

2. *That the demands on public budgets will remain great so that the competition for budget money will remain stiff.* This means that the opportunity cost in the public sector will be high. Whatever criterion is used, it must reflect the overall Federal budget position, including the needs for large public investment in human resources, the considerable outlays for military purposes, and the needs for social overhead investments in a rapidly advancing economy.

3. Third, as a fundamental postulate, *the high productivity of capital must be reflected in the interest rate used for planning and evaluating public investments.* The two-step procedure discussed above, that of using high social time preference rates and revaluing opportunity costs at a social time preference rate, does not appear to be workable for our government. The logic that a low interest rate must be coupled with cutoff benefit-cost ratios on the order of 2 is too obscure for Government and general public discussion. The first part of the method, that low interest rates can be justified on social grounds, is attractive. But the pressures on agencies and their desire to promote their programs are such that they will never accept the second part of the method, that investment programs only be accepted if benefits exceed costs by a factor of 2.

If the two-stage procedure is not workable, the interest rate itself must reflect the high opportunity costs of capital in the private and in the public sector.

The operational question then becomes: What should that interest rate be?

V. WHAT INTEREST RATE FOR PUBLIC INVESTMENTS?

Given these postulates, the social time preference approach is ruled out. With it is also ruled out any logic which would produce interest rates as low as 3 percent which are still applied in some Federal programs. There are no observable interest rates anywhere in the economy as low as this: Capital yields substantially more in all sectors, and households make their saving-borrowing choices also at much higher rates. This is not to argue that the social time preference consideration be eliminated completely in the derivation of the final rate, but the weight given to it must be very limited if resources are not to be grossly wasted.

The Government borrowing rate? This concept has some things to recommend it if it is used properly, but it cannot survive full theoretical scrutiny. On the one hand, it is the interest rate at which the Government, as an enterprise, is able to obtain capital by borrowing. It also is a measure of the pure, risk-free, long-term interest rate in the market. On the other hand, the rate is not appropriate because, in actual practice, public investment projects are not financed by borrowing but by taxation. The opportunity costs in the private or public sectors are likely to exceed the long-term Government borrowing rate.

Nonetheless, if the Government borrowing rate were applied correctly, it would yield a better answer than current practice. The trouble has been that the actual Federal interpretation, as spelled out for example in Senate Document 97, has been very different from a "businesslike" enterprise borrowing cost.