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WHY ARE PRICES SO LOW IN AMERICA?

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I. INTRODUCTION

AMERICAN tourists visiting Europe and Japan are typically struck by the high prices of most of the items they wish to purchase. This general impression of tourists is supported by the large body of data on international comparisons of prices and incomes collected by the International Comparison Program (ICP). While of course the comparison of US prices with those of Europe and Japan is affected by fluctuations in exchange rates, the data indicate that in a typical year US prices are substantially below the exchange-rate-converted prices of the other countries mentioned. This observation is a puzzle for those familiar with the ICP because the US is at or near the top in real income per capita, and according to the common finding of a positive correlation of national price level with real income, it should have a national price level¹ that is also near the top. The question is of considerable interest in its own right, but it also has significance for our understanding of the relationship between exchange rates and purchasing-power parities.

In Section 2 we consider several possible explanations for the puzzle, some of which we are able to test with international data, while others remain conjectural.

CHRISTOPHER CLAGUE is from the Department of Economics, University of Maryland at College Park. Valuable comments were received from Ken Reinert and an anonymous referee. The author would like to acknowledge financial support from the Center for Institutional Reform and the Informal Sector (IRIS) and the very competent research assistance of Christos Kostopoulos. Computer time was made available by the Computer Science Center at the University of Maryland.

¹ The term national price level refers to the purchasing-power parity (over the whole of GDP) of a country (say francs per dollar) divided by the exchange rate (francs per dollar). The national price level is unity for the reference country, which is usually the United States. A standard reference is Kravis and Lipsey (1983), which illustrates the strong positive relationship between national price levels and per capita real income.

These explanations have to do with rates of indirect taxation, with the agricultural policy of the government, with the competitiveness of service industries, and with the effects of the inequality of income on the prices of services. A final section states our principal conclusions.

2. METHODOLOGY, THE DATA, AND THE PUZZLE

The present paper attempts to throw some light on this puzzle of the relatively low US price level by examining the data for a sample of OECD members over a fourteen-year period. After presenting the data, we illustrate the phenomenon to be explained by running a regression of the national price level on real income and calculating the deviation for the US observation. We begin by reviewing some theoretical considerations.

It is widely accepted that the prices of nontradeables are not necessarily equalised through international trade, but it is often thought that the prices of tradeables do tend toward equalisation over the long run (see McKinnon, 1979, Chapter 6) and this assumption has been the basis for projections about the future course of exchange rates. Moreover, for countries at similar levels of income per capita, it is widely thought that the prices of nontradeables should not differ greatly in the long run. But if US prices are persistently below those of other high-income countries, there is something about the determination of prices and exchange rates that is not well understood.

The early empirical literature on national price levels treated real income as an exogenous variable. Two main theoretical explanations were offered for the positive correlation between real income and the national price level, the 'productivity differential' explanation, and the factor-proportions account. The former relies on the assumption that labour or total factor productivity differentials across countries are greater in commodities than in services; the latter is based first on the assumption that services are more labour-intensive than commodities, where labour intensity is defined in relation to either capital or natural resources, and second on the proposition that greater endowments of capital or natural resources per person produce higher levels of income per capita.

Recent contributions (Falvey and Gemmell, 1991 and 1992; and Bergstrand, 1991) have clarified our understanding of the correlation between real income and the price level by distinguishing empirically between these two explanations and by introducing demand-side factors into the theoretical and empirical analysis. Since the income elasticity of the demand for services seems to exceed unity, demand considerations reinforce the other explanations for the positive correlation.

The present study, however, returns to the earlier practice of treating real income as an exogenous variable. One reason for this decision is that the puzzle being addressed here remains intact regardless of the relative importance of the various

theoretical explanations for the positive correlation; since the US is the highest income country, it should have the highest or nearly the highest price level. A second reason has to do with data limitations. The empirical methods of Falvey and Gemmell require data on service prices and commodity prices, and these data are available only in the benchmark years of 1975 and 1980. The present study focuses on the averages of income and prices over the 1975-88 period.²

The countries in the sample are those OECD members that participated in at least one of the benchmark surveys of the ICP in 1975, 1980, and 1985. For each country the price level and income per capita were averaged over the years 1975 through 1988, using the Summers-Heston Penn World Tables Mark 5 (Summers and Heston, 1991).³ The data are displayed in Table 1. For a group called West Central Europe, the average income relative to the US is about 67 while the price levels for GDP and consumption average 118 and 121 respectively. For three northern Scandinavian countries, the price levels are even higher. The price levels for the 'land rich' countries of Oceania and North America are much lower. The price and income levels are lower in Southern Europe, but again the price levels are rather high for the income levels, except in Turkey. Finally, Japan and Ireland have very high price levels given their income levels.

a. Rates of Indirect Taxation

Part of the explanation for these differences lies in the rates of indirect taxation.⁴ Since the common practice is to rebate indirect taxes on exports at the border and to impose them on imports, the prices which theory suggests should be approximately equalised through international trade are the prices net of indirect taxes. For each country the 'taxes on goods and services' as a share of GDP was taken from the OECD Revenue Statistics (OECD, 1984) for the years 1975 and 1981 and the average share was calculated. This share was then subtracted from the ICP figures (which of course include indirect taxes) to give a price level net of tax. These figures are shown in Table 1. The price differences are somewhat reduced; the US price declines to 94.5, while the averages for West Central Europe decline to 103 and 107 for the GDP and consumption price respectively.

² The application of their procedures to price level averages would be worthwhile, especially when the service and commodity price data become available for 1985 and later benchmark years.

³ For countries with more than one benchmark survey Summers and Heston follow a procedure of reconciling the different benchmark years with national growth series. For countries with only one benchmark observation, the series are extrapolated backwards and forwards with national series. In all cases the Geary-Khamis procedure is carried out at the global level. For both of these reasons the Summers-Heston data are not identical with the published results of the individual surveys.

⁴ Note that the tourist in comparing prices may well forget that he needs to add the sales tax to the US price to obtain a price comparable to what he pays in Europe. He may also forget that he is mainly touring the capital cities where the prices are higher than in less cosmopolitan areas. Comparison with Manhattan prices would be more appropriate.

TABLE 1
Real Income and Price Levels, OECD Countries, Period Averages, 1975–88

Country	Real Income	Price Level		Price Level Net of Tax		Density	Income Share	
		GDP	Cons.	GDP	Cons.		Low 20%	Low 40%
Austria	61.4	112.2	115.0	97.2	99.7	0.05	na	na
Belgium	65.4	113.8	117.5	100.6	103.9	1.46	7.9	13.7
Denmark	68.0	131.5	141.2	111.2	119.4	-0.23	5.4	12.0
France	70.5	111.7	116.9	97.7	102.2	-0.16	6.3	12.1
Germany	69.9	121.7	125.2	109.7	112.8	1.04	6.8	12.7
Netherlands	67.3	113.3	113.8	100.8	101.3	1.97	6.9	13.2
W. Cent. Eur.	57.1	117.4	121.6	102.9	106.5	0.69	6.7	12.7
Finland	64.4	120.4	135.1	104.8	116.9	-0.67	6.3	12.1
Norway	76.7	133.3	142.8	123.4	132.2	-0.53	6.2	12.7
Sweden	71.9	133.2	134.4	117.9	119.0	-0.05	8.0	13.2
Scandinavia	71.0	129.0	137.4	115.4	122.7	-0.42	6.8	12.7
Australia	75.4	102.9	102.3	93.6	93.1	-0.75	4.4	11.1
N. Zealand	60.9	82.8	81.2	68.9	67.6	-0.64	5.1	10.3
Canada	90.1	101.2	99.3	89.9	88.3	-0.65	5.7	11.8
US	100.0	100.0	100.0	94.5	94.5	-0.57	4.7	11.0
Land rich	81.6	96.7	95.7	86.7	85.9	-0.65	5.3	11.2
Greece	34.3	82.7	85.1	72.9	75.0	-0.36	na	na
Italy	62.5	87.9	91.3	80.5	83.7	0.34	6.8	12.0
Portugal	28.2	61.3	70.9	54.1	62.6	-0.06	na	na
Spain	42.0	86.0	89.1	81.6	84.5	-0.37	6.9	12.5
Turkey	20.4	45.7	51.1	42.5	47.5	-0.41	na	na
South. Eur.	37.5	72.7	77.5	66.3	70.7	-0.17	6.9	12.3
Japan	62.7	120.2	123.7	115.4	118.8	5.34	8.7	13.2
UK	63.8	93.3	96.6	84.1	87.1	0.51	5.8	11.5
Ireland	38.1	94.2	97.1	79.1	81.5	-0.49	na	na

To see how much the correction for indirect taxes reduces the puzzle of the low US price, a regression of the price level on real income was run and the deviation of the US observation from the regression line was calculated. As shown in Table 2, the US deviation for the GDP price is -32.9, but when the prices are corrected for indirect taxes the deviation is only -25.3. The deviations for the consumption price are -34.5 and -26.7. Thus this correction goes part of the way toward explaining the puzzle, but the puzzle remains. We turn next to some conjectures about possible explanations for it, along with some very crude empirical tests.

b. Food and Agricultural Issues

One striking observation that comes out of Table 1 is that population density seems to play a significant role in the determination of the price levels. Why should

TABLE 2
Regression of Price Level on Real Income, 21 OECD Countries

Dependent Variable	Constant	Real Income	Scandin. Dummy	US Deviation	R-square (S.E.E.)
GDP Price	53.4 (4.14)	79.5 (3.98)		-32.9	0.4259 (16.9)
Cons. Price	60.7 (4.19)	73.7 (3.28)		-34.5	0.3275 (19.3)
GDP Price Net of Tax	45.9 (4.08)	73.9 (4.23)		-25.3	0.4582 (15.2)
Cons. Price Net of Tax	52.5 (4.15)	68.7 (3.50)		-26.7	0.3603 (17.8)
GDP Price Net of Tax	47.7 (4.70)	66.3 (4.14)	20.42 (2.35)	-19.5	0.5625 (13.64)

this be? One mechanism by which population density might affect the national price level is via the effects on food prices resulting from transportation costs. Densely populated countries tend to be net food importers while sparsely populated countries tend to be net food exporters. In the presence of transport costs on agricultural products, exporting countries should have lower costs of these products to their food processing industries than importing countries. There is some evidence in favour of this proposition in a sample of 51 countries for which food price levels and other data were available in 1980 (Clague, 1993), but the effect of density on food prices was not strong, and since food expenditures account for only some 10–25 per cent of total expenditures among the OECD countries, the effect of density on the aggregate price level via this channel would not be expected to be very large.⁵

To test this effect, population density⁶ was introduced into the price level

⁵ A second mechanism, which seemed initially to offer more promise of helping to explain the puzzle, is that countries with net imports of food products tend to protect their farmers more heavily than food exporters, and this protection takes the form of restricting food imports. These restrictions produce overvalued exchange rates, which affect the measured overall price levels. According to this argument, the high-income European countries and Japan protect their farmers so heavily that their exchange rates are overvalued relative to the currencies of the land-rich food exporting countries.

This mechanism has in fact been analysed in the context of the WALRAS computable general equilibrium model of the OECD Secretariat (OECD, 1990, pp. 138, 147). The effects on the real exchange rates of complete liberalisation of the agricultural sector were such as to move the price levels of the countries closer together, but the effects are quite small in relation to the puzzle to be explained. Details are in an earlier version of this paper, which is available from the author.

⁶ Population density is measured as the ratio of population to the sum of arable land, permanent crop land, and one-half of pasture land. The variable has been put in standardised form in a larger sample of countries, so that a value of 0.5, for example, means that the density is half a standard deviation above the mean in this larger sample. See Clague (1992) for details and sources.

TABLE 3
Regression of GDP Price Level Net of Tax, 21 OECD Countries

Const.	Real Income	Density	Trade Balance	Scandin. Dummy	US Deviation	R-square (S.E.E.)
45.5 (4.37)	72.9 (4.51)	4.68 (2.06)			-21.2	0.5368 (14.04)
44.7 (4.59)	74.4 (4.92)		-16.46 (-2.72)		-18.2	0.5943 (12.80)
47.5 (5.84)	63.2 (4.90)	6.00 (3.31)		25.3 (3.55)	-12.8	0.7182 (10.95)
46.2 (4.92)	69.1 (4.65)		-12.70 (-2.04)	13.9 (1.62)	-15.8	0.6276 (12.59)

regression (see Table 3). The variable has a modest positive effect on the price level and its introduction reduces the US deviation (in absolute value) by 4.1 points (from -25.3 to -21.2). If transport costs on food products are affecting the relationship of population density to national price levels, there should be a negative correlation between the price level and the agricultural trade balance. Given the fact that population density is a very crude measure of the value of agricultural resources per capita, the agricultural trade balance is probably a more accurate indicator of comparative advantage or disadvantage in agriculture. This variable⁷ is in fact a more powerful predictor of the price level than is density, as shown in the second regression in Table 3 and it reduces the US deviation by 7.1 points.

The density variable seems to give a misleading indication of the agricultural resources of the three northern Scandinavian countries, since much of their land is located where temperatures severely inhibit agricultural production. For this or perhaps other reasons these Scandinavian countries have extremely high price levels (see Table 1). A dummy for these three countries in the income regression reduces the US deviation to -19.5 (see Table 2); then in the density regression in Table 3, the density variable is somewhat stronger, and the US deviation is reduced by 6.7 points. With the Scandinavian dummy in the regression the introduction of the agricultural trade balance reduces the US deviation by only 3.7 points.

To sum up on this topic, there is some evidence that endowment of agricultural resources has some effect on the national price level; poorly endowed countries tend to have somewhat higher price levels, either because of transport costs on food or because agricultural protectionism is linked to these resource endowments. But the magnitudes of these effects are not very large, and they leave a substantial part of the puzzle to be explained.

⁷ The data are from the *FAO Trade Yearbook* for 1980.

c. The Price of Services

Service prices are thought to play an important role in the determination of international price levels, because the final demand services that enter into ICP price levels are generally not traded and are not subject to strong pressures toward equalisation via international trade. Therefore reasons that would explain why US service prices are comparatively low would contribute to an explanation of the puzzle. One conjecture is that in a number of service industries the degree of competitiveness is higher in the US than in Europe and Japan, as a result of competition competition policy, the extent of state ownership of public utility companies, and the effective size of the market.

A recent report by the McKensie Global Institute (McKensie, 1992) argues that these factors explain the higher US productivity in telecommunications, banking, airlines, and merchandising. In restaurants, by contrast, where the degree of competitiveness seems to be similar in Europe and the US, productivity is no higher in the US.⁸ Another reason why certain service prices may be lower in the US is that there is a relatively plentiful supply of low-wage labour that is used in restaurants, retail establishments, beauticians' and barber shops, domestic service, gardening services, and the like. A proxy for the wages of such workers is the income share of the lowest 20 per cent or lowest 40 per cent of the population. These data (taken from World Bank, 1991) are of questionable comparability and the suggestion is put forward here very tentatively, but the data in Table 1 reveal a modest tendency for high shares of the bottom 20 or 40 per cent of the population to be associated with higher price levels.

It is difficult to test this hypothesis because the income distribution data are missing for several of the low-income OECD countries and the omission of these countries from the regression sharply reduces the income coefficient in the regression and hence alters the US deviation. The test is also beset by problems of multicollinearity in that the countries with agricultural export surpluses tend to have relatively inegalitarian income distributions.

The argument that the US is more competitive in services than in commodities is at first sight inconsistent with some detailed data from the International Comparison Project (Kravis, Heston and Summers (KHS), 1982). A regression of *tradeables* prices on real income yields a US deviation of -33.0, while a

⁸ Productivity comparisons in services are notoriously difficult. The McKensie study measures productivity in restaurants by value added per employee, evaluated at final consumption PPP. The PPP for 'eating and drinking' in France relative to the US is 24 per cent higher than the PPP for final consumption. Thus if value added per employee were evaluated at the PPP for 'eating and drinking' the French productivity would appear 24 per cent lower. The assumption of the McKensie procedure is that the excess of the eating and drinking PPP over the final consumption PPP reflects higher quality food preparation and service. If this assumption is correct, quality-adjusted PPP for eating and drinking in France should be 24 per cent lower than reported in the ICP.

regression of *nontradeables* prices yields a US deviation of -15.7 . (The data are for 31 noncommunist countries in 1975. Nontradeables are defined as all services plus construction.) However, for several different reasons this finding does not appear to be a decisive refutation of the contention that US competitiveness in services may be part of the explanation for the low US price level.

First, the retail prices of tradeables that are measured in the ICP include a service component of wholesale and retail trade, so that some of the US competitiveness in tradeables may be due to competitiveness in these services. In other words, the theoretical separation of tradeables and nontradeables is not cleanly implemented in the data. Second, the service sector includes a number of categories in which the output cannot be priced, the so-called 'comparison-resistant services': the services of doctors, nurses, hospitals, teachers, and government employees (see KHS, 1982, p. 69). For these categories the ICP measures service prices by the earnings of the providers, with some adjustments for labour quality. Third, even in the categories of priced services, the problems of quality differences are especially severe, probably more severe than they are on average for commodities. Consider the unmeasured quality differences in the following priced services: local transportation, postal service, public entertainment, housing rents, and telephone service.

There are four categories of ICP services that correspond roughly to the services studied by McKensie. These are telephone, air travel, restaurants, and 'other services' (see KHS, 1975, p. 64) which includes banking fees, brokers' charges, legal fees, copying fees, real estate agents' fees, and charges for money orders. The US deviations for these services, as well as some others, are shown in Table 4. It can be seen that, according to these data, the US is quite competitive in the McKensie services except restaurants, consistent with the McKensie findings. The table also shows that excluding the comparison-resistant services does not change the US deviation, but excluding rents reduces it substantially. In summary, in view

TABLE 4
US Price Deviation in Regression of 31 Noncommunist
Countries, 1975

Sector	
Tradeables	-33.0
Nontradeables	-15.7
Nontradeables, excl. comp.-resistant services (also called 'priced services')	-15.0
Priced services, excl. rents	-25.1
Construction	-31.0
Postal services	-20.9
McKensie services: Telephone	-85.2
Air travel	-118.0
'Other services'	-64.1
Restaurants	-15.8

of the problem of separating tradeables from nontradeables, the quality problems, and the heterogeneous nature of services, these data do not by themselves invalidate the contention that US competitiveness in certain categories of services may help to explain the low US price level.

3. CONCLUDING OBSERVATIONS

The data presented in Table 1 of this paper indicate that there is a puzzle to be explained. The US price level is substantially below what would be expected on the basis of its income level, and the other 'land-rich' countries, Canada, Australia, and New Zealand, also have lower-than-expected price levels. Correcting for different rates of indirect taxation reduces but does not eliminate the discrepancy. Population density modestly reduces the deviation of the US observation, and a theoretical argument can be made consistent with this effect. However, the effect is not large. Another possible explanation, which we were not able to test econometrically, is that in a number of service industries the degree of competitiveness is higher in the US than in Europe and Japan, as a result of government competition policy, the extent of state ownership of public utility companies, and the effective size of the market. These circumstances may change as Europe unites.

The purpose of this paper has been to pose the puzzle and offer some tentative explanations. These explanations could be subjected to more detailed analysis, and additional tests can be run as more data on income distribution or wage structures and on international comparisons of service productivity become available. Resolution of the puzzle would contribute to our understanding of national price levels and exchange rates.

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The Political Economy of Agricultural Pricing Policy

Bruce L. Gardner

I. INTRODUCTION

FOR many years economists have known, and bemoaned, the discrimination against agriculture practiced in the developing world through pricing and other policies. In the volumes reviewed in this article,¹ Anne O. Krueger, Maurice Schiff, Alberto Valdés, and their team of 32 cooperating authors report on a tour de force of research on this topic, an audacious and monumental accomplishment that will provide the baseline on this subject for many years. The project was sponsored by the World Bank.

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- ¹ A review article of KRUEGER, ANNE O., MAURICE SCHIFF AND ALBERTO VALDÉS (eds.), *The Political Economy of Agricultural Pricing Policy, Volume 1, Latin America* (Washington: The World Bank, 1991, obtainable in Britain from Microinfo Ltd., PO Box 3, Omega Park, Alton, Hampshire, GU34 2PG), pp. xiii and 273, £29.65 hardback, ISBN 0 8018 4029 5.
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