Eco 200: Group Activity 6  
Chap 20 & 21

**Chapter 20:**
Economic Mobility

1.  4th Edition: p. 451, Problems and Applications, Q4  
    3rd Edition: p. 448, Problems and Applications, Q4
   a. To increase economic mobility within a generation, the government could support training programs  
      (to provide skills to unskilled workers) and workfare instead of welfare (to help the poor increase their incomes).
   b. To increase economic mobility across generations, the government might increase its support for education.
   c. The advantage of reducing spending on welfare to increase spending on programs that enhance economic mobility is that it gives people greater incentive to work hard to get ahead. The disadvantages are that such programs are expensive and are hard on those who do not make it.

Income Redistribution
2.  4th Edition: p. 451, Problems and Applications, Q6  
    3rd Edition: p. 449, Problems and Applications, Q6
   a. Leaks in the bucket are caused by the administrative costs of redistributing income, people who lie about their income to cheat the system, and the fact that labor supply is elastic, so that redistributive taxes reduce labor supply.
   b. Generally, Republicans believe the redistributive bucket is more leaky than do Democrats. As a result, they think the government should do less redistribution of income than do Democrats.

**Chapter 21:**
Normal Goods & Inferior Goods
3.  4th Edition: p. 479, Questions for Review, Q5  
    3rd Edition: p. 477, Questions for Review, Q5

Figure 7 shows the effect of an increase in income. The rise in income shifts the budget constraint out from BC1 to BC2. If both wine and cheese are normal goods, consumption of both would increase. If cheese is an inferior good, the increase in income causes the consumption of cheese to decline, as shown in Figure 8.

![Figure 7](image1.png)

![Figure 8](image2.png)
A rise in the price of cheese from $6 to $10 a pound makes the horizontal intercept of the budget line decline from 500 to 300, as shown in Figure 9. The consumer's budget constraint shifts from BC1 to BC2 and her optimal choice changes from point A (c1 cheese, w1 wine) to point B (c2 cheese, w2 wine). To decompose this change into income and substitution effects, we draw in budget constraint BC3, which is parallel to BC2 but tangent to the consumer's initial indifference curve at point C. The movement from point A to C represents the substitution effect. Because cheese became more expensive, the consumer substitutes wine for cheese as she moves from point A to C. The movement from point C to B represents an income effect. The rise in the price of cheese results in an effective decline in income.

Figure 9

Income & Substitution Effect
5. 4th Edition: p. 479, Problems and Applications, Q1
    3rd Edition: p. 477, Problems and Applications, Q1
a. Figure 10 shows the effect of the frost on Jennifer's budget constraint. Because the price of coffee rises, her budget constraint swivels from BC1 to BC2.
b. If the substitution effect outweighs the income effect for croissants, Jennifer buys more croissants and less coffee, as shown in Figure 10. She moves from point A to point B.
c. If the income effect outweighs the substitution effect for croissants, Jennifer buys fewer croissants and less coffee, moving from point A to point B in Figure 11.
b. If the interest rate on your bank account rises to 8 percent, your budget constraint rotates. If you spend all your income when young, you will spend just $30,000, as before. But if you save all your income, your old-age consumption increases to $30,000 \times 1.08 = $32,400, compared to $31,500 before. As Figure 20 indicates, the steeper budget line leads you to substitute future consumption for current consumption. But the income effect of the higher return on your saving leads you to want to increase both future and current consumption if both are normal goods. The result is that your consumption when old certainly rises and your consumption when young could increase or decrease, depending on whether the income or substitution effect dominates.