

Abstract

In this paper we investigate the effects of subsidizing low-skilled, labour-intensive services hired by high-skilled individuals in the presence of labour income taxation. Whether such a subsidy can be Pareto-improving depends crucially on the degree of substitutability of both types of labour in the non-service sector. In case of some substitutability, a service subsidy can benefit all and decrease inequality, but in case of complementarity, low-skilled individuals benefit and high-skilled individuals are worse off.