

Difference Between Cost of Living and Inflation

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Key Difference - Cost of Living vs Inflation

Cost of living and inflation are two terms that are often confused since they are used interchangeably. While they are somewhat similar in nature since both measure and compare prices, they are related to different economic conditions. Inflation is a [macroeconomic](#) condition that affects all parties in an economy while cost of living can be controlled by the mobility of resources. The key difference between cost of living and inflation is that **cost of living is the cost of maintaining a certain standard of living** whereas **inflation is the general increase in price levels in the economy**.

What is Cost of Living?

Cost of living refers to the cost of maintaining a certain standard of living (level of wealth, comfort, material goods and necessities available for a geographical region, typically a country). This is one of the primary indicators of economic prosperity in a country and is subjected to change over time. Cost of living is measured by the **Cost of Living Index**, a speculative price index used to measure the relative cost of living over time and countries. This was first published in 1968 and is available quarterly. This takes into account the price of [goods and services](#) and allows for substitutions with other items as the prices vary. Cost of Living Index also assists in comparing the cost of living among countries.

Cost of living index for a given country or region is calculated by setting another country or region's cost of living as the base, which is usually represented as 100. [Demand and supply](#) for resources in a geographical area directly affect cost of living.

E.g. On average, it is 35% more expensive to live in the UK than in Finland. Thus, taking the UK as the base (100), cost of living of Finland is 135.

Purchasing power parity (PPP) is another method of measuring the cost of living utilizing the differences in currencies. Purchasing power parity is an economic theory that states that the [exchange rate](#) between two currencies is equal to the ratio of the currencies' respective purchasing power. Therefore, the relative cost of living

varies among countries who use different currencies. This is a more complex method of calculating the cost of living compared to the Cost of Living Index.



Figure 1: Top 4 countries and their respective Cost of Living Indices in 2017.

What is Inflation?

Inflation is the general increase in price levels in the economy. Reduction in purchasing power is the main consequence of inflation.

e.g. If a customer has \$ 100 to purchase selected products in 2017, he or she will not be able to purchase the same amount of products with \$ 100 after 2 years since the prices would have increased by then.

Inflation is measured by the [Consumer Price Index \(CPI\)](#) and facilitates the measure of average prices of a sample of goods often referred to as a 'basket of goods'. Transportation, food and medical care are some of the main items included in the basket.

The highest inflation rate in 2016 (compared to 2015) was experienced by South Sudan (476.02%), Venezuela (475.61%) and Suriname (67.11%) Some economies experience abnormally high Inflation rates for a significantly longer period of time. This is referred to as 'Hyperinflation'; this can be considered as the main contributor to a long-lasting economic recession.

High inflation rates can prove to be detrimental to any country if risen to uncontrollable levels. Shoe leather cost and menu costs are two primary costs of inflation.

Shoe Leather Cost

This refers to the time spent because of having to shop around looking for alternatives to purchase goods at the best price since the prices are high.

Menu Cost

Due to high inflation, firms must change their prices often in order to keep up with economy-wide changes, and this can be a costly activity. The term is derived from the fact that firms such as restaurants having to continuously print new menus to reflect the changes in prices.

The opposite of inflation is termed as [deflation](#) and this happens when the prices of the goods and services are falling. This is not a favorable situation either since it indicates that there is no stable demand in the economy. Demand is the main factor that drives economic activity, thus without demand, the economy is often distressed. Therefore, every economy has to maintain inflation at a certain level; significant increases or decreases can only result in negative circumstances.

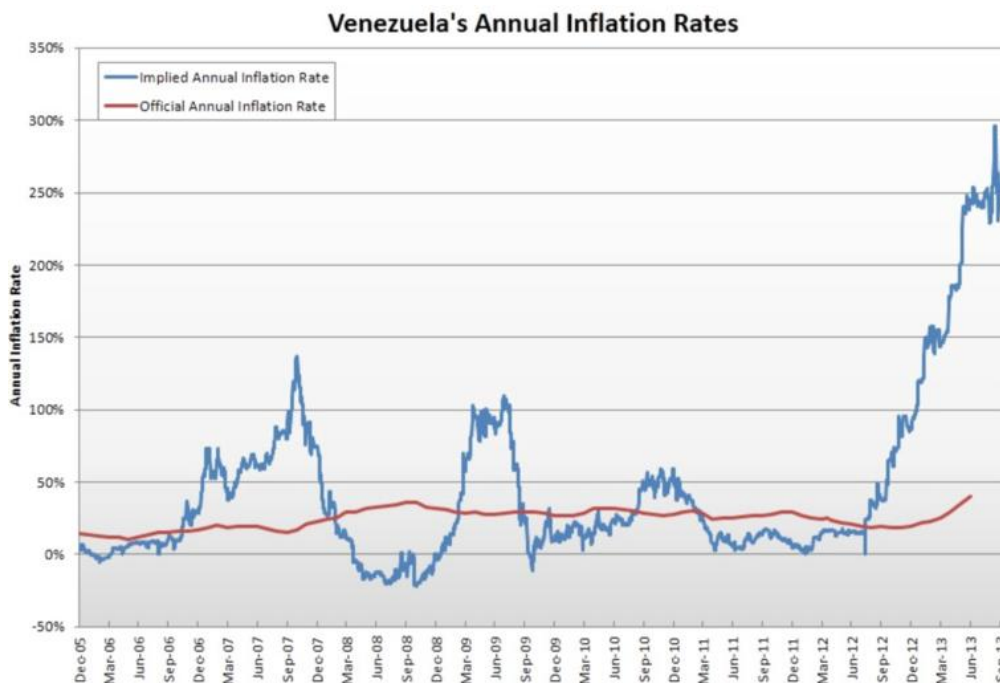


Figure 02: Inflation Rate is subjected to regular fluctuations

What are the similarities between Cost of Living and Inflation?

- Both cost of living and inflation measure and compare prices.
- Both of them are relative measures.

What is the difference between Cost of Living and Inflation?

Cost of Living vs Inflation	
Cost of living is the cost of maintaining a certain standard of living.	Inflation is the general increase in price levels in the economy.
Measurement	
Cost of living is measured by the Cost of living index or Purchasing power parity (PPP).	Consumer Price Index (CPI) is used to measure inflation.
Location	
Cost of living varies within any geographical area including city, state, country or region.	Inflation is calculated for each country.

Summary- Cost of Living vs Inflation

The difference between cost of living and inflation depends on a number of factors such as their scope and the way they are measured. Both are strong economic conditions that showcase the economic status in a country or region. In general terms, if there is high inflation, it is backed by high cost of living. Cost of living cannot be easily controlled by government intervention since cost of living is mainly dependent on demand and supply for resources in a geographical area.

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