William E. Simon’s Contribution to Tax Policy

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Abstract

This paper analyzes the role of William E. Simon in shaping tax policy during his tenure as Treasury Secretary from 1974 to 1977. Simon believed in supply-side economics. Therefore, the tax policy changes that occurred during his time as Secretary involved reductions in tax rates as well as simplification of rules. A far-reaching effect of the 1975 Tax Act was the introduction of the Earned Income Tax Credit, which retains popular support today. Although these changes did not immediately increase growth and curb inflation, Simon’s attempts to reduce marginal tax rates in the 1970s resulted in two decades of legislation to reduce the influence of government on the economy, which resulted in budget surpluses in the 1990s. (JEL H3, H24, E62)

“He was an extraordinarily effective Treasury Secretary in a time of very difficult economic and political transition.”

[Alan Greenspan, Tribute to William E. Simon, p. 22]

Introduction

This paper focuses on the role that William E. Simon, a fiscal conservative, played in shaping tax policy from 1974-77, the period during which he served as Secretary of the United States Treasury. The Treasury is a 125,000-person federal office that collects the nation’s taxes, pays its bills, manages its accounts, prints its currency, and mints its coins.

As Secretary, a post he assumed after serving one year as Deputy Secretary under George Schultz, Simon had a broad range of duties and functions. His position was a powerful one for several reasons. First, the personal income tax is the single most important source of revenue to the federal government. Second, many policymakers strive to alter the tax code as a way to shape their political agenda. Third, many economists believe and spend a great deal of time studying the idea that changes to the tax code can shape taxpayer behavior. Thus, the Treasury Secretary has the ability to help shape incentives through the tax code.

William E. Simon became Secretary of the Treasury in 1974, the nadir of the post-war economy. Simon was charged with formulating fiscal policy to simultaneously battle rising inflation, declining real output, and a widening budget deficit. He was Treasury Secretary under two Republican presidents, Richard Nixon (their collaboration was brief as Nixon resigned shortly after Simon became Secretary), and Gerald Ford. He resigned after Jimmy Carter defeated Ford in the 1976 presidential election.

The authors argue that a confluence of economic and political events prevented William E. Simon from using standard tools of fiscal policy to revive the economy. They further argue that it was during this time that William Simon, along with his contemporaries, began a political revolution to reduce the size of the federal government and its influence on the economy.
economy. That revolution was both bold and desperate. It was bold because unlike standard fiscal policy tools, the success or failure of the supply-side policies advocated by Simon and others would not be measured for decades. It was desperate because the fiscal and monetary policy choices available at the time were quite limited.

This paper begins with a discussion of the economic and political environment that constrained policymakers, including William Simon, at the time. It then looks at how supply-side economics grew out of that economic and political environment. Next, it considers the details of William Simon's tax policies. Finally, the authors ask whether Simon's policies were the right policies for the time and whether those policies had a lasting effect on the U.S. economy.

Macroeconomics of the Times

William E. Simon took charge of the Treasury during the U.S. economy's first experience with stagflation—simultaneously rising inflation and falling real output. In November 1973, the United States economy entered its longest and deepest recession since the Great Depression. The recession lasted from November 1973 through March 1975. Real output fell 9 percent in the fourth quarter of 1973 and 11.4 percent in the first quarter of 1975.1 The OPEC oil embargo, coupled with recklessly high money growth, pushed the inflation rate to 8.6 percent at the end of 1973 and then to a post-World War II high of 14.5 percent at the end of 1974.2

Stagflation presents a well-known dilemma for policymakers trying to use aggregate demand management policies to steer the economy. The rising inflation calls for stepping on the breaks while the declining real output calls for stepping on the accelerator. Thus, policymakers are left with a choice of higher inflation (if they choose to step on the accelerator to bring the economy out of recession) or a more severe recession (if they choose to step on the breaks to reduce the inflation rate).

In addition to stagflation, a further complicating factor for policymakers was the growing budget deficit. As shown in Figure 1, the budget deficit as a percent of GDP rose to a post-World War II high of 4.2 percent in 1976. Thus, rising inflation, coupled with a rising budget deficit, meant that it was difficult to cut taxes or increase government spending to increase real output. Where was monetary policy in all of this? With hindsight, it is now clear that monetary policy was part of the problem rather than part of the solution at the time. The 1970s have come to be dubbed the "Great Inflation."3 The consensus now among economists studying this period is that the Federal Reserve let the money supply grow too rapidly in its pursuit of (unrealistically) low unemployment. Arthur Burns, the chair of the Fed at the time, was seen as weak and ineffective [Greider, 1987]. The Fed policy committee apparently accommodated inflationary expectations and because it no longer had the nominal anchor of a fixed exchange rate, it had no credibility as an inflation fighter.

Thus, the Fed was part of the problem in the sense that it had allowed inflation to rise to such an extent that further demand stimulation, which is what was called for during the recession of 1974-75, was not politically feasible. Furthermore, even if inflation had been lower, the ballooning budget deficit also made further (fiscal policy) demand stimulus politically infeasible as well.4

The Emergence of Supply Side Economics

Looking back on the economy of the 1970s, it seems clear that the supply-side revolution was a natural outcome of the political and economic circumstances of the time. Nonetheless, it was clearly a bold political move to suggest that cutting taxes would not only stimulate output and increase productivity, but also increase revenue.