people who own neither farms nor small businesses."

If the estate tax has little effect on the concentration of wealth in America, as some opponents of the tax contend, then that, observe Gale and Slemrod, "could be construed as an argument for increasing, rather than decreasing, the tax." Abolition of "the most progressive tax instrument in the federal tax arsenal," they say, would hurt nonprofit organizations (to which the wealthy are induced by the tax to give), reduce federal revenues (by the amount the tax produces, which was $28 billion in 1999, or about 1.5 percent of all federal revenue), and "create a gaping loophole for capital gains in the income tax." (The estate tax gets at capital gains that were never realized and so escaped the income tax.) "Many arguments commonly made against the tax are demonstrably specious," Gale and Slemrod conclude. "To the extent that any of them are valid, they suggest reform rather than abolition."

Leon Friedman, a professor at Hofstra University's School of Law, writing in the *American Prospect* (Nov. 6, 2000), has a different idea: Abolish the estate tax, but impose a one percent tax on the net worth of the richest one percent of Americans "on a regular basis during their lifetime." This, he says, would generate more than $100 billion a year in federal revenues, "reduce the national debt, shore up Social Security and Medicare, allow for significant tax decreases for the middle class, and eliminate the need for an estate tax."

The Downside of Debt Reduction

"Life without Treasury Securities" by Albert M. Wojnilower, in *Business Economics* (Oct. 2000), National Assn. for Business Economics, 1233 20th St., N.W., #505, Washington, D.C. 20036.

Should the huge federal budget surpluses expected in coming years, assuming they actually materialize, be used to wipe out the $3.4 trillion national debt? Americans ought to think twice, warns Wojnilower, a former official of the Federal Reserve Bank of New York who now advises two private investment firms. Eliminating Treasury notes and bonds would have "radical implications for the financial system." One possibility: Japanese government securities could eventually emerge as the new international benchmark .

Because Treasury securities are backed by the U.S. government and are thus virtually risk-free, they are the anchor of the financial system. They have taken the place of gold, serving as a benchmark for calculating the riskiness of other assets, a hedge against those risks, and a safe haven in times of uncertainty. The trade in Treasury securities alone, $190 billion a day, generates steady earnings that encourage dealers to "make markets" in less secure bonds issued by corporations, government agencies, and other borrowers—thus expanding the supply of credit. More important, Treasuries are used in hedging: Investment firms that hold other kinds of bonds sell Treasuries "short," reducing potential losses if the other bonds lose value—which also expands the supply of credit.

But it's in a credit panic such as the one surrounding the 1998 collapse of Long Term Capital Management that Treasuries have their greatest value, says Wojnilower. Such crises trigger a "flight to quality," as people and institutions park their money someplace where its safety and liquidity are guaranteed. That "someplace" has long been Treasuries. Without them, Wojnilower says, investors would look to the few other big lenders in the world, with potentially unhappy results.

One alternative would be to seek the safety of the handful of banks deemed "too big to fail" by national governments. That, Wojnilower fears, would make these banks "inordinately huge and powerful," and would tempt governments to use them "as instruments of domestic and foreign policy." But markets could also seek safety elsewhere—in Japanese securities (if Tokyo finally sets its house in order), or in securities issued by U.S. government-sponsored corporations,

such as the Federal National Mortgage Association (Fannie Mae), which have Washington's unspoken guarantee behind them. If the corporations succeeded in claiming this role, Wojnilower says, they would have the ability to borrow and lend capital at the cheapest rates around. Inevitably, he fears, Congress would widen the permissible scope of these corporations' lending (currently restricted mostly to home mortgages), producing dangerously large "universal banks."

What to do? The Treasury could continue issuing securities if Congress stipulated that the proceeds, instead of being used to fund government operations, were to be lent to carefully designated "financial intermediaries." How much should the Treasury borrow? That, Wojnilower says, should be left to the Federal Reserve.

The Economics of Creativity

"Economics and the New Economy: The Invisible Hand Meets Creative Destruction" by Leonard I. Nakamura, in *Business Review* (July–Aug. 2000), Federal Reserve Bank of Philadelphia, Dept. of Research and Statistics, 10 Independence Mall, Philadelphia, Pa. 19106–1574.

For those persuaded that the United States has a "new economy," the watchword—taken, ironically, from an *old* economic theory—is "creative destruction," as former goods and livelihoods are replaced by new ones. Creativity, and the profits won by entrepreneurs who have it, are what make the capitalist system go, economist Joseph Schumpeter (1883–1950) thought—and the wealthy young wizards at Microsoft and elsewhere may be proving him right. But to find out if it's really time to wave goodbye to Adam Smith's "invisible hand" and welcome "creativity" as the engine of progress, economists must try harder to measure that elusive quality, argues Nakamura, an economic adviser in the Philadelphia Fed's research department.

Creativity is nothing new, of course. Even when Smith was writing his *Wealth of Nations* (1776), Nakamura notes, inventors and other "creative" folk had an economic impact. "But the flow of payments to creative work was minuscule compared with those that flowed to the labor, land, and capital that directly produced products." Economic progress came naturally from competition and wider markets, Smith believed. Taking their lead from him, neoclassical economists celebrate perfect competition and regard creativity as beyond the scope of economic theory.

Schumpeter, however, in his masterwork, *Capitalism, Socialism, and Democracy* (1942), took a different view, Nakamura writes. "He argued that what is most important about a capitalist market system is precisely that it rewards change by allowing those who create new products and processes to capture some of the benefits of their creations in the form of short-term monopoly profits. Competition, if too vigorous, would deny these rewards to creators and instead pass them on to consumers, in which case firms would have scant reason to create new products." In this view, governments should encourage innovation by granting entrepreneurs temporary monopolies over the fruits of their creative efforts. That is the reasoning behind such things as patents and copyrights.

The Schumpeterian view may be "a better paradigm for the current U.S. economy," says Nakamura. Most workers are no longer engaged in direct production of goods and services, but in white-collar jobs, he points out. "Managers, professionals, and technical workers, who are increasingly involved in creative activities," now make up 33 percent of the work force, almost double the proportion in 1950. There are six times as many "creative professionals": Scientists, engineers, architects, writers, designers, artists, and entertainers now number 7.6 million.

It is "inherently difficult" to measure the economic value of creativity, Nakamura notes. Many existing economic measures implicitly assume perfect competition, in which creativity has no economic value at all. Official statistics thus "understate nominal output, savings, and profits."