

Chapter Three Labour Supply and Public Policy



Prepared by Dr. A. Noordeh
York University
Assisted by I. Bershad

Learning Objectives

- Income Maintenance Schemes
 - Demogrant
- Welfare Programs
- Negative Income Tax
- Wage Subsidy
- Earned Income Tax Credit
- Unemployment Insurance
- Workers Compensation
- Childcare Subsidies

Income Maintenance Schemes

- Designed to supplement low incomes, which can arise from a various number of reasons
- No single program can address the multiple reasons for low income

Income Maintenance Schemes

Table 3.1 Spending of the Federal and Provincial Governments on Income Maintenance Programs in 2002 (\$ billions)

Canada/Quebec Pension Plan	27
Old Age Security	26
Employment Insurance	13
Federal Child Tax Benefits	8
Social Assistance	9
Workers' Compensation	5
Others	33
Total	121

Source: Adapted from Statistics Canada website: <http://www40.statcan.ca/101/cst01/gov05a.htm>.

Income Maintenance Schemes

Universal Programs vs. Targeted Programs

Universal Programs

- Administratively simple
- Everyone receives the same transfer regardless of income
- Expensive
- Also benefits non-low income people

Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

5

Income Maintenance Schemes

Targeted Programs

- Cheaper method
- Individuals are given exactly enough of a transfer to reach the poverty line
- Only those below poverty line would receive transfer
- Creates a disincentive to earn income and, hence, may cause individuals to reduce work effort

Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

6

Income Maintenance Schemes

Permanent or Transitory?

- Compensating **low wages** or shortage of **hours worked**?
- Low income may be due to the shortage of **hours** worked or **low wage** rate:
 - Shortage of hours is mainly associated with the loss of transitory income (needs transitory type policy)
 - Low wage rate, on the other hand, may represent permanent low income (needs permanent type policy)
- Difficult to isolate permanent from transitory

Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

7

Income Maintenance Schemes

Demogrant

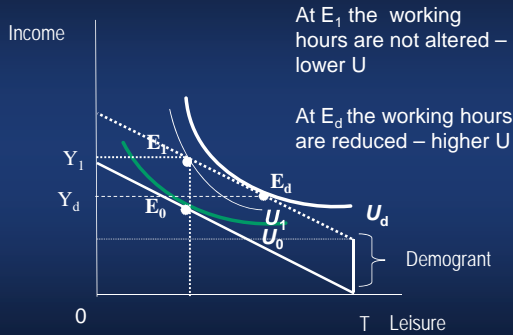
- Lump sum transfer or income grant (universal)
- Specific to a demographic group
 - Old Age Security (OAS): *Providing monthly benefits to people aged 65 and over*
 - Previous Family Allowance Program

Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

8

Work Incentive Effects of a Lump Sum Demogrant



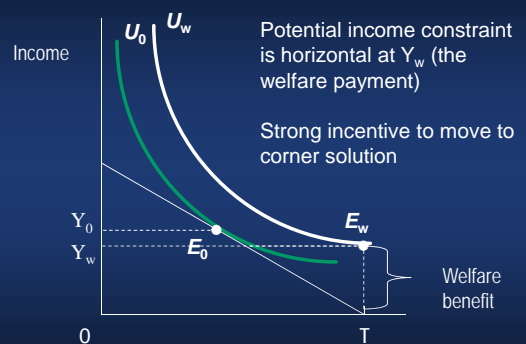
Work Incentive Effects of a Lump Sum Demogrant

- No substitution effect
- Work incentives are reduced
- Pure leisure-inducing income effect
- Increase in income is less than the amount of demogrant (all or a portion of the demogrant is used to buy leisure)

Welfare

- Administered by the provinces
- Financed partly by the federal government
- Benefits depend on:
 - needs of the family
 - assets
 - other sources of income

Welfare: 100% "Clawback"



Welfare: 100% "Clawback"

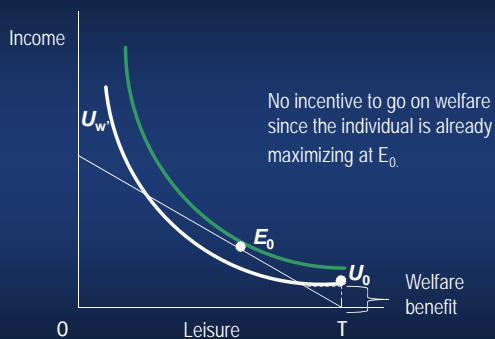
- Adverse effect on work incentives
- Work is not chosen because of the 100% tax on earned income

Possible Solutions

To improve work incentive of welfare programs:

- A. Reduce the welfare benefit
- B. Increase the wage rate
- C. Reduce the implicit tax (clawback)
- D. Change the preference

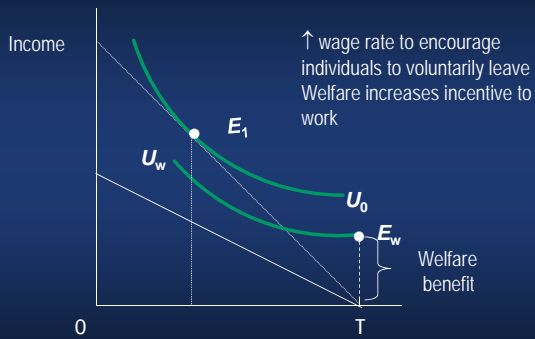
Welfare: A. Reduce Benefit



Welfare: A. Reduce Benefit

- Successful in reducing the number of people on welfare
- May deny welfare to those in need or provide inadequate income support to the unemployed

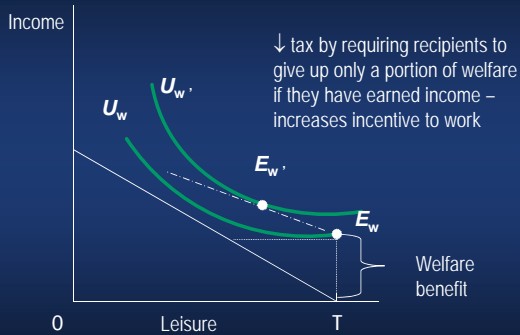
Welfare: B. Increase Wage Rate



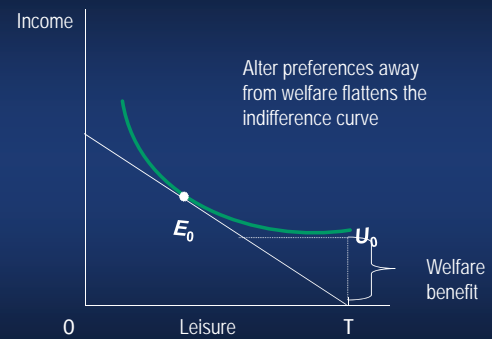
Welfare: B. Increase Wage Rate

- Increase wage rate through:
 - training
 - job information
 - mobility
 - government wage subsidy
 - institutional pressure (unionization, minimum wage)
- Costly

Welfare: C. Reduce the Implicit Tax



Welfare: D. Change Preferences



Negative Income Tax

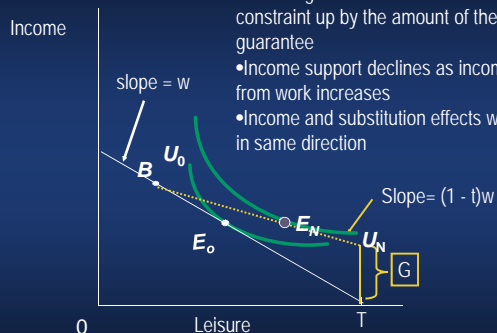
- Income guarantee
- Implicit tax rate of less than 100%
- Recipients receive more from the guarantee than they will pay out in taxes
 - Child Tax Credit
 - Guaranteed Income Supplement

$$Y = G + (1 - t)E$$

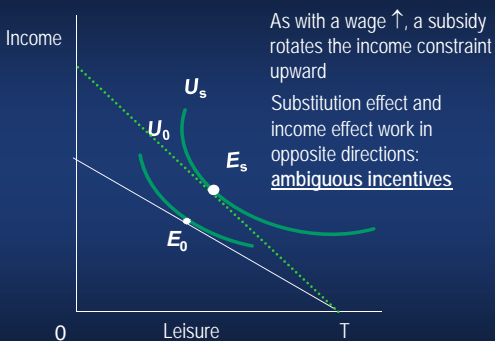
Where: G = Guaranteed Income
 t = Tax rate
 E = Earnings

Effects of a Negative Income Tax

- Income guarantee shifts the income constraint up by the amount of the guarantee
- Income support declines as income from work increases
- Income and substitution effects work in same direction



Wage Subsidy



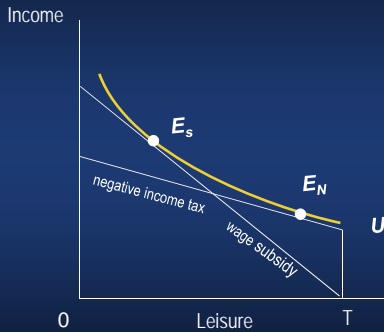
As with a wage \uparrow , a subsidy rotates the income constraint upward

Substitution effect and income effect work in opposite directions: ambiguous incentives

Wage Subsidy Effects

- Theoretically indeterminate
- Adverse effects of wage subsidy are not as great as those of the negative income tax
- Disadvantage: does nothing for the income of those who are unable to work

Wage Subsidy vs. Negative Income Tax



Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

25

Earned Income Tax Credit

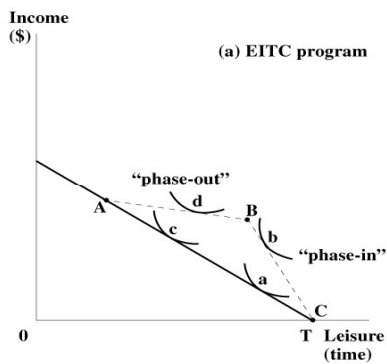
- An new “income-tested” wage subsidy program used in both US and Canada to reduce the cost associated with the pure wage subsidy programs
- It is a refundable tax credit or subsidy that is paid irrespective of other income taxes paid by the individuals

Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

26

Work Incentives of an Earned Income Tax Credit



Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

27

Earned Income Tax Credit (EITC)

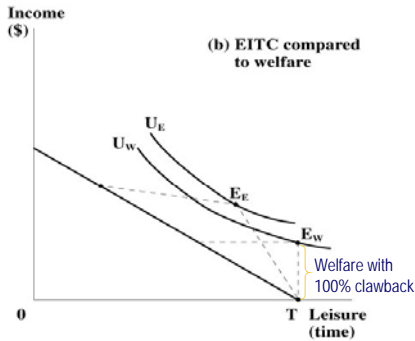
- **Two Phases of EITC**
 1. Phase-in: Similar to pure wage subsidy program. Substitution and income effects work in opposite directions.
 2. Phase-out: Similar to negative income tax. Both substitution and income effects work in the same direction and reduce the incentive to work.
- Compared to the welfare program, EITC results in more work incentive

Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

28

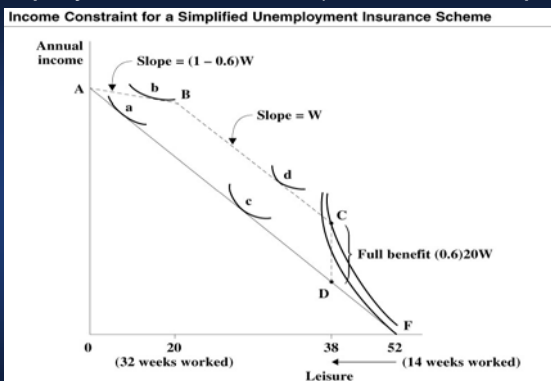
Work Incentives of an Earned Income Tax Credit



Employment Insurance

- The largest single income security program for non-elderly individuals in Canada
- The amount of income replacement rate is 55% of lost earning, subject to a maximum
- The duration of benefit ranges from 14 to 45 weeks, depending on the regional rate of unemployment
- To qualify individuals must have worked approximately 12 to 20 weeks, depending the unemployment rate of the region

Employment Insurance (Worked Example)

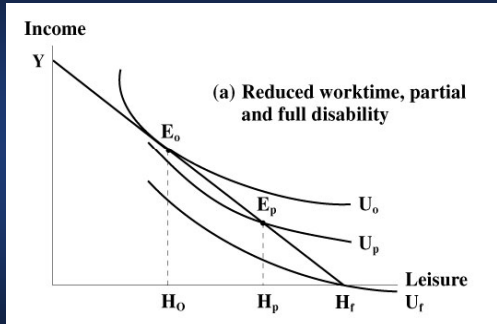


Disability Payments and Worker's Compensation

Effect of a Disability

- Budget constraint or preference curve could be altered
- Factors to be considered:
 - hours able to work
 - medical expenses
 - reduced ability to earn wages
 - disutility of labour market vs. other activities

Effects of Disability

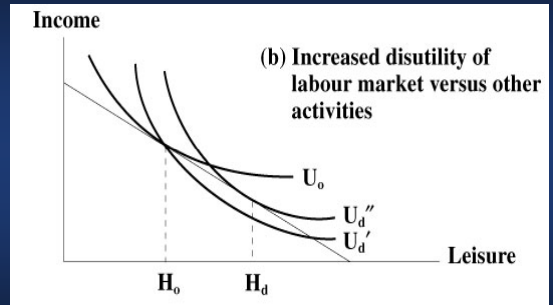


Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

33

Effects of Disability

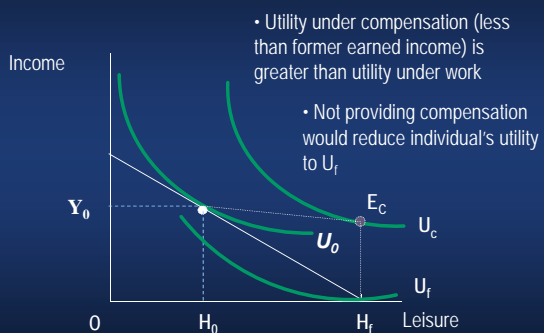


Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

34

Compensation: No Incentive to Return to Work

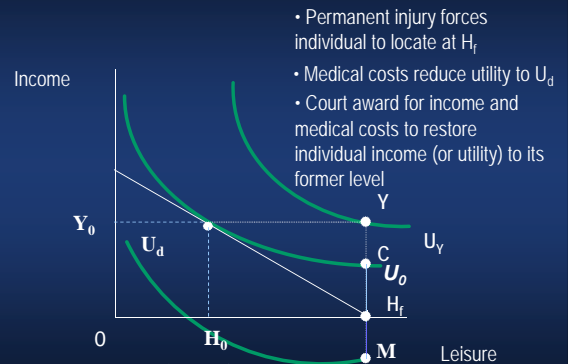


Chapter 3

© 2007 McGraw-Hill Ryerson Ltd.

35

Compensation: Restoring Income

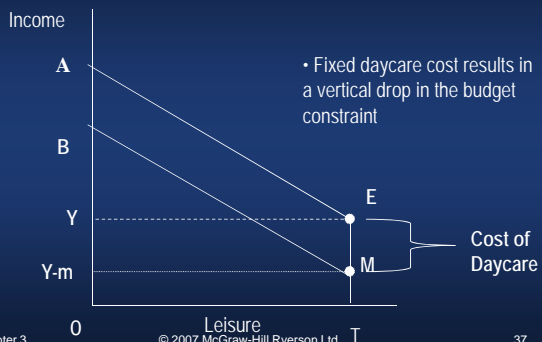


Chapter 3

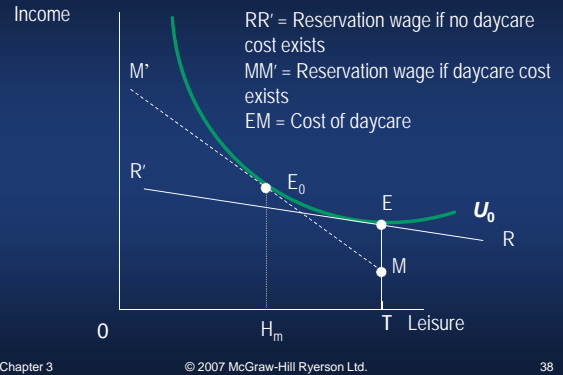
© 2007 McGraw-Hill Ryerson Ltd.

36

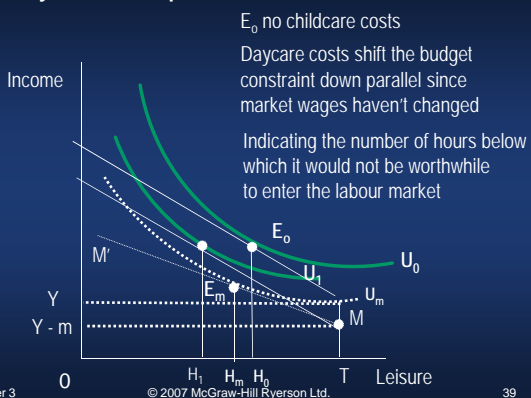
Childcare: Impact on Budget Constraint



Daycare: Impact on Participation



Daycare: Impact on Hours Worked



Daycare Subsidy

- Encourages labour force participation and part-time work
 - Reduces the hours of work for those already participating
- Chapter 3 © 2007 McGraw-Hill Ryerson Ltd. 40

Summary

- The Goal of Income Maintenance Programs
- Demogrants
- Welfare
- Negative Income Tax
- Wage Subsidies
- Employment Insurance
- Worker's Compensation
- Childcare Subsidies

End of Chapter Three