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IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

Dr. Norman B. Ture presented an address to the Commonwealth Club of California in San Francisco on October 13, 1981.

Ture, who was then serving as Under Secretary of the Treasury for Tax and Economic Affairs, discussed the conceptual basis and main features of the Reagan economic recovery program.

Dr. Ture's address was later printed by both the Tax Foundation (*Tax Review*, October 1981) and Tax Analysts (*Tax Notes*, November 30, 1981, pp. 1353-1356).

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New Directions In Economic Policy

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Address to the
Commonwealth Club of California

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I am delighted to have the opportunity to discuss with you one of the most exciting phenomena of our times -- the new directions in economic policy as embodied in President Reagan's Economic Recovery Program. I need hardly tell you that the President's Program has engendered great interest, not only in the United States but in virtually every part of the world. The occasion for this interest is the change in approach to the solution of the economic problems in the United States which the Reagan Program sets forth. The basic objectives of public economic policy do not change from administration to administration; we all want much the same things -- expanding opportunities for more rewarding jobs, steady advances in our real incomes, a stable price level, and continuing economic progress. The interest in the Reagan Program doesn't stem from changes in policy objectives, but from the fundamental changes in strategy upon which the Program relies in pursuit of these objectives.

The Basic Outlines of the Economic Recovery Program

In virtually every major respect, the Reagan Economic Program represents a dramatic and drastic shift in the perception of what are government's responsibilities with respect to effective

operation of the economy and how these responsibilities are most effectively discharged. Nothing is harder to relinquish than cherished beliefs; in challenging old ideas, the Reagan Program and the concepts it embodies have made many people uneasy. But the Program has also engendered greater and more broadly based enthusiasm than anything we have seen in decades, reflecting the fact that its philosophy touches a highly responsive chord among a great many of us.

The fundamental precept in that philosophy is that government must respect and must seek to protect and enhance the freedom and integrity of the individual. In doing so, government must reject policies and programs which, however well intended, constrain the opportunities for individuals to make their own decisions. All such policies, by relieving people of that responsibility, induce their dependency. In the field of economic policy, the philosophic thrust of the Reagan Program is toward providing those institutional arrangements which will be most conducive to individual initiative and responsibility for determining one's economic activities, status, and progress.

This, it must be recognized, is quite a different approach from that pursued for many years past. It is only slightly hyperbolic to characterize the underlying views which had long prevailed in prior administrations as holding that the market sector of the economy, left to its own devices, could do nothing right. This conviction, seldom expressly articulated but evident in virtually every phase of government policy, gave rise to an ever expanding participation by government over an ever broadening scope of economic activity.

This view is rejected by the present Administration. The fundamental premise upon which its economic program is based is that if government policies and actions interfere less with its operations, the market system can and will perform effectively -- far more so than it has. As a corollary, the outcomes of the functioning of the market system, operating in a much freer atmosphere than in the past, are deemed to be not only acceptable but, indeed, the best, overall, that can be achieved. This is not blind faith in the perfection of markets. Instead, it argues that the proper responsibility of government is to seek to identify and to remedy the sources of market failure and to facilitate more efficient market operation. This contrasts sharply with the prior approach under which government actions sought to constrain and to dictate market outcomes.

Disengaging the economy from government control means shifting responsibility for the initiation of economic activity and for determination of the composition of economic activity and its course over time, from government to the private sector. As a corollary, government must reject the elitist notion that public policy makers know better than private market participants what is good for them -- the private market participants. Similarly, government must relinquish its futile, if not, indeed, counterproductive efforts to manage aggregate demand and to seek to fine-tune aggregate economic outcomes to some ill-founded notions of optimum levels or trade-offs of employment and output, on the one hand, and the rate of increase in the price level, on the other. This change in policy rests on the finding that most deviations from a relatively

steady growth path result from government-originated disturbances. This policy posture holds that whether or not these disturbances can be averted or minimized, the private market system far more efficiently adjusts to and dampens these shocks if government doesn't intervene.

Rejecting short-run fine tuning, moreover, necessarily involves a shift in the focus of public policy to the long run. The priority goes to setting those conditions under which the economy can best perform over time, where "best" conforms with the consensus of individual preferences, rather than government dicta.

Government's relinquishing control of the economy calls for institutional arrangements in which the private market mechanism can more efficiently perform. To this end, clearly, the thrust toward an ever-mounting edifice of complex regulations must be reversed. The policy concern is not to dismantle the existing regulatory system nor to abandon totally the use of regulatory powers. Instead, the effort is to change the focus of regulation from mere circumscription, constraint, and control of how households and businesses perform toward allowing them to perform more efficiently by internalizing, where possible relevant external benefits and costs.

By the same token, government spending programs must be revised, not merely to reduce their aggregate preemption of the economy's production capability but also to assure that any such preemption is directed in the most efficient way toward appropriate objectives. No longer can we afford to proceed on the assumption that government programs have and are entitled to a life of their own, that an ongoing program must continue to go on, or that revising or reducing a spending program necessarily means irreparable damage to its current beneficiaries.

The shift toward greater reliance on the private sector requires drastic revisions in the tax structure. The aim here is a system of taxation which least distorts the signals cast up by the market system with respect to the most rewarding uses of production capabilities.

Finally, if the private sector is to be able to discharge its responsibilities effectively, monetary policy must facilitate the efficient operation of financial markets. A monetary policy which results in erratic and unpredictable changes in the stock of money imposes costly barriers to efficient portfolio management and distorts and confuses information about the real terms of trade between the present and the future. Where the growth in monetary aggregates is too rapid, the consequent inflation is likely to interact with the tax system to accentuate real tax rates and their adverse effects. At a minimum, the Reagan Economic Recovery Program requires a steady, moderate growth in the stock of money on which household and business decision-makers can confidently rely. Beyond this, the Program looks to eliminating antique regulations of financial institutions and to assuring that these institutions facilitate rather than impair the effective operation of the financial markets.

The Conceptual Basis of the Reagan Program

These prescriptions for economic policy are not the outcome of ad hoc decisions in the White House. On the contrary, in all of its major respects, the Reagan Economic Program rests on a consistent and systematic set of analytical constructions, inappropriately dubbed "supplyside economics." In fact, supply-side economics is merely the application to problems concerning economic aggregates of the most solidly established concepts of the economics discipline. Its antecedents are to be found in the work of the classical economists of the modern era, from Adam Smith, David Ricardo, John Stuart Mill, and Alfred Marshall through Irving Fisher and Milton Friedman. As such, it depends on no new body of theory; rather, it involves addressing the neo-classical mode of analysis to public economic policies, where these are focused on concerns of the economy as a whole or of particular groups. . . .

The basic and distinctive attribute of supply-side economics is to be found in the way it depicts the effects of government actions on economic activity. The first effect of any and all government actions, in this analysis, is on the relative costs of prices confronting households and businesses. Everyone feels comfortable with this idea in connection with an excise tax, say, on gasoline. Quite properly, we think of such a tax as raising the price of gasoline relative to the prices or costs of other things, and we expect that, in response, people will buy somewhat less gasoline than they otherwise would.

Supply-side economics holds that all government actions involve this sort of excise effect and that it is the way in which people respond to these excise effects -- these changes in relative prices or costs which are the initial consequence of government actions -- which determine the ultimate outcomes of the actions. These responses take the form of changes in the way we use existing production capability and in the way we dispose of our incomes. These changes are likely to result, more or less promptly, in changes in the total amount of economic activity, hence in the total amount of our real incomes. And these changes in our real incomes are likely to lead to further changes in economic activity.

For example, if the government changes taxes in such a way as to make working more rewarding -- hence less costly in terms of foregone leisure -- the result is likely to be an increase in employment. In turn, this is likely to result in more production; therefore more income produced. With more income, we are likely further to change what and how we do things -- how much of what we buy, how and in what ways we save, and so on. These subsequent changes in our income and how we use it, in turn, will impel other changes in production and income, and so on, in a dynamic process . . . .

Supply-Side Economic Policies

This way of analyzing how government actions affect the economy is quite different from the conventional approach which has guided economic policy formulation over the past four and a half decades. Not surprisingly, it leads to policy prescriptions which are quite different from those which have been standard for many years past.

For one thing, the supply-side analysis rejects the conventional view that increasing government spending will increase total output and income. It holds that, instead, government spending displaces private spending. It follows, therefore, that there need be no fear that curbing the growth of government spending will adversely affect total output, employment, and income. On the contrary, in the supply- side approach to policy, reducing the level or rate of gain in public spending should result in an expansion of private sector output and employment and very likely lead to a net gain in total output (except in the case in which the government activity which is curtailed involves more productive uses of production inputs than the private sector uses).

This perception is clearly embodied in the Reagan Program prescription for a very substantial reduction in the growth of Federal spending. Cutting this spending growth is perceived by the Administration as an essential step in freeing production inputs for more productive uses in the private sector, hence as a basic ingredient in a policy of invigorating private sector-initiated economic growth.

The tax policy predicated on the supply-side analysis rejects the futile -- indeed counterproductive -- efforts of the past to use taxes to redistribute income and wealth. Instead, the focus of policy is to eliminate or at least reduce the adverse effects of taxation on incentives to work, to increase one's productivity, to save and invest, to start new enterprises, to innovate in developing new and better products and production processes -- the kinds of activity on which economic progress always and everywhere depends. Thus, the principal concern of The Economic Recovery Tax Act of 1981 was to reduce the relative cost of working and of saving and investing by reducing marginal income tax rates. Moreover, many, indeed most, of the other provisions in the tax legislation as finally enacted reflected this primary concern with the effect of taxes on the relative costs of alternative actions of taxpayers. . . .

These differences in approach to government spending and tax policies together reject trying to use fiscal or budget policy to control aggregate demand. In the Reagan Program, government spending targets are not set by reference to any supposed contribution of these outlays to aggregate demand. Nor does policy focus on the amount of tax revenues as a means of influencing the level or change in total economic activity. Similarly, the size of the deficit is not a relevant variable for policy manipulation in the interests of attaining designated levels or rates of growth in employment, output, total income, etc.

The supply-side approach to fiscal policy affords quite a different appraisal from the conventional view of the effects of fiscal actions on the price level. For many years the prevailing view has been that tax and expenditure changes directly generate changes in total demand which are presumed to result in increases or decreases in inflationary pressures. In contrast, the supply-side analyses show that fiscal actions affect aggregate demand only as they first affect total output by changing how much people want to work, save and invest, etc. Thus, an income tax rate reduction makes it less costly to work and to save, hence generates increases in the supplies of labor and capital services and in output; the increases in real output necessarily result in increases in real income and real demand of exactly equal magnitude. No increase in inflationary pressures results. Any such increase would have to be the consequence of an unnecessary increase in the stock of money. Indeed, if the growth in the stock of money were maintained at the same rate as if the tax rate reductions were not enacted, the increase in output resulting from the tax reduction would lead to a reduction in any upward pressure on the price level. This perception of how fiscal actions take effect is fundamental in the Reagan Economic Program and underlies the Administration's confidence that recently enacted tax reductions will not enhance but will reduce inflationary pressure.

As a corollary, the supply-side analysis rejects the view that budget deficits per se are inflationary. The pseudoscientific view of budget deficits as a source of inflation rests on the observation that those deficits tend to be monetized -- to generate expansion of the stock of money by our monetary authority. But this is not an inherent or necessary consequence of budget deficits; the Federal Reserve is not required to convert increases in the government's debt into increases in the amount of money. The pressure on the Federal Reserve to do so depends to a large extent on how the deficit originates. Insofar as it results from tax or spending actions which depress or inadequately stimulate private sector saving, it is indeed likely to be financed by a greater monetary expansion than would otherwise occur which, in turn, may well result in accentuation of inflationary pressures. On the other hand, some fiscal actions, in particular supply-side tax reductions of the sort recently enacted, which reduce the relative cost of saving, are likely to generate a sufficient increase in private sector saving to eliminate the need for any monetary expansion to finance the deficit such tax cuts produce.

A major policy prescription which flows from this analysis is that the traditional institutional link between monetary expansion and government deficits should be broken. Monetary policy should pursue a firm policy of slow and steady growth in the stock of money, substantially oblivious to budget prospects or outcomes.

This, clearly, is precisely the prescription for monetary policy which the Administration has urged upon the Federal Reserve.

Supply-side economics rejects the view that price-level stability can be purchased only at the cost of unacceptably high levels of unemployment or that accptable growth in employment depends on pursuit of fiscal and monetary policies likely to spur inflation.

On the contrary, the supply-side analysis shows that public policy actions which are correctly designed to remove the impediments to employment and to saving and capital formation will constrain, not enhance, inflationary pressures. The root cause of inflation always has been too fast a growth in the stock of money relative to the growth in real output. It should be obvious that with any given rate of increase in the stock of money, the more effective government policies are in increasing the supply of labor and saving and investment, the less will be the upward pressure on the price level. A corollary is that a monetary policy which succeeds in curbing inflation will augment expansion of supplies of labor and capital services and total output and income. Inflation enhances the existing tax bias against effort and saving by increasing the real marginal rates of income tax. This bracket creep reduces the real after-tax returns for use of labor and capital services, and constricts the expansion of labor and capital inputs and total output. Pursuit of a "tight" monetary policy, i.e., one which holds firmly to a steady, moderate rate of increase in the stock of money, accordingly, is not at odds with high rates of growth in output and employment. On the contrary, an anti-inflationary monetary policy enhances the prospects for successful pursuit of those objectives.

Some Concluding Observations

The economic program upon which the Reagan Administration is launched represents a sharp break with many of the policies of the Federal government of the past four and a half decades. But the intellectual content of the Reagan policies is not fairly represented as novel or exotic. On the contrary, these policies conform very closely with the prescriptions cast up by the application of an extremely rigorous and hard-headed analytical system. Nor, let me hasten to add, is that system derived solely from intellectual abstractions. Indeed, there is an extensive factual record which consistently adds credence to the analytical propositions, to the policy prescriptions based thereupon, and to the projected results of these policies.

The Reagan Program is a grand design for restoring economic freedom and responsibility to the individual, thereby reinvigorating the types of activities upon which economic progress has always depended. There are, to be sure, many possible impediments to the effective implementation of that design. The current state of the U.S. financial markets, which so troubles us and our friends around the world, could impose a major stumbling block to the positive responses to the Reagan Program. The Administration does not take that situation lightly, you may be sure. We are confident, however, that the Program's objectives will be realized and that the resulting sustained prosperity will be widely shared.

Of paramount importance is that prosperity will be solidly founded on the initiatives and self-reliance of households and businesses responding to market signals. To a far lesser degree than in the past, that prosperity will not depend on the inherently uncertain course of government actions and policies. People will come to realize that their economic prospects rest basically on their own actions and that their future well-being is not to be secured as dependents of government. It is this shift from government to private direction of the economy which truly provides the new directions in economic policy.