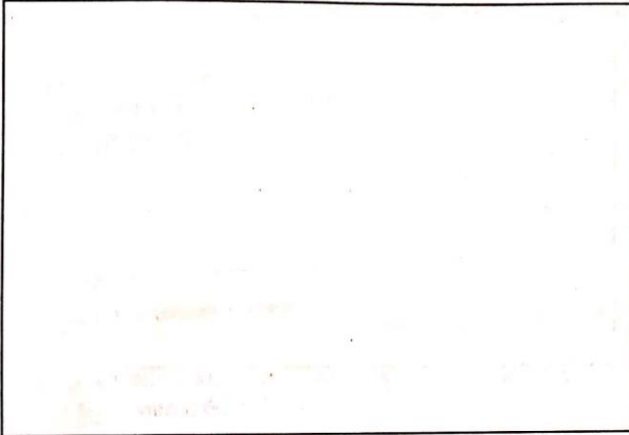


V. Increase in Unearned Income

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.



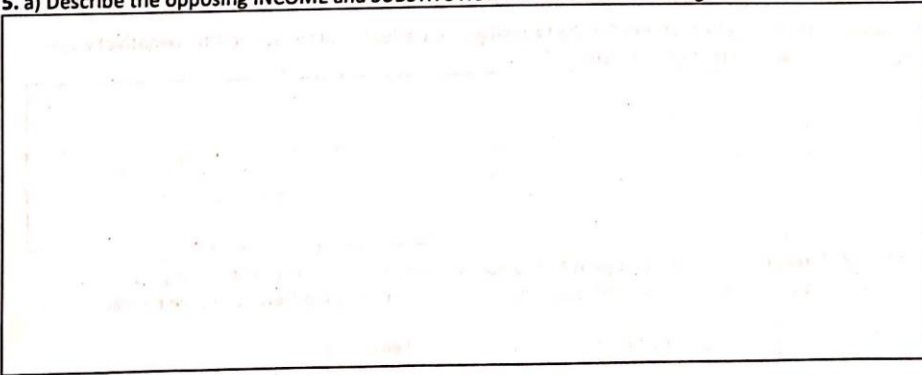
VI. Changes in the Wage: Opposing Income and Substitution Effects

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.



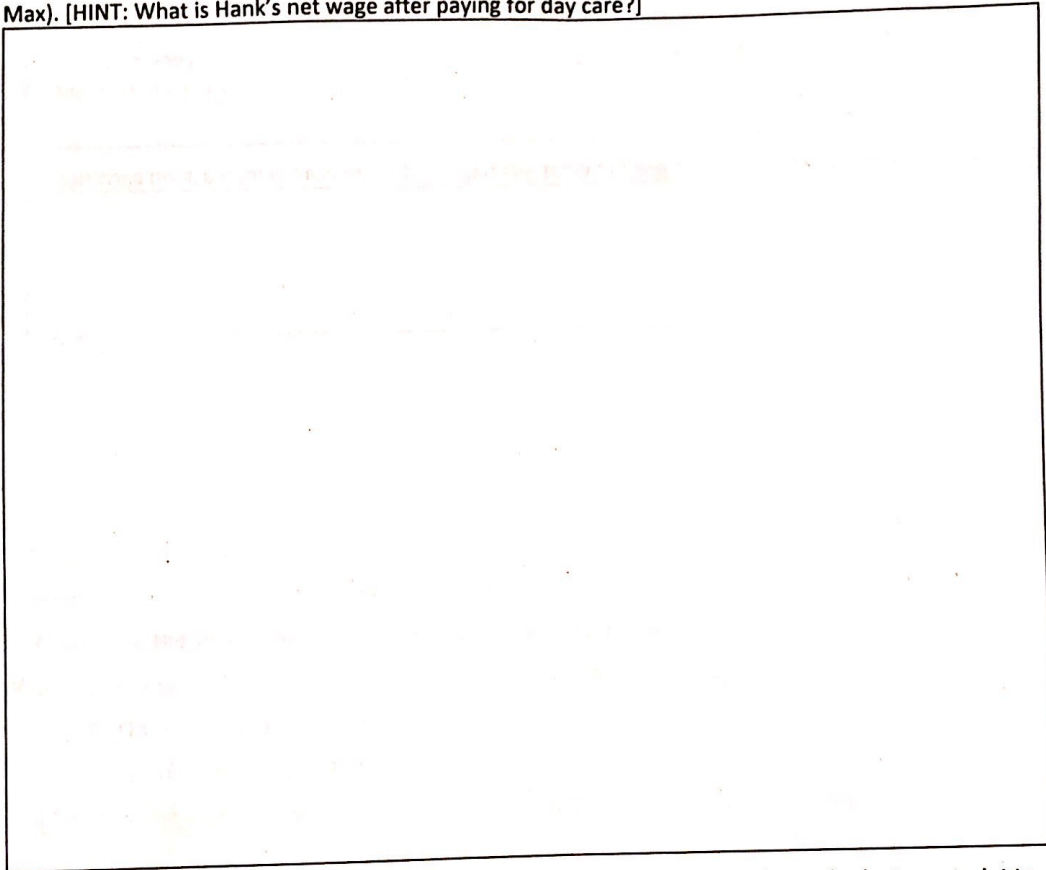
6. a) Describe the opposing INCOME and SUBSTITUTION EFFECTS when the wage falls.

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.

