Economics 150
Fall 2001
Homework #3: Due Thursday, 10/4/01

1. Consider a worker who earns the California minimum wage of $6.25 per hour and has no other source of income. For each of the following transfer programs, draw a diagram that shows the worker's budget constraint with and without the program. Discuss the work incentive effects in each case, comparing labor force participation and hours with and without the program.
   a. Payment of $25 per day if the person does not work at all, $0 if they work any hours.
   b. Income transfer that supplements labor earnings to achieve $25 of total income per day for anyone who earns less than that (guaranteed minimum income).
   c. Income transfer of $40 per day that is reduced by 25 cents for each additional dollar of labor earnings.

2. Using a diagram, discuss the work incentive effects of increasing the legal minimum wage for as worker currently paid the minimum wage, assuming that the worker would find employment at the legal minimum.

3. Suppose the Social Security Disability Insurance (DI) program was structured so that otherwise eligible recipients lost their *entire* disability benefits if they had any labor market earnings at all. Suppose too, that Congress was concerned about the work disincentives inherent in this program, and that the relevant committee was studying two alternatives for increasing work incentives among those disabled enough to qualify for it. One alternative was to reduce the benefits paid to all DI recipients but make no other changes in the program. The other was to maintain the old benefit levels (for those who received them) but allow workers to earn up to $300 per month and still keep their benefits; those who earned over $300 per month would lose all DI benefits.

   Use a diagram to analyze the work incentive effects of both alternatives. (Hint: Put monthly income on the Y axis and monthly leisure hours on the X axis.)

4. Consider a worker who earns $8.00 per hour and has no other source of income. Compare the following two transfer policies:
   (i) A negative income tax that sets the tax (per day) at $T = 0.2Y - 15$
   (ii) An earned income tax credit that subsidizes the worker at 40 cents for each dollar earned, up to a daily subsidy of $15, maintains the subsidy at $15 until the worker's labor earnings equal $45 per day, and then phases out at a rate of 20 cents per dollar earned.

   Discuss the relative merits of these two policies in terms of the following:
   a. Work incentives: Will one of the policies lead to greater labor-force participation? How do the policies affect the work hours of individuals who would be working under either policy?
   b. Well-being (preferences) of workers: Will one of the policies be preferred by all individuals? If not, which kinds of individuals prefer which policy?