V. Increase in Unearned Income

UNEARNED INCOME = NON-LABOR INCOME = Income that is not tied to work. Inheritance, lottery, rent, dividends, interest, TANF.

THE INCOME EFFECT IS A REDUCTION IN HOURS WORKED (AND AN INCREASE IN LEISURE HOURS) IN RESPONSE TO RECEIVING MORE INCOME.

4. Draw a graph that shows why "Trustafarians" (people who have tons of money because their parents put a ton of money in their name—in an account called a trust) are much less likely to work than people who don't have a trust.

VI. Changes in the Wage: Opposing Income and Substitution Effects

What happens to the budget constraint if I get a raise (i.e, my hourly wage rises)?

INCOME EFFECT → Work less

SUBSTITUTION EFFECT → Work more

5. a) Describe the opposing INCOME and SUBSTITUTION EFFECTS when the wage **rises**.

6. a) Describe the opposing INCOME and SUBSTITUTION EFFECTS when the wage falls.

b) Apply your analysis in Q6(a) above to predict what will happen if there is a tax increase on earnings.

IV. Child Care Costs

7. Karen and Hank are the parents of an adorable 3-year-old child, Max. Max's parents both can get jobs at $15 per hour. Child care is $5 per hour. One parent will work 8 hours per day. Suppose it is Karen.

a) Draw the budget constraint for Hank using Karen's income as Hank's non-labor income. Add an indifference curve to show how many hours Hank will work (or whether he will stay home to care for Max). [HINT: What is Hank's net wage after paying for day care?]

b) Now suppose a place opens up for Max at a free public pre-K. Add Hank's new budget constraint to your graph in Q8(a) above and show Hank's choice of working hours.

c) Explain the change.