Solution

The PRO Wage: Rethinking Support for Low-Wage Workers

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President Obama is touring the country and arguing that “nobody who works full time should ever have to raise a family in poverty.” It is a powerful appeal that taps into

central tenets of modern U.S. policy.

The first is that citizens should have a minimum standard of living. This goal reflects Americans’ fundamental sense of fairness and is echoed in the broad array of social safety net programs provided by federal, state, and local governments, as

well as private charities. Nobody in America supports the notion of a class living beneath acceptable standards.

Second, the statement reflects the importance of work. Work is a time-honored American value. Work is also the traditional route out of poverty, and the means to providing a bett

er future for one’s children and other loved ones.

Unfortunately, the president is using these core values in support of a campaign to raise the federal minimum wage to $10.10 (and index it for inflation) – a proposal that interferes with getting more Americans to work and is poorly targeted to alleviate poverty. In other words, the policy and the message aren’t exactly in sync.

The other main policy towards low-income working families is the Earned Income Tax Credit (EITC). The EITC has a strong track record of promoting work and effectively targeting poverty. At present, however, it provides little support for single men and women without children. However, because it operates through the income tax system, the EITC is distributed annually and cannot help to meet the week-to-week or month-to-month cash flow needs of the household. Even more problematic is the fact that roughly 20 to 25 percent of EITC payments are in error.

If one were starting from scratch to think about low-wage labor policies, it seems unlikely that you would settle on these two approaches. How about something that takes the president at his word: a policy that ensures that full-time work does not mean poverty. In this short paper, I sketch the implications of such an approach: the Poverty Reduction Opportunity (PRO) wage.

How the PRO Wage would work.

A PRO wage is calculated in 4 steps.

First, one must choose a target income level for a full-time worker**.** If, as the president argues, the target is to make sure that full-time work (2000 hours annually) reaches the poverty line, then the target wage earnings range is from $11,670 (for a single person) to $23,850 for a worker with a spouse and two children.

Notice, however, that the current EITC actually reaches much further into the income distribution. For example, only 37 percent are below the poverty line and another 46 percent are between 100 percent and 200 percent of the poverty line. Obviously, the target level of earnings is a policy choice that would have to be made.

The second step is to adjust the target for the number of workers in the household**.** For a family of four with two workers, the $23,850 poverty target would translate into target earnings of $11,925 for each worker.

Third, translate the target earnings into a target wage**.** Mechanically, dividing $11,670 by 2000 hours yields a target hourly wage of $5.84. Similar arithmetic for 2-, 3-, and 4-person families yields $7.87, $9.90, and $11.93, respectively. Importantly, not every employee works full time. Thus, while the objective is to provide the opportunity for a worker to reach the target income (the poverty line), this should only happen if the worker exerts full-time effort. In this way, the PRO wage is both anti-poverty, but also pro-work.

Notice that this is also very different than the minimum wage. Indeed the PRO wage could very well fall below the minimum wage for some individuals. Intuitively, the better work incentives of the PRO wage would trump the higher per-hour pay of some minimum wage laws.

The final step is to translate the target wage into a subsidy for employees' wages**.** If an employee worked full time, it would be simply the difference between the actual wage and the target wage for the appropriate family size. Using a single worker and the $5.84 target wage, a regular wage of $5.00 would be supplemented by $0.84 or at a rate of 17 percent. If that same single worker has two children, a regular $5.00 would be supplemented by $4.90 or at a rate of 98 percent to reach the $9.90 target wage.

The PRO wage is a simple approach that retains good labor market incentives, while supplementing work effort to each income-support goals.

The PRO Wage in Practice

The idea of a PRO wage raises lots of questions. How big would the subsidies be? How much would taxpayers have to contribute? What households would be affected? I take a rough cut at these issues in the table below.[1]

A threshold question is whether the proposal would apply strictly to those paid on an hourly basis, or would include salaried workers whose effective wage (earnings per hour) fell below the target. The table contains computations for both variations.

PRO Wage Impacts						
	Per Hour Average Subsidy	Per Worker Annual Average Subsidy	Budget Cost ($ billions)	Households	Workers	Children

PRO Wage Impacts						
Hourly Workers	$2.67	$3,498	$16.9	4,597,549	4,824,995	7,861,809
Salaried and Hourly Workers	$2.83	$4,818	$34.8	6,832,949	7,216,754	9,839,447

As shown in the first column, the average subsidy would be $2.67 per hour and amount to $3,498 dollars annually. Accordingly, the average recipient is working roughly 26 hours per week (and 50 weeks per year).

The estimated budget cost is roughly $17 billion, which would double if all workers were allowed to participate. Even so, this is less than the current cost of the EITC, which is in the neighborhood of $60 billion. Of course, the pro-work incentives mean that this is the lower bound; greater work and participation will raise the price tag. Moreover, as noted above, the EITC is not restricted to those with poverty-level (and below) incomes.

The final columns show that the proposal would affect between 4.6 and 6.8 million households, 4.8 and 7.2 million workers, and cover 7.9 to 9.8 million children.

The PRO Wage: Issues

The PRO wage raises several issues. In particular:

- Multiple jobs. Suppose, that a worker – as many do – has multiple jobs. Does that raise a problem? No. The PRO wage supplements the return to hours of work, regardless of where they occur. Each employer will know both the target wage for the individual and the actual wage being paid, so the subsidy will occur at the correct rate for the hours worked for each employer.

- Multiple workers. As noted above, the target wage is adjusted for the number of workers in the household. A potential weakness is the ability to ensure compliance. There is an obvious incentive for each worker to report that he or she is the only worker in a household, and to collect twice the appropriate amount. Audits and penalties would be needed to provide incentives for accurate compliance.

- Marriage penalty. A related issue is the impact of marriage. The poverty-level is adjusted for family size and goes up less than in proportion to the number of family members. At the same time, the PRO-wage subsidy is strictly proportional to the number of workers. The means that if two working singles marry, there will be a marriage penalty that is $7,470 annually.

- Incentives for children. Again, in this example, the target wage is the poverty level and this rises with family size. In this way, there is a modest subsidy for having children.

- Fluctuation in hours and wages. Individuals can work more or less during a given pay period, and many workers get wage increases. Employers should have little difficulty accommodating these changes.

- Effective tax rates. As individuals earn more, their PRO-wage is unchanged – meaning there is a zero effective marginal tax rate – until they reach the poverty level. At that point, the subsidy ceases and yields a sharp marginal tax rate. Beyond that, however, the wage remains unchanged and the zero marginal tax rate returns.

- Other forms of compensation. A potential weakness of the PRO wage is that it ignores non-wage compensation like fringe benefits. True enough, but this is a characteristic shared by the minimum wage, the EITC and virtually every other low-income policy.

- Capital income. The PRO wage ignores any dividends, interest, or capital gains the household may receive. Put differently, the PRO wage is not targeted explicitly on poverty households and could be received by higher-income individuals. This is a problem shared by the minimum wage, but better handled by the EITC. In practice, however, there are relatively few high-income households likely to be recipients, and the advantage of a timely, pro-work subsidy outweighs the weaker targeting.

- Taxes. The PRO wage as computed above ensures that pre-tax earnings hit the poverty threshold. An obvious – if costlier – policy would ensure that post-tax earning hit the threshold by raising the subsidy. Since poverty-level households would be unlikely to be paying any income tax, the key would be to raise the subsidy enough to offset the combined employee shares of the Social Security (6.2 percent) and Medicare (1.45 percent) payroll tax rates. This would raise the target wage and subsidy by about 8 percent.

- Incentives for employers to cut wages. Wouldn't enacting the PRO wage cause employers to cut wages and implicitly capture the subsidy? Perhaps, but employers *always* have an incentive to pay lower wages. They do not because competition for workers and their skills makes it unprofitable to do so. That is why so few workers today earn the minimum wage. The same competitive dynamics would remain in place if the PRO wage were adopted.

- What happens to the minimum wage and EITC? A full-scale commitment to a PRO-wage strategy would imply the need to rethink these other approaches.

- How would employers administer the PRO wage? Employers would require information sharing that gave them the target wage for each employee (easily computed by the household size and number of workers). They could pay the subsidy each month and handle cash-flow issues by offsetting tax payments by the amount of the subsidy paid.

The American economy remains the greatest the globe has seen, and is built on valued tradition of work. Americans simultaneously support an efficient social safety net for the least well off. Safety net policies that are inefficient or interfere with work should be discarded in favor of those that incentivize work and genuinely address poverty.

[1] I sincerely thank Ben Gitis for his assistance with the computations. Details are available upon request.