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Norman B. Ture addressed a conference on "Supply-Side Economics in the 1980's" in Atlanta, Georgia on March 18, 1982. The conference was organized by the Emory University Law and Economics Center and the Federal Reserve Bank of Atlanta.

Dr. Ture, who was then serving as Under Secretary of the Treasury for Tax and Economic Affairs, explained the intellectual underpinnings of President Reagan's economic program in his talk.

Tax Notes later printed Ture's address (*Tax Notes*, April 5, 1982, pp. 75-80).

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Supply Side Economics -- the Economics of the Reagan Economic Program

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Presentation at

Conference on
Supply-Side Economics in the 1980's

Emory University Law and Economics Center
and the Federal Reserve Bank of Atlanta

Atlanta, Georgia
March 18, 1982

I am very pleased to be here and to have the opportunity to discuss supply side economics -- the economic concepts underlying President Reagan's economic program.

THE PREMISES OF THE REAGAN PROGRAM

The fundamental premises upon which the Reagan program rests are philosophically familiar and appealing to a nation which has always esteemed the individual and sought to protect individual rights and responsibilities. What distinguishes this program from those in the past is that the specific policy prescriptions seek to implement these premises rather than merely to give lip service to them.

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. It is only slightly hyperbolic to characterize the underlying views which had long prevailed in prior administrations 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 less interfere 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 should not be construed as blind faith in the perfection of markets. Instead, it leads to the broad policy prescription that the responsibility properly to be assigned to government is to seek to identify the sources of market failure and to seek to facilitate more efficient market operation. This is in sharp contrast with the prior approach under which government actions sought to constrain and to dictate market outcomes.

The obvious concomitant of this disengagement of the economy from government control is a shift in assignment of responsibility for the initiation of economic activity, for determination of the composition of economic activity and its course over time from government to the private sector. Clearly, one corollary of this policy posture is that 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 therewith to fine-tune aggregate economic outcomes to some ill- founded notions of optimum levels or trade-off of employment and output, on the other hand, and the rate of increase in the price level on the other. This policy posture holds that whether or not economic perturbations can be averted or minimized, the private market system far more efficiently adjusts to and dampens these shocks if government doesn't intervene.

A Focus on the Long Run

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 and is most likely to achieve an optimum long-term growth path, where the level and shape of that path is determined in the private sector by households' expressed willingness to trade off hours of market- directed effort for "leisure" hours and to exchange current consumption for future income streams, given the constraints of technology on doing so.

Setting those conditions entails providing the institutional arrangements in which the private market mechanism can more efficiently perform. To this end, clearly, the policy 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 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 toward appropriate objectives and in such ways as to offer the greatest possible assurance of efficient pursuit of these objectives. In turn, this requires rejecting the assumption that government programs have and are entitled to a life of their own.

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. The focus of tax policy is to minimize the excise effects of taxation, i.e., the alteration of the (explicit or implicit) relative prices which would prevail in the absence of taxation.

Finally, if the private sector is to be able to discharge its responsibilities effectively, monetary policy must facilitate the efficient operation of financial markets. Insofar as monetary policy results in erratic and unpredictable changes in the stock of money, it imposes costly barriers to efficient portfolio management and distorts and confuses information about the real terms of trade between the present and the future. And 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 excise effects.

At a minimum, the Reagan economic program requires a steady, slow growth in the stock of money. Beyond this, there is an important focus on eliminating antique regulations of financial institutions and on assuring that these institutions facilitate rather than impair the effective operation of the financial markets.

THE ANALYTICAL CONTENT OF THE REAGAN ECONOMIC PROGRAM

In all of its major respects, the Reagan economic program reflects the influence of the so-called supply side thesis. I do not mean to suggest that the President or his principal policy advisers toiled through the supply side exegesis in order to formulate the programs. But had they done so, had they insisted on precise text book specification of all the relevant relationships and insisted on program prescriptions which were rigorously determined by those specifications, the overall program would have differed little, if at all, from that which the President presented and

which was initiated in 1981. The inference one may fairly draw is that the supply side thesis drives toward public policies which place increasing reliance on private markets and assign a lesser role to government for determining economic outcomes.

Supply side economics is merely the application of price theory in analysis of problems concerning economic aggregates. Its conceptual antecedents are to be found in the work of the classical economists of the modern era; it rests on a rich intellectual tradition which has been splendidly surveyed by Bob Keleher and Bill Orzechowski in their "Supply Side Aspects of Fiscal Policy: Some Historical Perspectives." As such, supply side economics presents no new body of theory; rather, it involves addressing the neo-classical mode of analysis to public economic policies, whether these are focused on concerns of the economy as a whole or of particular groups.

The basic and distinctive characteristic of supply side economics is that it identifies the initial effect of government actions in terms of the changes in relative prices (explicit and implicit) confronting households and businesses which these actions entail. It is the response by these private sector entities to these relative price changes which determines the ultimate effects of the government actions. These responses involve change in the allocation of existing production resources and claims on output which may result, more or less promptly, in changes in the total volume and/or composition of economic activity. Insofar as volume changes occur, aggregate real income is also changed, and this change in total real income will lead to further changes in economic activity.

In other words, the effect of government activities on relative prices is the "first-order" effect, and the consequences of private- sector responses thereto for total income is the "second order" effect. This sequence of effects -- the precedence of price over income effects -- is one of the critically important premises of the supply side analysis.

Equivalently the supply side analysis points out that government actions first affect the allocation of resources and that one of the consequences of any such allocative effect may be a change in the level of aggregate economic activity. Moreover, to repeat, no change in the level of aggregate economic activity can result from government actions except as the second-order consequence of the allocative responses to the first-order price or excise effects of those actions. This mode of analysis similarly holds that these allocative effects of fiscal actions also largely determine the distributional consequences of fiscal action.

Important Propositions

To appreciate the importance of this set of propositions, bear in mind that for several decades past the conventional wisdom has held that diverse public policies separately and independently determine the allocation of resources, the distribution of income and wealth, and

the rate of increase in total economic activity, in both nominal and real terms. This view, which the supply side analysis rejects, was responsible for policies aimed at redistribution of income and wealth, disregarding the consequences of such policies on people's willingness to undertake the activities on which economic progress depends.

The basic supply side proposition denies the possibility that government actions can initially and directly change the total real income of the economy. This denial of first-order income effects, to repeat, is the critically distinguishing feature of the supply side analysis.

It confronts the prevailing view that government actions directly affect aggregate real income, a view which derives from perceiving these actions as impacting initially and directly on aggregate demand, via effects on disposable income, the changes in which are deemed to result directly in changes in total production. The supply side analysis, on the other hand, holds the government actions have no direct initial impact on real aggregate demand and, indeed, will affect nominal aggregate demand only if accompanied by accommodating changes in the stock of money. Changes in real aggregate demand, to be sure, would elicit increases in total output.

The pertinent question is how changes in real aggregate demand can occur without a preceding change in total output. By definition, aggregate demand, the sum of purchases of all types by all economic entities -- governments, businesses, households, etc., must exactly equal aggregate income which, in turn, at every moment in time must just equal the value of aggregate output. Changes in real income occur only as changes in output occur. And, changes in output occur only as a result of changes in the amount of production inputs or in the intensity or efficiency of their use. To have a first-order effect on income, therefore, government actions would have to alter directly the amount or effectiveness of production inputs committed to production. But government actions, in and of themselves, do not change the aggregate amount or productivity of production resources available in the economy. Changes in the amount of production inputs committed to production will result only if the real rewards for their use, i.e., the real price received per unit of input, is changed. To assume the contrary requires one to believe that the opportunity costs for providing more labor or capital services are constant in the short run, i.e., that short-run factor supply curves are horizontal or infinitely price elastic. Clearly, an increase in nominal, rather than real, aggregate demand resulting from government action could elicit an increase in real output, hence real total income and real total demand, only if suppliers of production inputs mistake increases in nominal for increases in real rewards for these inputs.

Illustrations

Let me briefly illustrate these supply side propositions. To begin with, assume that the government's budget is balanced at the outset and that taxes are then reduced without any reduction in government spending. Also assume that the fiscal change impels no change in the

stock of money. These actions, in the first instance, increase disposable income, and this increase in disposable income in the conventional aggregate demand approach results in an increase in total private sector spending. In the supply side view, no such increase in total private sector spending can in fact occur as the initial response to the tax reduction.

Since the tax reduction, by assumption, is not matched by a government spending reduction, the loss in tax revenues -- equals the increase in disposable income -- results in an equal deficit. But gross private saving -- total pretax income less consumption less taxes -- increases by exactly the amount of the tax reduction=the deficit. Since deficits along with gross investment are financed by gross private saving, the increase in disposable income, the increase in saving, is -- must be -- fully allocated to financing the deficit. Nothing is left for financing an increase in consumption or any other spending. Any such increase requires a preceding increase in total output, hence total income.

This rejection of an aggregate demand effect of a tax change does not mean that all tax changes are perceived by the supply side analyst to be inconsequential. On the contrary, since virtually every tax has some excise effect -- alters the cost of something relative to the cost of other things, virtually every tax change will impel some response in the form of a change in the composition in the demands for the use of resources and in their allocation among their alternative uses. A tax reduction which reduces the cost of market- oriented effort relative to "leisure" uses of one's time and resources will result in an increase in the supply of labor services, and other things equal, in an increase in real output, real income, hence aggregate real spending. It is not the effect of the tax cut on the deficit which generates this result but the effect on the relative costs of work and leisure. Similarly, a tax reduction which reduces the cost of saving relative to consumption will lead to an increase in the supply of capital services, hence to an increase in output, real income, and real spending. In either case, the magnitude of the effect on real output and spending is not a function of the size of the deficit but of the nature of the tax cut and the magnitude of its effect on the respective relative costs of effort and of saving.

Consider next an alternative "expansionary" fiscal action -- holding taxes constant while increasing government outlays. Suppose first the increased spending is in the form of transfer payments, i.e., involves no direct increase in government demand for goods or services. As in the case of tax reductions, those whose disposable incomes are increased -- the recipients of the additional transfer payments -- may well seek to add to their total outlays, but others must reduce their spending since the deficit must be financed. The identity of the spenders and the composition of the spending may well change, but the aggregate amount of real spending cannot, at the outset, be increased. It could increase only if the transfer payments increased the real rewards for providing production inputs or, equivalently, reduced the real costs of these inputs to those using them in production activities. In fact, however, virtually all such payments have precisely the opposite effect -- they reduce the amount of productive service which will be

offered at any prevailing market price, hence increase the cost of their use. The reason is that such payments are, in fact, subsidies for "leisure" and excises on working.

Obviously, the "supply side" analysis of government transfer payments does not address the humanitarian aspects of these programs. It does, however, explain how these programs impact on the level and/or composition of economic activity. In particular, it shows that these programs should be seen as having none of the expansionary consequences attributed to them by the standard aggregate demand view of things. Indeed, the effects are to constrain the supplies of production inputs, particularly labor, to enhance downward rigidity of wage rates, and to distort relative prices of subsidized services. The programs may nonetheless be deemed to be worthwhile; their justification is to be found, however, elsewhere than in desirable effects on aggregate output, employment, and real incomes.

Government Purchases of Goods and Services

Suppose the increase in government outlays takes the form of purchases of goods and services. These additional outlays cannot be deemed to expand aggregate demand since the matching deficit they generate, unlike that from a tax reduction, decreases gross national saving. The reduction in GNS, in turn, reduces gross investment. Nor should the additional government outlays be thought to increase the real or effective demand for production inputs, hence, to increase aggregate employment, output, and income. To repeat an earlier observation, only if the opportunity costs for providing more production inputs are constant in the short run -- only if short-run factor supply curves are horizontal or infinitely price elastic -- would an increase in nominal government demand for outputs or production inputs result in increases in total output. In the real world, government spending in the form of purchases of goods and services alters (explicit or implicit) relative prices by changing the composition of aggregate demand. Government purchases of any given product or service initially increase the nominal demand for those products, hence for the production inputs their output entails. This change in demand per se must increase the nominal price of the products or services, compared to the prices at which they would otherwise sell in the private sector. The consequence of this price distortion is a reduction in private sector purchases of these goods and services. The increase in the direct or derived demand for the particular inputs raises the market price faced by private sector purchasers of these inputs, hence reduces private sector purchases, thereby shifting their use from private sector to government sector outputs.

These changes in demand resulting from government purchases do not per se entail any change in the productivity of the production inputs involved. The real rate of return for any given quantity of any such input is, therefore, not altered. By the same token, the supply of the production inputs is not increased, although the allocation clearly is changed. No change in aggregate output, accordingly, results on this score from the government purchases.

The reallocation of production inputs, on the other hand, may result in a change in total real output if the real productivity on the inputs is enhanced or diminished in the government's, as opposed to the private sector's, use. A change in the amount of government purchases does not change total output and income by altering aggregate demand; any such change in real total income results only from changes in the effectiveness with which the production inputs are used. Changes in total output of this sort, obviously, need not be positively correlated with the amount of government purchases.

These relative price and allocative consequences of government spending are recognizable as precisely the same in character as those attendant on the price effects of taxation. Identifying government outlays in this way, moreover, urges that their effects on the aggregate performance of the economy are of the same nature as those of taxation. This focus, clearly, is in sharp contrast with the conventional aggregate demand view which treats taxes as drains on aggregate income flows and government expenditures as additions thereto.

The Effects of Monetary Expansion

In the preceding illustrations, I've made the restrictive assumption that the deficits generated by tax reductions or government expenditure increases are not monetized. The objective in doing so was to prevent confusion of monetary and fiscal impacts. At this point, let us relax the assumption and consider the effects of a monetary expansion, whether or not associated with an increase in the government's deficit.

In the supply side analysis, the concern is to identify the effect of a change, particularly an unexpected change, in the quantity of the relevant monetary aggregate on a pertinent relative price. The basic assumption is that any such change disturbs portfolio equilibrium: the marginal utility of the additional money falls below that of the other elements in the portfolio, impelling efforts to reduce the quantity of money and to increase the holdings of other goods and assets. This effort portends an increase in the level of prices at a rate greater than that anticipated prior to the (unexpected) acceleration of the monetary expansion.

The allocative response to the expected change in the future price level relative to the present resulting from changes in the pace of expansion of the money stock is, as one would expect, an opposite change in the allocation of current income between exercises of claims on output in the present vs. the future. A speedup of monetary expansion, implying an accelerating rate of gain in the price level in the future, induces an increase in the current demand for goods and services, at least for those which can be inventoried. This allocative effect, then, takes the form of increases in the proportion of current income used for consumption and a reduction in the portion of income that is saved.

The question is whether this unanticipated increase in nominal aggregate demand results as well in an increase in real output. If any such expansion of real output is to occur, there must be an increase in the amount of production inputs supplied. To obtain this result, one must either assume that suppliers of production inputs confuse increases in nominal for increases in real supply prices or that somehow the increase in the money stock reduces the cost of effort relative to leisure and/or the cost of saving and investing relative to consumption. But the increase in the money stock has no such relative price effect. Indeed, to the extent that it is seen as leading to an increase in the price level, it is far more likely to be perceived as increasing the real cost of effort relative to leisure and of saving- investment relative to current consumption by way of its effects on real marginal tax rates. This perception, of course, would lead to a decrease in inputs supplied, hence to cuts in output.

These supply-side hypotheses about the consequences of unexpected changes in the stock of money presuppose no significant institutional impediments to prompt changes of prices. In fact, various institutional factors are widely deemed to preclude prompt adjustment of contract terms and specific prices. The allocative adjustment, accordingly, may be impeded, taking the form of changes in the use of production inputs, hence in output, in response to the change in nominal aggregate demand. But notice that these real changes are functions of institutional rigidities and lead to temporary rather than long-term or permanent adjustments. Supply- siders and monetarists are in perfect accord that in the long run, monetary magnitudes do not determine real output and income.

SUPPLY SIDE ECONOMIC POLICIES

It is evident from this part of my discussion that the application of the supply side analysis leads to quite different policy prescriptions from those which have been standard for many years past. It is equally evident, I believe, that the Reagan economic recovery program is completely consistent with the new prescriptions.

For one thing, the supply side approach obviously rejects the view that there is a positive relationship between levels of government spending and total output. It follows therefore, that there need be no hesitation on grounds that this will adversely affect total output, employment, and income, in prescribing policies for curbing the growth of government spending. 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 lead to a net gain in total output except in the case in which the government activity which is curtailed involves equal or 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.

Implications for Tax Policy

Regarding the implications of supply side analysis for tax policy, it should be clear that the focus shifts from the amount of tax liability to the excise effects of alternative tax provisions or systems. 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 bracket -- marginal -- income tax rates. The effects of these rate reductions on the amount of tax liability at any given income level -- on average tax rates -- was a matter of secondary concern. 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. For example, the dramatic revision in our tax provisions pertaining to capital recovery -- scrapping our antique depreciation system and replacing it with an accelerated cost recovery system -- was impelled by the perception that some such revision was essential to reduce the basic income tax bias against saving and capital formation, particularly in view of the effect of inflation in accentuating that bias.

The Effect on Aggregate Demand

These differences in approach to government spending and tax policies together reject focusing fiscal or budget policy on the control of aggregate demand. Government spending targets are not to be set by reference to any supposed contribution of these outlays to aggregate demand. Nor is policy to focus on the amount of tax revenues as a means of influencing the level or change in total economic activity. In this same context, 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.

By the same token, the supply side approach to fiscal policy affords quite a different appraisal from the aggregate demand approach of the effects of fiscal actions on the price level. In the aggregate demand analysis, tax and expenditure changes generate changes in aggregate demand which, since conditions of supply are deemed to be unchanged by fiscal actions, may lead to increases or decreases in inflationary pressures. In contrast, the supply side analysis delineates fiscal actions as impacting on aggregate demand only insofar as it first affects aggregate output by way of first- level price effects. Thus, an income tax rate reduction, by virtue of its relative price effects, generates increases in the supplies of labor and capital services and in output; increases in real demand of equal magnitude are necessarily associated with the increase in output. In this analysis, accordingly, no increase in inflationary pressures results. Any such increase would have to be the consequence of an unnecessary increase in the rate of expansion of 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 the 1981 tax reductions in and of themselves will not enhance inflationary pressures.

Are Budget Deficits Inflationary?

As a corollary, application of the "supply-side" analysis leads to rejection of the view that budget deficits per se are inflationary. The view of budget deficits as a source of inflation rests on the observation that those deficits tend to be monetized. This surely is not an inherent or necessary consequence of budget deficits. The notion, frequently found in financial and business columns, that a "tight" money policy is at odds with a "loose" or expansionary fiscal policy is wholly without analytical substance. At issue is not whether there is an adequate supply of money to finance the deficit and the business borrowing needed for private investment. Deficits and private investment alike are financed by private saving, not by the money supply.

A major policy prescription which flows from this analysis is that the 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, I am sure you all will recognize, is precisely the prescription for monetary policy which the Administration has repeatedly urged upon the Federal Reserve.

Inflation and Unemployment

One of the principal analytical outputs of the supply side economics is the rejection of the so-called "Phillips-Curve" relationship between inflation and unemployment. By the same token, it rejects the view that price-level stability can be purchased only at the cost of unacceptably high levels of unemployment or that acceptable growth in employment depends on pursuit of fiscal and monetary policies likely to spur inflation. There is no analytical basis for seeking recession as a means of wringing inflation out of the system.

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 -- increases in the overall level of prices -- 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 tax measures are in regard to increasing the supply of

labor and in reducing the tax bias against saving and investment, the less will be the upward pressure on the price level.

The corollary is that a monetary policy which succeeds in curbing inflation will enhance expansion of supplies of labor and capital services and total output and income. Inflation augments the existing tax bias against effort and saving by increasing the real marginal rates of income tax, thereby reducing the real after-tax returns for use of labor and capital services, hence constricting 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 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 indeed with the prescriptions cast up by the application of an extremely rigorous and hard-headed analytical system. Nor is that system derived solely from intellectual abstractions. Indeed, there is an extensive empirical 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 could impose a major stumbling block to the positive responses to the Reagan program. But if the appropriate monetary policy is achieved and adhered to, the condition of those markets will rapidly improve. One of the major indications of that improvement will be a structure of interest rates which far more closely than at present reflects the real marginal product of capital and expected inflation. In this setting, significant gains in output in housing, construction, consumer durables, and capital goods will be forthcoming. Irrespective of these gains, the progress toward greater economic freedom, toward investing the individual with greater opportunity and responsibility for determining his or her economic status should be seen as the real measure of the Reagan economic program's success.