THE RESEARCH ROOM

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# The Ins and Outs of Inflation

Inflation has been in the news for the last several years. While most people understand that "inflation" means "things are getting more expensive," there are also many misconceptions about the term. What is it really? This article explores what inflation is and what it is not, common misunderstandings, and how businesses and consumers respond to inflation.

## Prices vs. inflation

Any discussion of inflation must begin with a clear distinction between prices and inflation. To calculate inflation, prices of a "basket of goods" purchased by a "typical" household are measured by the federal government and aggregated into an index.

The most well-known index is the Consumer Price Index for All Urban Consumers (commonly referred to as CPI-U and often shortened to CPI). Published monthly by the federal Bureau of Labor Statistics (BLS), the CPI "basket" consists of about 80,000 products meant to be a representative sample of the purchases made by the average urban household. "Inflation" is the percentage change in this index. In other words, inflation is the estimated change in prices facing the typical consumer. The change in the index is reported on a monthly and annual basis.

Perhaps because the CPI and inflation are discussed together so often, some use the two terms interchangeably even though they are not the same thing. While the CPI is an index that measures the price level, inflation measures the change in that price level.

The CPI, and its associated inflation rate, is the most well-known index, but there are others. For example, BLS generates several regional indices, and the Bureau of Economic Analysis publishes the Personal Consumption Expenditures Index and its associated inflation rate.

## Rising vs. falling inflation

Inflation numbers over the past several years highlight the common misconception between inflation and prices. Beginning in April 2021, year-over-year inflation started increasing, jumping from 2.6% during the March 2020-March 2021 period to 4.1% during the April 2020-April 2021 period. The year-over-year inflation rate peaked at 9% in June 2022. What did that mean in terms of prices? The CPI, a measure of prices, rose 15.2% over 26 months.

Since then, inflation has come down. As of September, annual inflation was at 2.4%. At times, we hear that "costs are coming down." But are they? Inflation has come down, but that simply means that prices are increasing at a slower rate. Over the 27 months since inflation peaked, the CPI rose 6.7%. In consumer terms, the typical monthly grocery bill that might have been $300 in April 2020 was $345 in June 2022 and $369 in September 2024.

## Responding to inflation

There are various ways, beyond paying and charging higher prices, in which consumers and businesses respond to inflation.

The first is referred to as substitution. A consumer might prefer to buy a name brand product such as Cheerios but may opt for a store brand cereal because of the price. Substitution is one reason that inflation is felt differently from person to person. Some consumers prefer specific name brands, some prefer generic brands, and some choose the cheaper option regardless of brand. In addition, some consumers have many substitution alternatives while others have few.

In periods of rising inflation, the prices of inputs that businesses use to produce their goods often increase as well. When these rising input costs are passed on to consumers, inflation goes up. Businesses have a few options to keep costs low despite rising input prices. The two most visible are "shrinkflation" and "skimpflation."

"Shrinkflation" refers to the reduction in the size of a product without a corresponding reduction in price. When companies use this method, they often try to shrink products with as little disruption to the package design as possible to not draw the attention of the consumer. For example, a jar of peanut butter has an indent on the bottom. Making the indent larger reduces the quantity of the product while not really changing the look of the jar. Other examples of shrinkflation may include a bag of potato chips with fewer chips or paper towel rolls with fewer sheets.

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Shrinkflation is not new. However, it has received greater attention over the last several years as consumers have become more aware of the practice.

Meanwhile, consumers buying a bag of chocolate chip cookies may not notice fewer chocolate chips on each cookie or more high fructose corn syrup and less regular sugar. These qualitative changes to consumer products are colloquially known as "skimpflation" — that is a reduction in quality to maintain current prices in the face of rising input costs.

BLS attempts to account for shrinkflation in the CPI by measuring the cost of a product based on weight, volume and other variables. Turning again to the peanut butter example: If the enlarged indent in a jar reduced the product weight from 16 ounces to 14 ounces, BLS would capture that price increase by measuring the cost per ounce, even if the price of the specific product stayed the same. However, BLS typically cannot measure the change in the quality of products, making skimpflation harder to quantify.

## Individual experience

As mentioned above, the CPI is a measure of average prices for the typical urban consumer. Yet, there is a common refrain that "statistics mean nothing to the individual." In the case of inflation, there is some truth to that.

Individuals and families purchase goods and services in different quantities. Purchases of a retired couple are much different from a young family. The former's spending may be more sensitive to medical costs while the young family is more sensitive to the cost of diapers and formula.

Location can also play a role in personal inflation. Prices and price changes likely differ between New York City and Milwaukee. Inflation in rural Wisconsin can differ from overall urban inflation.

While each individual and family experiences inflation differently, the price of consumer products will generally increase over time. Businesses will continue to address rising costs through price hikes, shrinkflation and/or skimpflation, and consumers will continue to respond by spending more, purchasing less or substituting one product for another. Yet, as the rate of inflation returns to a more "normal" level, these types of behaviors may be less pronounced. ■

*Forward Analytics is a Wisconsin-based research organization that provides state and local policymakers with nonpartisan analysis of issues affecting the state.*