The question isn’t why wage growth is so low. It’s why it’s so high

By Neil Irwin
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One of the economy’s biggest mysteries is this: The labor market is the strongest it has been in a decade, yet wages are rising barely faster than inflation.

For some reason, the booming job market and ultralow unemployment rate, which fell to 4.4 percent in April, haven’t led employers to raise pay in a meaningful way. That flies in the face of a basic assumption of how the economy works: A tight labor market is expected to lead to pay increases that in turn fuel broader inflation.

But the mystery of the missing pay raises may have a surprisingly simple solution, and one that sheds light on the larger economic challenges of our age.

Consider a simple model for how much the average worker’s pay ought to be rising: You could simply add together the productivity growth rate — how rapidly the output generated by each hour of labor is increasing — and the inflation rate, which tells us how quickly prices are rising.

Over the last 24 months through March, inflation has come in at 1.4 percent a year, and productivity growth at 0.6 percent. Those are very low numbers. And in our supersimple model, you may expect average worker wages to have risen only 2 percent.

In fact, the average hourly earnings for nonmanagerial private sector workers rose 2.4 percent a year in that period. You may not feel like cheering about that, but it’s more than we might have expected, with inflation and productivity so weak. The real mystery, then, isn’t why wages are rising so slowly, but why they’re rising so fast.

If anything, the numbers show that workers are capturing more than their share of the spoils from a growing economy. And that, as it happens, is the reverse of a decades-long trend. For most of the last half-century — 84 percent of the time since 1966 — average wages have grown more slowly than would be predicted based on productivity and inflation growth. The rise in the share of employee compensation that takes the form of health benefits instead of wages is a factor, but doesn’t explain the whole gap; for long stretches, that gap exceeded 2 percentage points a year.

That means the labor share of national income was shrinking, or, more plainly, that workers’ slice of the economic pie got smaller while the part taken by shareholders and other owners of capital grew.

In the last few years, though, that trend has partly reversed: Workers’ slice of the pie has increased a bit. More than at any time since 1970, wage gains in the two years through June 2016 outstripped the gains predicted by inflation and productivity in our simple model.

Why? Minimum wage increases in several states probably contributed. Obama administration efforts to shift the playing field toward workers may have helped, too. But we don’t know whether this is a temporary blip or the beginning of a trend, in which employee paychecks will swell with a greater share of the fruits of economic growth.

Surely, the low unemployment rate is an important factor. Economic theory tells us that when workers are scarce, employers have to raise wages, though it hasn’t always worked out that way: Wage growth underperformed productivity and inflation during some periods of low joblessness, including in the mid-1980s and mid-2000s.

Indeed, economists at Goldman Sachs recently studied which factors drive wage trends in 10 major economies, and identified low productivity growth as the main culprit behind the recent weakness in wage numbers around the world. (Low inflation, Jan Hatzius and Sven Jari Stehn found, has been “a negative but more temporary factor.”)

Recently, labor costs have begun to grow faster than revenue for some companies, which attribute that development to a mix of government policy and general good times.

“While food costs are pretty benign, you are seeing, certainly in some markets, some pretty good inflation rate in wages,” said Patrick Doyle, the chief executive of Domino’s Pizza, in a recent conference call with analysts. “Some of it is a result of the minimum wage, but some of it is simply because there are areas in the country where employment levels are strong.”

Even if we don’t have complete answers, that much is relatively straightforward. But the wage question quickly leads us into more difficult economic questions.

Everything in macroeconomics is linked, though not in ways that are fully understood. The relationship between joblessness and inflation is known as the Phillips curve, for example, and it points downward: The lower the unemployment rate, the higher the inflation rate should be.

Or at least that’s the theory, and one that is a starting assumption for a great deal of policy making. The Federal Reserve Board reckons it can’t let the unemployment rate get too low, or a burst of inflation will come. In reality, though, the relationship between unemployment and inflation is not straightforward and seems to be always moving.

Even less is known about the ties between wages and productivity. This is particularly important if, as our analysis of wage trends suggests, low productivity growth is the culprit behind Americans’ small inflation-adjusted pay increases during the last few years.

One way of thinking about productivity growth is that it is rooted in unpredictable innovations that have little to do with anything else in the economy. Say a genius inventor creates a robot that mows your lawn perfectly. Human landscapers might lose their jobs, but if they find something worthwhile to do, the productive capacity of the economy will grow.

The causation could go in other directions, however: Wage growth, or the lack of it, might affect innovation and productivity. Perhaps if businesses pay their employees as little as possible, for example, those companies will lose the incentive to train and develop more productive workers. Some employers, including the mega-retailer Walmart, have examined this problem and found that by paying somewhat more in wages, they get a more productive work force.

That suggests that the productivity slump could be a result of businesses that have failed to pass on the gains from a growing economy to their workers for decades. Some left-of-center economists are exploring whether a higher minimum wage or a stronger social welfare system might increase productivity growth and the supply of labor.

Unfortunately, the picture isn’t entirely clear. The process by which businesses and their workers become more productive is something of a black box, deeply important yet not really understood. But perhaps we can at least ask better questions: The real mystery isn’t why wage growth is so low, but why productivity is so low. And solving it could leave both workers and their bosses better off.