

Accepted Manuscript

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PII: S0022-1996(16)30117-9
DOI: doi: [10.1016/j.jinteco.2016.10.004](https://doi.org/10.1016/j.jinteco.2016.10.004)
Reference: INEC 2990

To appear in: *Journal of International Economics*

Received date: 11 April 2015
Revised date: 28 July 2016
Accepted date: 12 October 2016



Please cite this article as: Zhang, Qi, The Balassa–Samuelson relationship: A micro-analysis, *Journal of International Economics* (2016), doi: [10.1016/j.jinteco.2016.10.004](https://doi.org/10.1016/j.jinteco.2016.10.004)

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The Balassa-Samuelson Relationship: A Micro-Analysis[★]

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Abstract

This paper shows that the specification of the Balassa-Samuelson relationship, i.e. the positive relationship between a country's per capita income and its national price level, at the level of the products used in constructing national price levels is different for 'services' and 'manufactures'. It further offers a new candidate explanation for the B-S relationship in manufactures, which appeals to mismeasured quality. This explanation yields a second, distinctive, testable prediction: controlling for per capita income, a non-monotonic relationship should exist between a country's income inequality and its national price level. I show that this second prediction is consistent with empirical evidence.

Keywords: price level; income distribution; inequality; quality; Balassa-Samuelson.

JEL classifications: C43; D31; E31; F31; L15.

[★]I thank the World Bank for granting me access to the ICP 2005 benchmark dataset. Financial support from the Dorothy Hodgkin Postgraduate Awards at the London School of Economics are gratefully acknowledged.

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