

The Cost of Nations

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Traditional approaches to international price comparisons yield a single set of symmetric and transitive (purchasing power parity) indices. Although these indices are useful measures of aggregate differences in goods prices, in general they lack welfare foundations. In this paper, we discuss how we can create indices that measure a nation's cost of living by using a social welfare function. We develop indices that capture the cost of keeping a country at the same social welfare level at foreign prices. These "Cost of Nations" indices aggregate explicitly from optimizing individuals and allow for heterogeneity and non-homothetic preferences. As with the analogous individual-level Kon us cost of living index, Cost of Nations indices are not, in general, symmetric and transitive. However, we propose two methods of imposing symmetry and transitivity. In contrast to existing approaches, our approach allows us to characterize the size of the required adjustments to a social-welfare-constant index. Conversely, we can document the deviations from symmetry and transitivity required to have a social-welfare-constant Cost of Nations index. We apply our ideas to micro data from the U.S., the U.K and Spain.