

Preferences, Purchasing Power Parity, and Inequality: Analytical Framework, Propositions, and Empirical Evidence

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Paper Abstract: This paper makes analytical, methodological and empirical contributions to the literature on purchasing power parity. Purchasing power parities are required in a host of cross-country welfare comparisons, such as poverty rates and gross domestic product. The subject has recently generated much interest in the wake of the release of the final results of the 2011 International Comparison Program. This paper introduces a preference-based analytical framework that departs from the conventional Balassa-Samuelson framework in deriving empirically verifiable propositions on the link between purchasing power parity and exchange rates, and between purchasing power parity and inequality. The paper also provides an alternative methodology for calculating purchasing power parities that are benchmarked against the 2011 International Comparison Program purchasing power parities. As this study shows, the alternative methodology is capable of easy implementation on readily available data sets. The benchmarking exercise suggests that the 2011 International Comparison Program generally understates purchasing power parity and overstates gross domestic product, and that the purchasing power parities vary across expenditure percentiles. The study reports regional variation in the direction of the difference between the two purchasing power parities. The empirical evidence is supportive of the positive association between inequality and purchasing power parity derived in the paper.