the government officials attempt to adjust for quality, which is an interview method. They survey the manufacturers and ask them about quality changes. But it's also I think maybe even more common for the government statisticians to use hedonic adjustment, and this interestingly enough is done not directly in calculating GDP, but in calculating the price index that's used to determine real GDP. So that's the whole government statistics procedure, right? You add up the dollar value of all the final goods produced in the economy to get nominal GDP, but everybody knows that part of that increase would be just through changes in the money relations, just through monetary inflation making prices higher. And so you have to have a makeshift way of taking that out, taking out the price increase, price inflation effect, leaving you with what's called real GDP. And that's the statistic that's used to measure economic progress, and that's the statistic that Feldstein's criticizing.

So the hedonic adjustment is done in prices in the price index that's used to deflate nominal GDP to get real GDP. And what they do to — well, the price index itself has to be calculated by coming up with a market basket of goods and then, in order to isolate the price change effect, you need for this market basket to stay the same, not only in the particular goods, but in their quality. So if the quality of a good goes up and it fetches a higher price on the market, if you don't adjust for that, that would be reflected as a price inflation effect. And so that's what hedonic adjustment does. That's what the survey method is intended to do to keep the quality of the product the same in the market basket, even though the quality of the product has improved in the real economy.

And the hedonic adjustment does this by regressing changes in the price of the product against changes in measurable quality factors that are characteristic of the product. So for example, in a computer, the increase in price or the change in price would be regressed against processor speed and pixel density of the screen and these other objective features that would be somewhat of a stand-in for quality. And then — so this is all done to assess what part of the increase in price could be accounted for by changes in the quality factors, and then that part of it is taken out. The price of the product then is lowered by these quality-adjusted factors. And then all that remains ideally or hypothetically is the inflation effect.

WOODS: How well do you think that process works?

HERBENER: [laughing] Well, as Feldstein points out in criticizing the other technique, the problem with this is it's a production-side adjustment, whereas what we really want to know is the subjective value of the consumers. How valuable do the consumers actually see this quality improvement, because that's what's going to determine the upward movement of price. It isn't somehow embedded in the objective characteristics of the features.

So just to take a concrete example, the new iPhone X came out earlier this week and the price Apple's asking is $1,000. And the old iteration of the iPhone, the iPhone 7 was selling for something like $750. So that change in price would give us a better indication of the improvement in quality. We can this directly maybe from the market, because that $1,000 would be brought about by the increased demand the consumers have for the product given that it has these enhanced features.

WOODS: I mentioned earlier on — and I'm skimming the article now, so I can't remember if he's got it. But yeah, let's see. Okay, he says that "A basic government rule of GDP measurement is to count only goods and services that are sold in the market." And he says, "Services like Google and Facebook are excluded from GDP even though they are of substantial value to households." Well, I would go way beyond Google and Facebook. I mean, there are *so* many things. There is so much information I can get for free. There's the fact that I can now call anybody I want to for free, and that's partly because I either a flat fee per month for my phone, or I use Skype, and Skype to Skype is free. Skype to a phone is very inexpensive, but Skype to Skype is free all over the world. You remember how much it used to cost to call a place like Australia, much less India or whatever?

HERBENER: Yeah, outrageous, right

WOODS: It was just ridiculous. And then there were these long lags in the audio. There's no lag with Skype. You can have a normal, relaxed conversation.

HERBENER: Right.

WOODS: And if I sat here, I could probably make a list of 25 things that I value somewhere on par to how I value Skype, and they're all given to me for free. So again, that's got to be something in favor of the Feldstein thesis.

HERBENER: Absolutely, yeah. I completely agree with this. He's absolutely right about that. And as he points out, you can't capture this effect in the statistics precisely because the product's given away for free, and so it has no price and so it doesn't enter into GDP. And so that again is why you need to just sort of objectively list out what a person is able to enjoy in terms of the consumer goods. Just make a judgment really as to how we think our standards of living have changed, because the statistics could never account for this.

WOODS: I'm reminded, by the way — not that I'm really in the Koch orbit, but a few years ago, apparently it was one of the Koch brothers said something to *Time* magazine along the lines of, You know, it's a shame the way the statistics are gathered that if we were to go and take some of our missiles and bomb some places and then we would have to replace the missiles, that this would be viewed on net in the statistics as an improvement in GDP.

HERBENER: [laughing] Right.

WOODS: And the headline that *Time* magazine came up with was, "Koch says we can improve GDP by bombing." I mean, I kid you not, that's how they summarized that remark.

HERBENER: [laughing]

WOODS: That doesn't happen by accident. Like, you can't possibly be that stupid that you would summarize it that way. All right, so the problem with — See, I got this article over on EconomicPolicyJournal.com, which I read regularly. And there are some criticisms of the article in the comments, so I want to go over those and see if you think those are getting to the heart of what may be the shortcomings of the article. So for example, somebody says, Well, what about household debt? Maybe people can boast some gains in their standard of living, but if they're in debt up to their eyeballs, maybe it's not even a wash. Maybe it's actually retrogression. What about that? Is that a legitimate complaint?

HERBENER: Well, we'd have to account for that. I don't think it's legitimate on the face of it to say that. What needs to be looked at would be the equity that people have in the assets that they own. So that would in fact be important to notice, because the person would obviously be better off materially if they are building equity and not destroying it by excessive borrowing. But as long as the family had a debt load that was more than covered by the assets that they had acquired, then that's a reasonable strategy that they're building their equity and would also indicate that they're better off materially.

WOODS: Well, then another person says, Well, this is just "a shoddy assessment with no reference to stealth inflation." Is that the problem with the article?

HERBENER: No, I wouldn't say that that's the problem. I mean, this is another difficulty, right? There's always, as Mises pointed out, a non-objective character to forming price indexes, and so they can be manipulated of course politically to make it appear that we're not having as much price inflation as we might if we had a different market basket and so on, but we should be able just to look at what's happened to the market basket to see if there's any manipulation going on so we could identify sources of that.

By the way, just to give you the example on the hedonic adjustment — because the hedonic adjustment will lower the rate of price inflation, at least when it's done for goods whose quality is improving. And so when you adjust that, you're lowering the price that you use in the index. But that adjustment has been done for computer goods, consumer electronics dating all the way back to 1959. And so it isn't as if in 1980, they just introduced this hedonic adjustment and it's distorting the price index. In fact, the later adjustments that were made to hedonic price indices were made in the '90s for housing and clothing and things like that, where their prices go up. And so the clothing goes down — you know, their price is rising more than they should otherwise, and so they actually have — that hedonic adjustment actually increases the price index. So on balance, in fact, the hedonic adjustments, some prices down and some prices go up for quality adjustments, roughly balance out. And so on that ground, there doesn't seem to be any distortion introduced into price inflation estimates. Now, there may be other things that the government does that would distort it, but these are public information that we can look at and analyze.

WOODS: I sometimes have the sense that when you write an article like this — and we'll be a little bit more critical of it in a few minutes, but when you write an article like this, there's almost always some libertarian pushback, that they refuse to believe that things could actually be getting better because there's so much government, so they've got to find — so this must be a shoddy article. This must be bad. This must be careless and flawed. But to the contrary, maybe it's the case that the market economy is so resilient that it can still generate results even when under the influence of a substantial state apparatus.

HERBENER: Yeah, absolutely. You know, we have a bifurcated economy, where the government heavily interferes in health care and education and so on where we see quality declining and prices going through the roof, and then sectors of the economy where the government is basically hands-off. And there we see the quality improving, prices going down. We see the normal capital-accumulation, technological-innovation process of the market.

WOODS: All right, so we're going to get into this question of how we should assess whether or not our kids are going to be better or worse off than we were after we thank our sponsor.

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Before we go on, Jeff, there was one other complaint about the article, saying that if you're really going to claim that the incomes of the young will exceed — or at least the standard of living of the young will exceed that of their parents, you have to reckon with the fact staring you in the face that so many of these young people are living with their parents at the moment and living with them much longer. So it seems like if their prospects really were improved, that wouldn't be the case. Well, I don't know. That sounds like a legit point.

HERBENER: Yeah, it's true, right? There are lots of different factors, pro and con, as to what the trajectory of the economy's going to look like going forward. It's a little unclear. You'd have to do some more analysis to figure out exactly the state of affairs for millennials hanging out with their parents. Are they just worried about being underemployed? Have they gone through the government schools and been mis-educated in lines where there's no feasible job opportunities? Has the government rigged job markets in such a way that they're inflexible and can't accommodate more supply of labor? And so on and so forth.

So I think it is true that there are negative factors in the economy and there are positive factors in the economy, and we have to balance them out and see whether or not we think overall things will improve or whether overall things are on a downward trajectory.

WOODS: So if you, Jeff Herbener, were writing this article, maybe you would include some of these factors. Trying to sort out, given all the different possible angles from which we could look at this question about what is the standard of living going to be for the rising generation, yeah, I would want to include that sometimes government statistics conceal improvements in outcomes. But is there another side to this, that maybe is Feldstein being too optimistic? So how would you have balanced this all out?

HERBENER: Right. I think the only way really to do this in any systematic way is to think about the degree of freedom in the economy moving forward and the degree of integration of the world economy, the extent of saving and investing and the capital-accumulation process and the American economy as an outlet for that in the whole world economy. I don't think you can do this very effectively with government statistics, so we have to work the problem the other way around. We have to work on looking at the causal factors that are going to bring about the effect instead of trying to measure the effect.

If he wanted to try to measure the effect, it would be more direct and useful if he disaggregated the data. And the Bureau of Labor Statistics does this, right? They produce wages and income and then employment figures for various sectors of the economy and so on. And so one could look at that data and see what trajectories were in play in the different sectors of the economy and get maybe some sense of how sort of Middle America and job prospects look. But really, we're just left with this procedure of looking at — it seems to me, of looking at causes and then trying to anticipate the effects, trying to see what areas of the economy the government is interfering more heavily in. Is it more overall interference in the economy? Are there areas in the economy that are being freed up? And how this would all play out given that the American economy is in a world economy where other factors are going to play into this, like free trade and so on.

WOODS: Sometimes I hear it said that things were better in, you know, the '50s or the '60s or, heaven help us, the '70s. My immediate response to that is: if you could press a button and go back and live in 1978 and drive a Pinto and have no Internet and be typing on a typewriter and have extremely limited communications and have a whole array of goods not available to you at all and to lose the ability — any time you want to, "You know, there's an interesting clip I think I'd like you to see," and boom, you can just find it. You want to lose that forever? Go ahead. Press that button. Press it. If you think you're going to be richer, press it. I don't think people would. So I think this is a lot of bluster. I don't think they would. And the fact that they would not press that button means they are better off. Whatever the numbers say and whatever the Fed has done to harm us, that's a separate matter. If they wouldn't press that button, that means they're better off today.

HERBENER: Yeah, absolutely. As you suggest, it's like doing a thought experiment where we have a choice between enjoying the consumer goods that we have today as average, middle class Americans versus having the set of goods that a middle-class family would have had in the '50s. That's really the only way that we can tell whether we've progressed or not, is to just know what it's like to live with the consumer goods that we enjoy in one period versus another. That's the actual evidence that we have of whether we've progressed or not.

WOODS: So therefore, what would your assessment be when we're talking — Let's not talk about incomes, then, because even that conceals the real question, which is purchasing — and not even just purchasing power, because even purchasing power I think makes it sound like we can maybe buy more milk than we used to. But the kind of changes we're talking about are so much more significant than that. We can live lives that are, some aspects of them are almost inconceivable to people who lived before us. How would you assess — I mean, in a way, isn't this subjective? I mean, maybe there are people who would rather not have the Internet and would rather have bell bottoms and disco dancing. I mean, maybe there are people like that.

HERBENER: Right, yeah, this is the classic judgment of the historian, as Mises would put it. It does require an assessment by — hopefully an informed assessment by the economist as to the relative importance of these things. And as far as people who would rather not enjoy these goods, they can in fact do this. So here in Pennsylvania, we have big Amish communities, and they don't imbibe in these goods, and they live pretty much at a material standard of living as their parents and those before them. So you know, we're still free enough in this country to live with the set of consumer goods that we choose.

WOODS: Well, I think that pretty much covers it unless you think there's anything we missed?

HERBENER: No, I don't think so. I think that's the gist of it.

WOODS: All right, well, good, good. All right, well, thanks for doing that, because I read this article and I thought I think this might be interesting to try and hash this all out. So I'll link to the article itself at TomWoods.com/1005 for people who'd like to read it, and thanks so much, Jeff.

HERBENER: Oh, thank you, Tom. Always a pleasure.

WOODS: And I guess I should say, as long as I have you on: I will see you in New York City coming up October 6th to 7th. I think those are the dates. And it's going to be fantastic. It's the Mises Institute's 35th anniversary event. Amazing and great and wonderful. I've got it linked at TomWoods.com/events. And I'm looking forward to seeing you and so many wonderful people there. Judge Napolitano will be there, Ron Paul, Hans Hoppe. It's going to be amazing.

HERBENER: Absolutely. I'm looking forward to it too.

WOODS: Actually, wait a minute, wait a minute. Hold on a minute, Jeff. Wait a minute. Are you having your Austrian Student Scholars Conference at Grove City College next year?

HERBENER: I'm glad you brought that up, Tom. Yes, we have it on the schedule for February 16th and 17th, 2018. So as usual, we'll take submissions of papers from students working in the Austrian tradition in economics, political philosophy, and history and so on. They can submit their papers to me at Grove City College, just to my email. They can send a submission. And we go through a process of evaluating and accepting those papers. And yeah, we usually get 20 to 30 students that come, and we'll have a couple of keynote speakers. Dr. Guido Hülsmann has already verified that he'll give one of the talks, and we're still waiting on verification for the other speaker.

WOODS: All right, listen, everybody. If you are an undergrad — is it undergraduates and then early graduate students who can submit papers?

HERBENER: That's correct, Tom.

WOODS: All right, let me tell you about the significance of this. This gives undergraduates a very unusual opportunity that's normally reserved for graduate students and professors, which is to give a paper at a conference, which looks good on your resume, and it also gives you experience, important experience. And frankly, it's a great exposure of students to people like Jeff Herbener and the folks in his department at Grove City College, who are the best of the best when it comes to Austrian economics. Not only that — as if I need to appeal to this aspect of your nature, folks — but there are also cash prizes involved for the top three papers. And in fact, you remember there was one year where I mentioned the conference on my show and one of my listeners decided that sounds pretty good, and he showed up and he won the first prize? [laughing] It was so great, so great.

So I just want to let people know about it. It's really, really a great and important event. I mean, this is a way to bring young students into the Austrian world, and so I can't emphasize enough the importance of it. So if you have any interest in doing this, you have months to plan for it and get ready to present a paper. But it's a great experience. And plus, to hear a couple of great speakers, including Guido Hülsmann, fantastic. So definitely check that out. Now, you have a website but it doesn't yet have the 2018 details up on it.

HERBENER: Right, yeah, we'll get that updated as soon as possible, right.

WOODS: Okay, so I'll have some items — I'll have like one or two sentences about it at TomWoods.com/1005, including — should I put your contact information there if people want to propose papers?

HERBENER: That would be great, Tom. Thanks.

WOODS: Okay, we'll do that. So if you're interested in this, for now, go to TomWoods.com/1005, and then when the website for the event is up, then on that page I'll just link to that website. All right, anyway, now, Jeff, I'm sure we're done and I'll see you in New York. Thanks.

HERBENER: All right, thank you, Tom.