### The effects of income inequality

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**Abstract:** Over time have been addressed many possible effects arising from inequalities of income. Criticism for each of these effects were immediate, most of them claiming that the selection of samples used to demonstrate the assumptions made were "carefully" selected in order to achieve the target and that there is not a direct relationship between income inequality (their increment) and these effects.

Of the many effects that income inequalities have, identified in the literature, this paper will analyze three of them, namely: economic growth, human capital and social cohesion.

Keywords: income inequality, social cohesion, economic growth, human capital

### Introduction

Inequality is one of the critical factors impacting the progress of a process of development in a society. Other factors also have an impact, such as health and education level

of the population; scientific and technological development; competitive economic system, value chains, production networks and business units to which they belong; environmental protection; degree of social cohesion; effectiveness and transparency in the management of public affairs. The impact of all these factors on development is felt in all countries and regions, but with particularities of each set of national and / or regional circumstances.

Influencing factors of income inequality previously presented influence and condition each other. It is not always clear which is the cause or effect, because relationships can evolve according to circumstances arising and, therefore, as well as the specific importance of each factor acquired in the evolution of society.

## 1. Income inequality and economic growth

Contemporary global economy is characterized by the fact that there are large inequalities of income by the current economic liberal paradox. There are many developing countries which records high levels of economic growth, but still have high income division in terms of income inequality.

Income inequality is a difference which arises because of large divisions in personal economic and non-economic income of people. Economic growth is assumed to occur when individuals use their resources and rearranges / recombine it in ways that make them more valuable (generates added value). Recombination processes of resources must be innovative to support the economic growth rate. Growth is essential to increase economic income for participants. The problem I want to analyze is if income inequality is necessary to achieve economic growth or undermine it.

Todaro<sup>1</sup> made four arguments according to which a higher level of equality for <sup>1</sup> Todaro, M. P., Economic Development (6th ed.), London: Longman, 1997, p. 151

developing countries could be a prerequisite for a sustainable economic growth. Thus, inequality would lead to: non-productive investments of the rich, a lower level of human capital of the poor, the consumption among the poor based on local goods and a rejection of the politics of the masses (ordinary citizens).

Starting from an endogenous growth model in which human capital endowment is considered heterogeneous and capital markets are considered imperfect, Aghion, Caroli and Garcia-Penalosa<sup>2</sup> argue that there are at least three reasons why inequality has a nevatively direct impact on growth, namely: reduces investment opportunities, reduces borrowers incentives, generates macroeconomic volatility.

In the same context, Knowles<sup>3</sup> highlighted four ways in which inequality can harm economic growth. The first argument is that an unequal income distribution will create pressure in terms of redistribution and therefore will reduce growth. The second argument is that inequality may lead to social and political instability, which will reduce investment and growth. On the other hand, inequality may lead to a reduction of investment in human capital and hence to a reduction in growth. The last argument refers to the effect that inequality has on fertility

<sup>&</sup>lt;sup>2</sup> Aghion, F.; Caroli, E.; Garcia-Penalosa, C., Inequality and Economic Growth: The Perspective of the New Growth Theories, Journal of Economic Literature, Vol. 37, No.4, 1999, pp.. 1615-1660

<sup>&</sup>lt;sup>3</sup> Knowles, S., Inequality and Economic Growth: The Empirical Relationship Reconsidered in the Light of Comparable Data, University of Otago, 2001, p. 26-27. – disponibil la http://otago.ourarchive.ac.nz/bitstream/handle/10523/1079/DP0105.pdf?sequence=3&isAllowed=y – accesat la 20.08.2014

change which may also lead to a decrease in investment in human capital, with negative effects on growth.

Arguments to the effect that redistributive policies can support growth by reducing inequality, are not new. According to the model of growth presented by Su<sup>4</sup>, if inequality is seen as a negative factor for social institutions (and the environment), then the elasticity of production factors substitution in developed and developing countries will increase, causing a decrease in aggregate production and a slowdown in economic growth in all countries.

According to Banerjee & Duflo<sup>5</sup>, opportunities for economic growth do not automatically translate into real growth. According to them, when the economy grows, people with high income are experiencing an inequality decline, while the opposite is the case for low-income people. The belief that investors should be encouraged by government incentives to save is less convincing because developed nations spend billions of taxpayers' money to rescue financial institutions led by the elite. Redistributive policies such as education subsidizing in order to invest in human capital can have very good results for economic growth and reducing income inequality.

Technological and mass export of developing countries can only provide higher <sup>4</sup> Su, Q., Factor Movement and Economic Growth, Working Paper, Institute of Management, Humboldt University of Berlin, 2001, p. 16-21 – disponibil la http://www.econbiz.de/archiv/b/hub/management/inequality.pdf - accesat la 15.09.2013

returns for educated and skilled people. He also argued that technology has completed the tasks performed by skilled workers such as financial sectors, while in some cases replaced unskilled work in factories, mines etc.

By investing in human capital countries can enjoy a more equitable economic growth. There are other benefits of equal societies. Japan is considered one of the most egalitarian societies, people having a long life, crime is low and there are low levels of violence. Kay<sup>6</sup> argues that deaths among men of working age are uncommon in egalitarian countries such as Sweden, than in less egalitarian countries such as England or Wales. An egalitarian society brings with it less social stress for both rich and poor. It also creates a suitable environment to attract foreign investment.

Another approach to inequality is given by Sen<sup>7</sup> who considers that income inequality may differ substantially from inequality on other relevant issues such as welfare, freedom and different aspects of quality of life. He claims that should not be made an identification of economic inequality with income inequality, without taking into account the neglect deprivation of unemployment, sickness, lack of education and social exclusion.

The positive effects that come with an egalitarian society are some that each country should aim, but the reality is that countries that engage in massive social programs are well developed and rich countries (eg Scandinavia). A government may allocate

<sup>&</sup>lt;sup>5</sup> Banerjee, V. A.; Duflo, E., Inequality and Growth: What Can the Data Say?, 2003, p. 2-3 -disponibil la: http://www.budgetspeechcompetition.co.za/download\_files/UG\_Article%203.pdf – accesat la 15.09.2013

<sup>&</sup>lt;sup>6</sup>Kay, J., Financial Times. The benefits of equality, 2009 [Online]. Disponibil la: http://www.ft.com/cms/s/0/3a901490-15b9-11de-b9a9-0000779fd2ac. html

<sup>&</sup>lt;sup>7</sup> Sen, Amartya, Dezvoltarea ca libertate, Editura Economică, București, 2004, pag. 20

funds for these programs but, in general, the effects will be short-term and this will inevitably put the economy in the way of destruction. The alternative to this is to promote policies that will reduce long-term income equality and ensure that the country maintain sustainable growth levels. The objective of governments should be pursuing sustainable long-term positive effects. Income inequality is necessary in some way for economic growth and redistributive policies are a short term solution, causing economic distortions and may leave an inefficient economy.

# 2. Income inequality and human capital

According to the dictionary of poverty<sup>8</sup>, "human capital consists of educational capital (skills acquired by individuals in training school, but also outside it) and biological capital (physical abilities of individuals, synthesized mostly by health) ".

The relationship between education and labor productivity growth is base of "human capital theory" initiated by Becker in 1964, which assumes that education and professional training are the main source of future income.

According to the theory of human capital wage differences can be explained based on different investments in education, made by individuals.

Human capital can be acquired before entering the labor market through school years or over working life due to continuing training. Investing in education can be regarded as any investment: individuals accept "to sacrifice" today, if in the future this

will bring additional income. "Sacrifices" can be seen both in the form of direct costs (eg tuition costs) and the form of indirect or opportunity costs (the amount of money that an individual would have obtained if they had not invested in education). Depending on the expected costs and income levels, an individual can invest more or less in education.

Among the factors that influence an individual's opportunity to invest in education we can include:

- Skills of individuals positively influencing the duration of studies and reduce the cost of education;
- The family which directly affects the duration of studies through several channels. Firstly the transmission of knowledge from one generation to another and secondly through social relations that they have;
- Financial situation of the family from which the individual comes a good financial situation will positively influence the duration of the studies, however a precarious situation will cause dropouts.

Income inequality has a strong tendency over generations and is regularly transmitted from parents to children. A "disadvantageous family heirloom" usually affects negatively the opportunities of children in terms of both the education and future earnings. For example, when children are selected in different schools, depending on their ability and merit (often related to their socioeconomic status) and there is no mobility between these schools, the family becomes extremely important.

The exclusion in education can occur both in access to education, quality of education, or results of this process and can have a cumulative effect lasting negative consequences. Education systems that separate

<sup>&</sup>lt;sup>8</sup> www.iccv.ro/romana/dictionar/dictionar.htm - accesat la 12.10.2013

pupils and students in that way, do nothing but reinforce existing inequalities rather than solve them.

With regard to training opportunities, Fischer and Kmec<sup>9</sup> found that living in neighborhoods with a lower socio-economic status reduces the ability of parents to convert their human capital in positive education results for their children.

Ioannides and Loury<sup>10</sup> emphasizes the idea that there is a well-established international consensus that social networks affect job opportunities, but there is also evidence that group differences exists in both the ability to use these networks and utility of networks itself. There are also a number of studies showing that these differences affect average group wages and influence levels of inequality.

Campbell<sup>11</sup> suggests that an increase in the extent of economic inequality in the United States over the past decades has intergenerational effects with broad social implications. Thus, increasing family income and wealth inequality leads to greater dispersion in the level of education, primarily because those who benefit from a lower part of the distribution of education achieve a level of education below average.

When the disadvantage caused by human capital "inherited" is compounded by the racial disadvantage, the effect is even greater, and the racial gap in education becomes larger.

Because the success on labor market is often related to academic achievement, the result of extending disparities in access to education will probably be a further increase in income inequality. Thus, the cycle of disadvantages that we have already seen is likely to be further increased if there are not adopted policies to counter or at least to mitigate the effects of growing economic disparities.

A potential productive route would be to provide greater resources to improve school education at all levels of schooling. Tuition subsidies to encourage secondary schooling may be another solution. Tuition costs are significantly and negatively associated with high school completion and enrollment suggests that subsidies are likely to be more effective if young people and their parents are informed about it during the high school years, long before reaching the point of deciding whether or not to apply for college.

Another factor that expresses strong impact on the level of education attained by an individual is the education level of the parents. Studies show that socio-cultural structures reproduce, so the current educational structure will depend on the past, people from educated families tending to become more trained and vice versa. Also entail an increase in the average level of school education, the trend is determined by cultural modernization, technological progress, increased quality of life and level of aspirations etc.

<sup>&</sup>lt;sup>9</sup> Fischer, M; Kmec, J. A., Neighborhood Socioeconomic Conditions as Moderators of Family Resource Transmission: High School Completion among at-Risk Youth, Sociological Perspectives, Volume 47, No. 4, 2004, pp. 507-527.

<sup>&</sup>lt;sup>10</sup> Ioannides, Y.M; Loury, L.D., Job Information Networks, Neighbourhood Effects, and Inequality, Journal of Economic Literature, Volume 42, No. 4, 2004, pp. 1056-1093.

<sup>&</sup>lt;sup>11</sup> Campbell, Mary; Haveman,Robert; Sandefur, Gary; Wolfe, Barbara, Economic inequality and educational attainment across a generation, 2005 disponibil la http://www.irp.wisc.edu/publications/focus/pdfs/foc233b.pdf

### 3. The influence of income inequality on social cohesion

When Henry Ford began his career in automobile construction, he paid his employees a salary double than the competition. This infuriated competitors who wanted to know the motivation of this gesture. Ford's answer was very blunt: "I want my employees to be able to buy the cars they produce" (as a side effect, the quality of Ford cars dramatically improved). This is a lesson that managers with "unjustified" large salaries have completely forgotten about.

Social cohesion is a characteristic of a society based on social connections and relationships between social units and individuals, groups, associations and between teritorial units. Sociologist Emile Durkheim was the first to use the concept of social cohesion. He believed that social cohesion is a future order of society and defined it as interdependence characterized by loyalty and solidarity among members of society. Issues often referred to in the description of social cohesion are: strengthening social relationships, shared values and existence of a common way of interpreting, living a common identity and a sense of community and trust among community members.

Social cohesion is a characteristic of the social environment, characteristic that favors development, equitable economic growth. This is based on what is defined as social capital, ie norms, networks and other forms of social relations and implies people's confidence that their common shares will benefit in the long term, even if short term entail losses. More specifically, social cohesion implies avoiding deepening inequality and social exclusion, strengthening feelings of trust and confidence and spirit of cooperation,

building transparent institutions, accountable and flexible to manage risks and rewards.

In addition to affecting levels of trust and civic engagement, inequalities in society, proved to be highly correlated with crime rates. Economic inequality affects crime through psychosocial processes that influence social interactions, cultural norms, values and behavior. They can be affected by inequality, by social status, social support, community cohesion, self-esteem, sense of control over one's life, loneliness, tension, anxiety, confidence, and depression.

Most studies that have examined the relationship between crime and inequality have focused on homicides - since homicides are almost identical defined in all nations and jurisdictions. These studies show that the trends for violence are more common in societies where income differences are larger. The research was conducted comparing developed countries with less developed countries, and by studying different regions within countries.

Elgar and Aitken<sup>12</sup> analyzed how income inequality leads to an increase in crime. In the 33 countries analyzed, they found some statistical links to prove the link between inequality growth and increasing crime. According to the results found, the correlation between income inequality and trust was 0.64, and between inequality and homicide 0.8. They found no link for tending of more egalitarian societies to increase spending on health and education.

They concluded that "companies which record large differences in income and low <sup>12</sup> Elgar, Frank J; Aitken, Nicole, Income inequality, trust and homicide in 33 countries, European Journal of Public Health. 2010, pp.1 Disponibil la: http://eurpub.oxfordjournals.org/content/early/2010/06/04/ eurpub.ckq068.full.pdf +html

levels of confidence can deprive society's ability to inhibit violence and creating a safer community."

Gilligan<sup>13</sup>, who, as a prison psychiatrist, examined issues of violent men, argues that inequality makes people more sensitive to the experiences of inferiority, such as a lack of respect, lack of confidence and humility situations that are among the most common causes triggering violence

Daly, Wilson and Vasdev<sup>14</sup> found that among US states and Canadian provinces there is a tenfold difference between homicide rates relative to the degree of inequality. They estimated that about half of all changes in homicide rates can be explained by differences in levels of inequality present in each province or state.

Lederman, Fajnzylber, Loayza<sup>15</sup> found a similar relationship worldwide. They used changes in various measures in the Deininger-Squire data inequalities to predict changes in the offenses of murder and robbery in 20 industrialized countries and 19 middle-income countries between 1965 and 1994. To measure these changes they used average levels of inequality and crime for different periods (because not all countries had data for all 6 possible periods) of 5 years in each country. They found a strong relationship in these countries between trends in

inequality, homicide and robbery. This relationship has been confirmed regardless of the way in which the inequalityis measured. They also found a strong correlation between policy measures of violent crime in successive periods of five years.

Richard G. Wilkinson and Kate Pickett's<sup>16</sup> research have also presented evidence that both social cohesion and health problems of the population are higher in countries or jurisdictions where economic inequality is higher. They point out, for example, that crime, mental health problems and teenage pregnancies recorded are lower in countries like Japan and Finland (or in general the Nordic countries) compared to countries with a higher degree of inequality, as for example USA and Great Britain.

Wilkinson, Kawachi and Kennedy<sup>17</sup> showed an inverse relation between income inequality and social cohesion. In countries where there is a greater equality, it is more likely that people trust each other, social measures suggests greater community involvement, and homicide rates are considerably lower.

Eric Uslaner and Mitchell Brown<sup>18</sup> showed that there is a high correlation between the trust that citizens have in society

<sup>&</sup>lt;sup>13</sup> Gilligan, J., Preventing Violence, Thames and Hudson: London, 2001, pag .12-15

<sup>&</sup>lt;sup>14</sup> Daly, Martin; Wilson, Margo; Vasdev, Shawn, Income inequality and homicide rates in Canada and the United States, Canadian Journal of Criminology, April 2001, pp. 219-236

Lederman, Daniel; Fajnzylber, Pablo; Loayza, Norman, Inequality and Violent Crime, Journal of Law and Economics, Vol. 45, No. 1, Part 1 May 01, 2002, pag. 2-4

Wilkinson, Richard G.; Pickett, Kate, The Spirit Level: Why More Equal Societies Almost Always Do Better, Penguin, 2009, pag. 15-18

<sup>&</sup>lt;sup>17</sup> Wilkinson, Richard G.; Ichiro Kawachi; Bruce P. Kennedy, Mortality, the social environment, crime and violence, Sociology of Health and Illness 1998, 20, pag. 578-597;

<sup>&</sup>lt;sup>18</sup> Uslaner, Eric.; Mitchell, Brown, Inequality, Trust, and Civic Engagement, American Politics Research, , Sage Publications ,Vol. 33 No. 6, Noiembrie 2005, pag. 868-894

and the degree of equality / inequality of income.

Other studies<sup>19</sup> have also found that people from different countries or regions with high levels of inequality tend to be less confident in state institutions and politicians. Low confidence can make voters more skeptical about promises that health will be improved through public spending.

If the Meltzer-Richard<sup>20</sup> hypothesis is correct, greater economic inequality among voters should make median voters more likely to support government spending on health and education.

Alesina, Baqir and Easterly<sup>21</sup> shows that the average public property for members of the community will decrease when the heterogeneity increases. If income inequality makes voters preferences more heterogeneous, this could reduce government spending on health. In addition, increasing economic inequality may permit the rich to afford the purchase of a larger political influence that could lead to reductions in government spending on health and education.

Schwabish<sup>22</sup> used transnational data to show that a greater distance between the 9th and 5th decile of the income from the market, determines the rich to increasingly support less public spending. However, the mechanisms that determine this relationship are not clarified.

Low confidence can be also linked to friendship groups or smaller social networks that are associated with mortality of more advanced age specific.

While the vast majority of research in this area confirms the link between income inequality and violent crime, the evidence presented have their opponents. Neumayer<sup>23</sup> is one of the scientists who question the link between inequality and violent crime (homicide and robbery). He recognizes that this relationship is widely accepted among academics and international agencies, including the World Health Organization and the World Bank. But using data from the international database of income inequality (http:// www.wider.unu.edu/research/Database/ en\_GB/database) he suggests that there is no link between income inequality and robberies. He argues that this is evidence that "effects / country specific elements" influence inequality and crime, such as for example cultural differences. However, such effects

<sup>22</sup> Schwabish, J.; Smeeding, T.M., Osberg, L., In-

come Distribution and Social Expenditures: A Cross-National Perspective, 2004, pag. 32-34 – disponibil online la http://www.russellsage.org/sites/all/files/u4/Schwabish,%20Eriksen,%20Marchand,%20Smeeding,%20%26%20Osberg\_Income%20Distribution%20%26%20Social%20Expenditures.pdf – accesat la 12-10.2014

<sup>&</sup>lt;sup>23</sup> Neumayer, Eric, Inequality and violent crime: evidence from data on robbery and violent theft, Journal of Peace Research. 2005, vol. 42, pag.101-112

<sup>&</sup>lt;sup>19</sup> Alesina, A.; Ferrara, E., Who trusts others?, Journal of Public Economics, Volume 85, No.2, pag. 207-234.

<sup>&</sup>lt;sup>20</sup> Meltzer, A.; Richard, S., A Rational Theory of the Size of Government, Journal of Political Economy, Volume 89, No. 5, 1981, pag. 914- 927

<sup>&</sup>lt;sup>21</sup> Alesina, A.; Baqir, R.; Easterly, W., Public Goods and Ethnic Divisions, Quarterly Journal of Economics, ,Volume 114, No. 4, 1999, pag. 1243-1284.

have been taken into account by Fajnzylber, Daly and other researchers mentioned above. Another explanation of Neumeyer's findings could be that he analyzed more the robberies problem rather than a homicide, and these types of offenses have different relationships to inequality. In addition, data related to robberies are well known to be less reliable than data related to homicides, especially for international comparisons because of different definitions and interpretations of these offenses that each state have.

#### Conclusions

The diversity of income sources make social policy of income domain one particularly complex. Economic inequalities between individuals or states are inherent, as - under certain conditions - is inherent in their emphasis. Studies on the evolution of income inequality have identified their downward trend during the "gold" of the welfare state. With the start of the reform process of social protection systems, due to the focus on enhancing individuals' responsibility to ensure their own wellbeing, income inequalities in society began to widen.

Social policy income must retain the role of national economic growth factor and shall not restrict (through inadequate support) future development. With this in mind, it is necessary that redistributive social protection, achieved through financial support, to be harmonized with the distributive, achieved by regulations to stimulate innovative capacity (entrepreneurial), work motivation and professional development.

Directions adjustment redistribution should consider providing a social minimum, to be completed with facilities that encourage individuals to be concerned with achieving revenue consistent with the possibilities, but also their expectations, while promoting private insurance. In social policy of income, tax system is assigned to a distinct role designed to reward the efforts of self, and personal development made by individuals.

An divided economy (society) tends not to provide equal opportunities to individuals that compose it, cleavages (seen in many facets: financial potential, social status, etc.) are becoming more meaningful; such, a person is born in a family with a low living standards (in conjunction with, for example, a belowaverage educational level of the family) has fewer opportunities - theoretically on - to exploit the true potential to a person enjoying an existential context on the opposite to previous illustration.

Trust between people is higher in countries with less inequality and statistics measuring their involvement in community life and social capital shows similar relationships. Economic inequalities contribute to division of society and social corrosion. They adversely affect the quality of social relations in a society.

To fight against inequality, an individual outside the richest quintile should educate themselve become more competitive on the labor market (if owns necessary resources) but must be supported by policy factors, political representation of interests of the majority of citizens.

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