

Urban Economics (Econ 50-03)
Spring 2002
Homework 3: Due March 20
(40 points)

1. (16 points) You have been appointed to your city's Anti-Poverty Task Force. They ask you to research on the likely effects of welfare reform on labor supply.

The old welfare program pays a poor person \$100 per week if the person does not work. If the person begins to work, the government reduces the welfare payment by 80 cents of every dollar the person earns. The poor person can be expected to make \$5 per hour if s/he works, and s/he has 100 hours per week to work for pay or not work for pay.

Under the old welfare program:

- a. Draw a graph with consumption per week on the y-axis and unpaid-work time per week on the x-axis. Then, draw the budget constraint for a typical poor person who does NOT participate in the welfare program. Make sure that you label your axes and the budget constraint's intercepts fully.
- b. Now, draw a similar graph and the budget constraint for a poor person who does participate in the welfare program. Label fully.
- c. With the old welfare program, should we expect the poor person to work more or less? Answer this question by discussing the income and substitution effects of the program.

Consider welfare reform:

- d. Now consider the following reform: Instead of reducing the welfare payment as the recipient begins working, the state government allows the recipient to earn \$15,000 per year before her payment is reduced. Graph the effects of this reform on the recipient's budget constraint. Will the recipient work more or less than under the old welfare program? Be sure to discuss the income and substitution effects of the change.
- e. What does the empirical evidence say about the effects of the 1996 welfare reforms on labor supply of mothers with children? On poverty rates?

2. (12 points) The Earned Income Tax Credit is another anti-poverty policy.

- a. Draw and fully label the budget constraint for a typical recipient of the EITC.
- b. What is the income effect of the EITC on labor supply? The substitution effect?
- c. If the effects work in opposite directions, which effect tends to dominate? That is, what does the empirical evidence say about the effects of the EITC on labor supply?
- d. How has the EITC affected poverty rates?

3. (8 points) According to Rebecca Blank, what is the most important source of poverty rate reduction in the United States? Based upon what she says, and what you know about the effects of various anti-poverty policies on labor supply and poverty rates, what policies do you support? Why?

4. (4 points) Chapter 14, page 403, exercise 11.