Why CPI is not a perfect measure of cost of living?

Answer: CPI is not a perfect measure of cost of living because it has some biases.

The CPI may overstate the true inflation for four reasons:

New goods bias

Quality change bias

Commodity substitution bias

Outlet substitution bias

1. New Goods Bias

New goods that were not available in the base year appear and, if they are more expensive than the goods they replace, the price level may be biased higher.

Similarly, if they are cheaper than the goods they replace, but not yet in the CPI basket, they bias the CPI upward.

2. Quality Change Bias

Quality improvements generally are neglected, so quality improvements that lead to price hikes are considered purely inflationary.

3. Commodity Substitution Bias

The market basket of goods used in calculating the CPI is fixed and does not take into account consumers' substitutions away from goods whose relative prices increase.

4. Outlet Substitution Bias

As the structure of retailing changes, people switch to buying from cheaper sources, but the CPI, as measured, does not take account of this outlet substitution.

The bias in the CPI:

- Distorts private contracts,
- Increases government outlays
- Biases estimates of real earnings.

Therefore, it can be concluded that CPI is not a perfect measure of cost of living.