

mgr Jan Fabisiak
mgr Sergiusz Prokurat

Centrum Studiów Polska-Azja

The BRIICs and inequality: income inequality trends in major emerging markets and their implications

ABSTRACT

This paper seeks to study the trends in income inequalities in the BRIIC countries. The first section of this paper investigates the evolution of the understanding of income inequalities, moving on to their classification, measurement and proposed impact on growth. The following section examines the nature of the BRIIC countries, their commonalities, future perspectives on the world stage and, most importantly to this paper, their income inequality dynamics. The last section concludes with a cross-country comparison.

INCOME INEQUALITIES – WHY THEY EXIST AND HOW THEY ARE MEASURED

The debate on the nature of inequalities has raged on since ancient Greece – Aristotle embraced them, while Plato pointed out their negative effects on society [Pipes, 2000: 20, 24]. One might be under the impression that also to many contemporary economists the question of rising income inequalities has become a proxy for a global socioeconomic threat. Yet such inequalities have historically been quite volatile, both between and within countries. Present-day trends seem to be in many ways unique due to ongoing globalisation – the creation of a level ‘playing field’ where individuals may collaborate and compete [Friedman, 2007]. This might imply the rising significance of inequalities between countries rather than in-country. But does this change the debate on income disparities?

Bourguignon and Morrisson find a 30 percent increase of global inequalities between 1820 and 1992, the difference being principally driven by disparities across countries [2002: 742]. Meanwhile, Saez demonstrates a significant build-up of in-country inequalities among developed-world countries at the beginning of the XX century, followed by a sharp flattening of income distribution in the years of the Great Recession and a consequent new wave of income accumulation in the top percentile; a process which accelerated in the last 25 years of the

previous century [2006]. Data before 1820 are scarce if any, nevertheless, a historical perspective suggests that income inequalities are cyclical and contemporary distributions of earnings are neither excessive nor unprecedented. This brings us to the fundamental question – what is the nature of income inequalities and why are so many preoccupied by their current elevated levels? Policymakers and economists alike have disagreed on income inequality and justice for decades. The truth is that inequality matters to people, as it is often perceived as a sign of injustice. This is the view of Egalitarians, who believe that an equal society is most desirable. On the other end of the spectrum, Libertarians value freedom first and foremost. They hold that liberty and equality are incompatible, and that liberty should take precedence over equality. Egalitarians agree that liberty and equality are incompatible, but, to them, equality is more important than freedom.

In a Libertarian free society, however, the focus switches to economic freedom. The free-market viewpoint understands economic liberty as the freedom to produce, trade and consume any goods and services acquired without the use of force, fraud or theft. This is embodied in the rule of law, property rights and freedom of contract, and characterised by external and internal openness of the markets, the protection of property rights and freedom of economic initiative [Bhalla, 1997: 205; Rowley and Schneider, 2004: 161–171]. It's defined sometimes, implicitly, as the opportunity available to all alike to earn as much money, and accumulate as much wealth, as one can.

Egalitarians consider the whole inequality debate in the category of a trade-off between equality and liberty. This implies that the matter is inherently subjective and based on different moral judgments of society. The Libertarians disagree – it's much more, a trade-off between growth and equality. Interestingly, a relatively low-earner in a developed economy would be considered well-off in most other parts of the world. Yet, according to Libertarian thinking, the difference in affluence was brought about by growth, which in turn could only be possible with significant income disparities. This just goes to show that the relationship between inequalities and growth remains a highly controversial subject among economists.

Perhaps the best comment to this debate is that capitalism is principally (as its name suggests) a way of amassing wealth and a certain degree of income inequalities is natural, as without any inequalities no incentives for growth would exist [Goody, 2006: 40; Champernowne and Cowell, 1998]. Aside from all the scholarly research mentioned, it has to be noted that most (if not all) Marxist, communist and socialist doctrines regarded the smoothing or complete eradication of income inequalities as central to their ideology.

There are quite a few ways of measuring income inequalities, such as the Theil Index, Atkinson Index, nonetheless the most popular measure is by far the Lorenz Curve and its derivative, the Gini coefficient. The Gini coefficient

emerged as the best tool for country-to-country comparisons and for times series. It can be calculated as the ratio of the area between the aforementioned 45° line and the Lorenz curve to the total area beneath the diagonal line [Gastwirth, 1972]. Hence, its value will always be in the $<0,1>$ range, where 0 means perfect equality and 1 means perfect inequality.

Simplicity and a constant value range have undoubtedly contributed to the prominence of the Gini coefficient. Yet over-simplicity is always a threat when studying such data. It has to be noted that income inequalities are *not* wealth inequalities and therefore may not fully reflect living standards. Accumulated wealth may be a source of potential future cash flows by dissaving or leveraging assets; it may also be a form of health, unemployment or old-age insurance [Davies *et al.*, 2007: 1]. Therefore, wealth inequality may be more important than income inequality. However, wealth inequality data are far scarcer and keep economists guessing – while one may expect high earners to also be at least as asset-rich as their share of income would suggest, there is no conclusive evidence.

IMPACT OF INCOME INEQUALITIES ON GROWTH

Notwithstanding the above caveats to the Gini coefficient, it has become a widely accepted measure of income inequality. If so, what effect (if any) does its value have on economic growth? Economists tend to agree with one of the four mainstream explanations. Alesina and Rodrik offer the opinion, that a high Gini coefficient is a negative contributor to growth [1994]. Several explanations for this are put forward, such as political instability caused by large inequalities [Perotti, 1993; Alesina and Perotti, 1996; Alesina *et al.*, 1996] or entrenched interest groups which block reform [Rodríguez, 2000]. It can be implied from such studies that too large disparities in income cause too large a distance between poor and rich, thwarting upward mobility and incentives to work. Some even move as far as to postulate a link between higher disparities and larger environmental harm [Boyce, 2007] or lower levels of trust and higher costs of enforcing contracts in more unequal societies [Soubbotina, 2004: 30]. To prove that fast economic development and a stable and fairly equal income distribution is possible, some cite the case of Taiwan, which managed rapid catch-up in the years 1979–1994 while maintaining a Gini coefficient below or slightly above 0.3 [Bourguignon, Fournier and Gurgand, 2001]. Recapitulating, , mainstream economists of the likes of Alesina and Perotti believe there to be an optimal level of income inequalities (the usual range is given as $<0,2;0,4>$) for economic development.

These propositions go against the models developed by Kaldor and Kalecki, who independently came to the conclusion that significant income inequalities

have a positive effect on growth [1960; 1971]. This view is also present in later research – Li and Zou directly criticise the approach taken by Alesina and Rodrik, empirically demonstrating that income inequality is positively and significantly correlated with economic growth [1998]. Barro and Sala-i-Martin proposed the notion that significant inequality is good for growth at high levels of *per capita* income with the converse being true in low-income countries [1995]. This seems to be contradicted by Figure 1, which plots *per capita* income against the respective country Gini coefficients – poorer countries have, on average, much higher Gini values, while undergoing much more rapid expansion than developed economies.

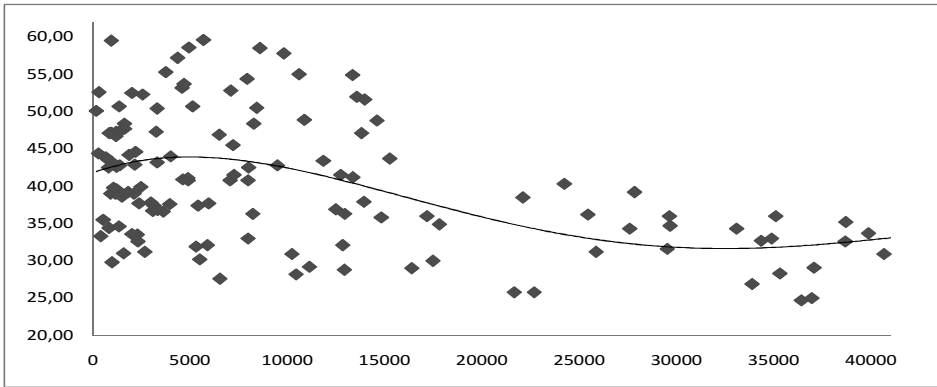


Figure 1. Gini coefficient (2000–2010) vs GNI per capita (PPP 2008 \$)

Source: The United Nations Development Programme.

However, yet another approach to the income and inequality debate, which avoids categorising income disparities as indisputably positive or negative, does not contradict empirical findings. Recently, a number of scholars have developed the notion that there exist two types of income inequalities: good and bad for growth [Ravallion, 2007; Facchini, 2008; Becker, 2011]. Good inequalities are those, which ‘reflect and reinforce the market-based incentives that are needed to foster innovation, entrepreneurship, and growth’ [Ravallion, 2007: 3]. The same author goes on to define bad inequalities as such which hamper potential growth and thwart poverty reduction. Therefore, if income disparities lead to or manifest themselves in ‘[s]ocial exclusion, discrimination, restrictions on migration, constraints on human development, lack of access to finance and insurance, corruption, and uneven influence over public actions’, they are considered to be a drag on growth [Ravallion, 2007: 3]. In other words, income inequalities *per se* are not the real problem (they are actually beneficial), human capital underdevelopment and inadequate access to markets are the biggest con-

straints to growth. Facchini adds to the above that ‘bad inequalities are the result of rent seeking activities, while good inequalities originate in productive activity or entrepreneurial profit seeking’ [2008: 1].

The debate is far from compromise, which only shows that the relationship between inequalities (be they in income, wealth or less tangible assets) still has not been fully studied and understood. The extent of the disagreement is best epitomised by some scholars, who introduce a fourth opinion which states that income inequalities have no meaning to growth whatsoever [see Dollar and Kraay, 2002].

BRIC OR BRIICS: PROBLEMS DEFINING EMERGING MARKETS’ LEADERS

The original BRIC acronym, which stood for Brazil, Russia, India and China, was developed by O’Neill [2001]. It quickly became universally recognisable. The BRIC acronym came to symbolise the supposed convergence of developed-world and emerging-markets income levels and the rising prominence of the large yet underdeveloped countries, primarily the four mentioned by O’Neill.

While China and India will become global leaders in manufactured goods and services, Brazil and Russia will come to dominate supply of most raw materials, completely re-aligning world trade and wealth distribution [O’Neill, 2001; Goldman Sachs, 2007].

If the BRIC thesis in large part can be explained by potential, understood as the product of size and growth dynamics, than Indonesia, argue some, should be included into the BRIC grouping, effectively turning it into BRIIC [Schuman, ([http](http://www.oecd.org/dataoecd/1/1/44648222.pdf)) 2011a]. This view is also shared (and expanded) by the OECD, which uses the BRIICS acronym, also including South Africa [Newfarmer, 2008; Reyes, García and Lattimore, ([http](http://www.oecd.org/dataoecd/1/1/44648222.pdf))]. This last inclusion, despite a lack of clear definition of a BRIC country, does not seem consistent with the other countries. For one, Euromonitor International points out that South Africa is nowhere near the other BRIICs in terms of demographic potential, with a population of 50.1 million.

Brazil, India, Indonesia and China share another important likeness, they have managed to sustain dynamic economic expansion of their huge economies for the last two decades. Russia’s economy seems to be far more dependent on commodity prices, yet this diversity of development models makes for an adequate bellwether of general trends in low-income countries. What is more, all five BRIIC countries share another success – they are lifting unprecedented numbers of their own citizens out of poverty, potentially creating the biggest consumer markets on the planet.

Justifying the creation of BRIC-like models by economic and political clout will most probably remain a controversial subject. Meanwhile O’Neill, the au-

thor of the original BRIC acronym, argues against *any* new inclusions into the 'BRIC club', rejecting the notion that any more countries meet the potential of Brazil, Russia, India and China [Frangos, (http)]. Instead, a further eleven emerging economies have been identified as those, which in the future may or may not achieve BRIC status [Wilson and Stupnytska, 2007]. This paper, taking into account the above debate and growth and demographic potential, will use the BRIIC (that is Brazil, Russia, India, Indonesia and China) as base for comparisons. It is important to note that the countries chosen by this paper have, in general, seen a significant increase in Gini-measured inequality, as shown in Figure 2.

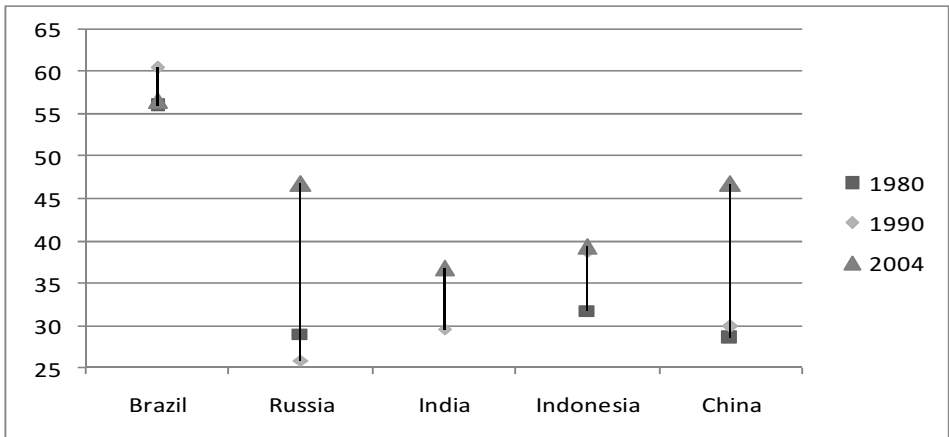


Figure 2. Gini coefficient values in BRIIC countries

Source: World Institute for Development Economics Research.

Note: For the year 1980 the USSR's Gini coefficient is used as proxy for Russia.

BUILDING BRIIC BRICK BY BRICK

Over the last decade the BRIIC group has symbolised the rapidly growing power of the world's largest and most prosperous emerging economies and their potential impact on the global economic and, increasingly, political order. Brasil, China, India, Indonesia and Russia have all liberalised and opened up their economies since the time of far-reaching government control. But surprisingly they're not bastions of *laissez faire* philosophy either. Indeed openness has served the BRIICs very well and they all have been huge beneficiaries of free capital flows, which have increased their wealth and created jobs for their large populations. However, giant FDI inflows to the BRIIC countries tended to be in large part destined for big cities with excellent international accessibility. This phenomenon has caused ur-

ban-rural inequality to skyrocket both due to the geographical concentration of FDI and their heavy knowledge-related bias [OECD, 2008]. Over the past 15 years, total trade as a proportion of GDP grew by over 50% in Russia, nearly doubled in China and more than doubled in Brazil and India [OECD, 2007].

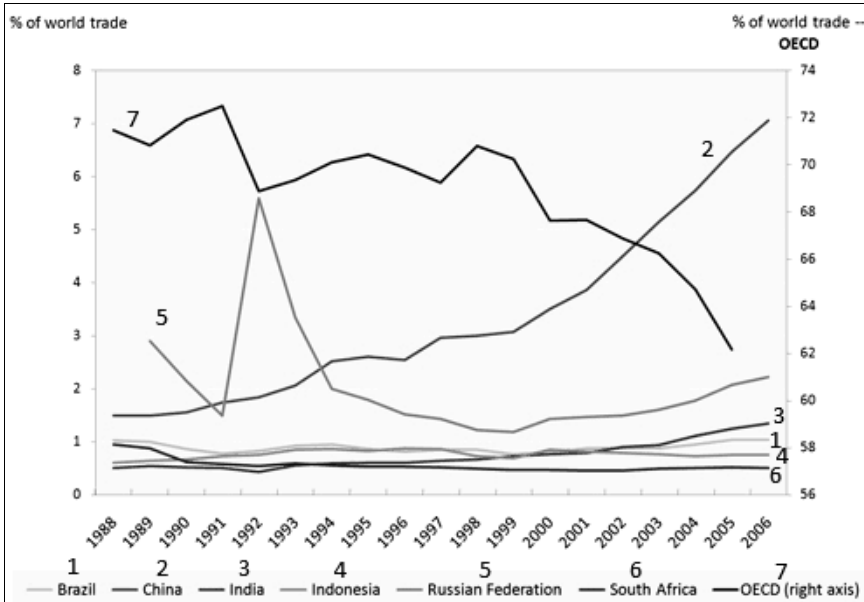


Figure 3. BRIIC and South Africa and OECD share in world's exports of goods and services

Source: OECD 2008.

Despite relatively high levels of state intervention in the economy, the BRIIC countries can be characterised by low taxes and high social inequalities. Paradoxically, the BRIICs want to enjoy the benefits of free markets in trade while making away with some market rules they don't find beneficiary to their goals. Therefore they do not shy away from using such government interventions as standard policy tools.

Table 1. Doing Business Ranking for BRIIC countries

	Ranking 2010	Ranking 2011
Brasil	124	127
Russia	116	123
India	134	135
Indonesia	115	211
China	78	79

Source: The World Bank.

Comparative analysis literature proposes two main models of capitalism – the Liberal Market Economy (LME) and Coordinated Market Economy (CME). The former is exemplified by the USA; the latter has been adopted by most EU countries [Hall and Soskice, 2001]. A recently-proposed third model, Dependent Market Economy (DME), has been developed as a state coordination model for transition economies of Central and Eastern Europe [Nolke and Vliegthart, 2009]. Owing to the BRIICs' success a new concept of state coordination, based on transaction-cost economics, is being developed. The BRIIC model of 'state-permeated market economies' (SME) is also sometimes referred to as 'statist market economies' [Nolke, 2010]. True to the model's name, the BRIIC variety of capitalism is dominated by intertwined relationships between public authorities and major domestic enterprises which act as the central coordination mechanism of economic policy. Therefore for the BRIIC countries, or at least most of them, markets are a matter of convenience rather than conviction [Schuman, (<http>) 2011b].

REDUCING POVERTY IN BRIIC COUNTRIES

An OECD report states that rapid integration of large, low-wage countries such as Brazil, China, India or Russia into the world economy may have exacerbated trends of developed countries' workers becoming less competitive internationally; this rings especially true because the BRICs now represent 45 percent of world labour supply, compared with less than 20 percent for the 30 OECD countries [OECD, 2007].

Yet BRIIC countries have little real wealth of their own. Their people are a resource that developed countries use for fuelling their own prosperity. Fortunately for the BRIIC countries it also causes wealth accumulation in their domestic economies. As long as this continues (and indeed high-wage countries have become dependent on BRIIC exports) their prospect for growth is sustainable

Brazil, China, and India have successfully reduced their poverty rates and uniquely have managed to move on from the preconditions for take-off to the actual Rostovian take-off stage. What the BRICs are really showing us is that there is no specific ideological path to development and sustained economic growth and that income inequalities' dynamics may be over-rated as a benchmark of progress, as each of the analysed countries has different patterns of disparities. China, India and Brazil are reserving the right to use multiple macroeconomic tools to achieve their own objectives.

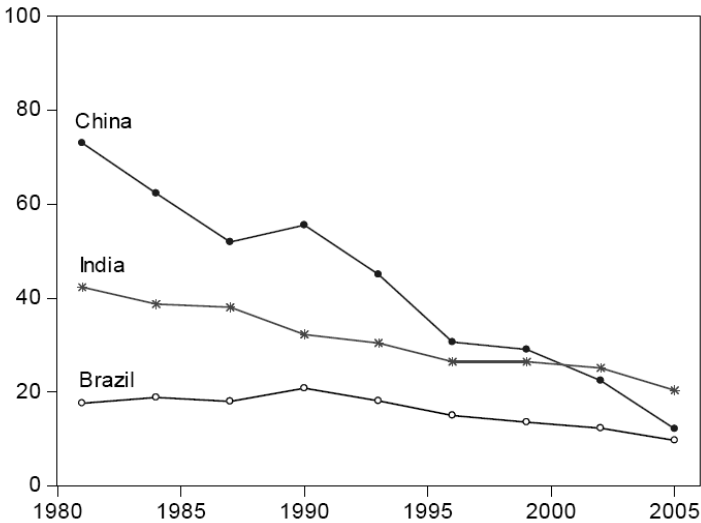


Figure 4. Percentage of population living for 1.25 USD a day at 2005 prices (PPP)

Source: Ravallion M., 2009, A comparative perspective on poverty reduction in Brazil, China and India, "Policy Research Working Paper Series", no. 5080, The World Bank.

The BRIC countries are home to half the world's poor, yet in the past this used to be even higher. Each country combined market-oriented reforms with varied social policy, in effect producing different combinations of growth, inequality and poverty reduction. Each of these unique paths have set the example for other developing countries seeking their own ways out of poverty. However, other factors – in particular information technology advances, which create demand for more skilled labour, have probably been a more important contributor to sustained growth. The fact that wage inequality has also tended to increase in developing countries, including the BRIC economies, is consistent with the skill bias which has re-aligned the patterns in global labour demand.

CONCLUSION

In 1989 Fukuyama published his famous essay: 'End of history?' [Fukuyama, 1989]. O'Brien followed by announcing that the 'end of geography' is near [O'Brien, 1992]. Later Cairncross put forward the notion of the 'death of distance' in global trade and recently Friedman argued that the 'world is flat'. Friedman understands this as a combination of institutional, technological and organisational changes which are 'flattening out' the world and making it more equal – a platform for global collaboration and competition on the labour market

[Cairncross, 1997; Friedman 2007]. However, it doesn't apply to inequalities. Globalisation and the rapid adoption of information and communications technologies have enabled an unprecedented fragmentation of global supply chains. What this means is that one product or service is outsourced and distributed across many countries before reaching its final consumer. This process has greatly benefited the BRIIC countries, which started out as low-margin producers and are now beginning to climb up the value chain. Yet this success has come at a price, as the BRIICs' societies now consist of the winners and losers of these new and skill-demanding times – the 'insiders' and 'outsiders' of their countries' rapid transformation.

Although inequality in many developing countries grew significantly during the past 30 years, world poverty actually greatly declined. This is because the *per capita* incomes of developing countries with big populations, principally Brazil, China, India, and Indonesia, grew at a much quicker rate than did the *per capita* incomes of the rich Western countries. Hence while in-country inequalities rose, world poverty declined and so did the income gap between poorer and richer countries.

To illustrate this one might conduct a thought experiment – if overnight the *per capita* wealth of citizens of a certain country were to double, then waking up the next day these citizens would not only be twice as well-off as they were before, but inequality would increase twofold as well. In the debate on inequalities in the BRIIC countries we must not forget that this is the case. Disparities may have increased considerably in absolute terms (which is more visible to the general population), but their relative increase is not quite as big. This calls for a broader approach and recognition of the fact that inequalities may both contribute to growth and hamper it. For this reason Milanovic looks at inequality, as far as economic efficiency is concerned, as cholesterol: there is 'good' and 'bad' inequality, just as there is good and bad cholesterol. 'Good' inequality is needed to create incentives for people to study, work hard, or start risky entrepreneurial projects. None of that can be done without providing some inequality in returns. But 'bad' inequality starts at a point – one not easy to define – where, rather than providing the motivation to excel, it provokes discouragement, bad habits and provides the means to preserve acquired positions [Milanovic, 2010: 12].

Arguing about inequalities, Becker stated that many people, especially academics and intellectuals who take the egalitarian stance, find the phrase 'good' inequality irritating mostly because they can hardly think of any aspect of inequality as being 'good'. However, some types of economic inequality have great social value. For instance, it would be hard to motivate the vast majority of individuals to exert much effort, including creative effort, if everyone had the same earnings, status, prestige, and other types of rewards. Fewer individuals would engage in the hard work involved in finishing high school and

going on to college if they did not expect their additional education to bring higher incomes, better health, more prestige, and better opportunities to marry [Becker 2011].

Because of the nature of the view of equality and inequality, Libertarians generally believe that people are entitled to their lives [Narveson and Sterba, 2007: 228]. This also means advocating equality of opportunity that completely blinds them to the social, collective and structural dimensions of inequality. However, imposing equality still violates economic freedom, which is necessary for rapid growth. We believe that to sustain current growth and achieve the developed world's wealth levels the BRIIC countries at some point need to switch to high-margin economies and that requires a more educated workforce. Therefore it is worthwhile to reduce inequalities in terms of education while leaving other substantive freedoms intact. Krueger's research suggests that allocating more resources to education and training of the disadvantaged could reduce inequality [2002]. He justifies redistribution of income to the poor by using education and training because it can be in the interest of the wealthy as well as the less well-off.

The secret of economic growth is motivating as many people as possible to work as intelligently and diligently as possible. It's as simple as that. It means that first of all people should be convinced that hard work pays and that it is worthwhile getting proper education. In both developed and developing countries the more educated the workforce is, the more productive the economy will be.

The BRIICs' successful poverty reduction wasn't achieved in accordance with liberal thought. However, the liberalisation of trade has served the interests of the poor, giving them incentives for social mobility, while institutional reforms provided the key to self-fulfillment. This is evidence that low-income countries can successfully navigate a growth-equality trade-off. The lesson from the BRIIC countries, especially from China, is that rising inequalities is the inevitable result of higher growth and less poverty.

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Nierówności w krajach BRIIC: trendy w nierównościach dochodowych na głównych rynkach wschodzących i ich konsekwencje*Streszczenie*

Artykuł bada trendy kształtowania się nierówności dochodowych w krajach BRIIC. Pierwsza część opisuje ewolucję pojmowania nierówności dochodowych, przechodząc do ich klasyfikacji, metod pomiaru i wpływu na wzrost gospodarczy. Kolejna część definiuje kraje BRIIC, ich cechy wspólne, ich przyszłe perspektywy w globalnym układzie sił, oraz, co najważniejsze z punktu widzenia tego artykułu, zmiany w ich nierównościach dochodowych. Ostatnia część podsumowuje debatę, przeprowadzając porównania między poszczególnymi krajami.