

1. (15 pts) When it comes to assisting the working poor, economists generally prefer expansions in Earned Income Tax Credit to raises in the minimum wage. Briefly explain this preference. Now recall the topic of tax incidence from earlier in the semester. Why might economists who support the EITC favor a minimum wage that *equals* the market equilibrium wage prior to an expansion of the EITC?

Economists recognize the minimum wage as a price floor, and as such believe that the minimum wage increases unemployment among the very low-wage earners it is supposed to help. This perverse outcome is exacerbated by the reality that a large percentage of those earning the minimum wage are teenagers from relatively well-to-do households. The EITC, on the other hand, transfers resources to the working poor without creating unemployment and more directly targets needy households. Regarding incidence: It is possible (and even likely) that firms are able to capture some amount of the EITC by lowering wages paid. (The worker is still better off than without the EITC, but not as well off as if she received the credit in its entirety.) A minimum wage that is not binding in the absence of the EITC would guarantee that low-wage earners were the primary beneficiaries.

2. (10 pts) We discussed three political philosophies (utilitarianism, liberalism/Rawlsian, and libertarian) that pertained to income redistribution. Briefly summarize each position with respect to income inequality. Separately explain whether each philosophy advocates a complete equalization of income.

Utilitarians believe that, like most everything else, income is subject to the law of diminishing returns. As such, those with higher incomes derive less satisfaction from the “marginal dollar” than those with lower incomes, and society as a whole can be made better off with some transfer from the rich to the poor. Rawlsians believe that, behind the veil of ignorance, we would all try to insure ourselves against being unlucky. They correspondingly assert that society should strive to improve the economic situation of this unluckiest individual. Libertarians, by contrast, believe that the fairness of the process is the only consideration and that considering outcomes is counterproductive. Since each position recognizes that the available amount of wealth depends upon incentives to produce, none of these philosophies advocate a complete equalization of income. They do, however, vary in their support for programs that reduce such inequality, with Rawlsians typically being the strongest advocates, followed by utilitarians, and libertarians denying the validity of the question in the first place.

3. (15 pts) Economists like to believe that a primary role of government is to eliminate or reduce the impact of market failures. Below are a number of federal government programs. Consider (with a brief explanation) what if any market failure has prompted government intervention. If a significant market failure does not seem to exist, why do you think the program is around?

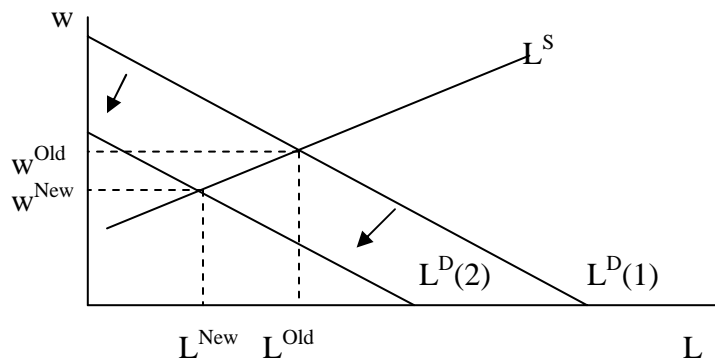
A. National defense
Public good

B. Agricultural incentives to let land lie fallow (i.e., unplanted)

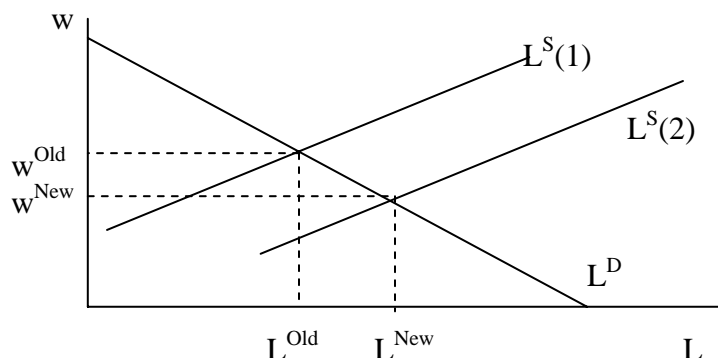
- No market failure – rent-seeking among farmers at expense of public (masquerades under common resource argument regarding soil erosion and surplus commodities)
- C. Temporary Assistance to Needy Families (i.e., welfare block grants)
Public good (reduction of most severe poverty, especially with respect to children)
- D. The system of courts (hint: think Coase)
Public good (enforcement and clarification of property rights)
- E. The space program
Positive externality from technological spillovers OR public good from national pride
- F. The Department of Justice Antitrust Division
Market power (trying to make the country a more competitive place)
- G. The Environmental Protection Agency
Environment as common resource (avoiding Tragedy of the Commons)
- H. Grants to universities
Positive externality from research OR positive externality from more highly educated populace
- I. Subsidies to the mohair industry
No market failure – rent-seeking (believe it started out in '50s as national security item for military uniforms)

4. (15 pts) Over the past 25 years, wages for domestic low-skilled labor have not kept pace with wages for high-skilled labor and have actually declined over some periods of time. Three possible explanations for this phenomenon are technology, immigration, and foreign competition. Graphically show how each explanation would affect the low-skill labor market. Which explanation(s) are consistent with the observed decline in the amount of low-skill labor?

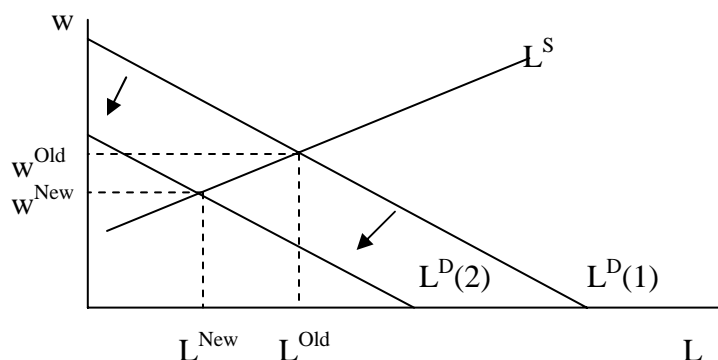
A. Technology: We would typically think of technological advances as raising wages by increasing the marginal productivity of workers, so how technology might lead to lower wages is at first puzzling. The key is to distinguish between skilled and unskilled labor. Recent technological advances have increased the productivity of the skilled and *replaced* the unskilled. In this way, one might think that technology has decreased the demand for unskilled labor.



B. Immigration: Increases in immigration will increase the supply of labor and (most likely) leave labor demand unchanged.



C. Foreign competition: If other countries have an advantage in the production of goods that use unskilled labor, then they will force the world price for those goods to fall. As these prices fall, the value of the unskilled marginal productivity also falls. This will lead to a decrease in labor demand.



All three explanations predict a decrease in the market wage for unskilled labor. The second, however, predicts an increase in the amount of unskilled labor that is hired. Since this runs counter to the reality (less unskilled labor has been hired), only the first and third explanations are consistent with the economic data.

5. (10 pts) Our government is subject to the will of the people, and people can (if they so desire) donate to charities that alleviate poverty. Some argue that this potential for private charitable giving implies that the government's antipoverty programs must be against the popular will and should therefore be abandoned. Counter this argument with an economic (not moral or emotional) defense of government efforts to reduce poverty.

It seems likely that Americans dislike the idea that people in their own country go hungry, can't pay for heat in the wintertime, and are in other basic ways impoverished. If this feeling is indeed widespread, then reducing poverty takes on the basic characteristics of a public good: everyone feels better when poverty is reduced, and there is no way to prevent someone from enjoying that knowledge. Consequently, the standard free-rider problem exists, and an opportunity for welfare-improving government intervention exists.