

developed a methodology similar to those used in this paper and in the Comptroller General's report, but applied it to the raising of funds by taxation rather than by borrowing. This raises questions like (a) Are there reasons why the opportunity cost of public funds obtained via borrowing should be regarded as superior to the opportunity cost of funds raised by taxation as the relevant discount rate for public project evaluation? (b) Since funds come from both sources, should not the relevant rate be an appropriately weighted average of the two opportunity costs? (c) Should not different rates of discount be used depending on how the funds in question are raised?

I cannot here go into all the ramifications of these questions, but will instead briefly sketch the main issues and propose the outlines of some answers. With respect to question (c), the first problem is that we do not know, except for the case of earmarked taxes, what is the source of the funds used in any particular project. Second, there should be—apart from a risk adjustment which would undoubtedly vary from project to project—a single rate of discount used for all Federal projects, since to do otherwise would mean that projects are undertaken in some areas which are inferior to projects rejected in other areas.

With respect to question (b), one faces first the issue of what weights to apply to the opportunity costs of funds raised by each of the innumerable possible ways of increasing tax revenues. There simply is no standard pattern in administration recommendation or congressional decisions about changes in tax rates, tax bases, and the like. On the other hand, there is presumably a definable pattern in which Government borrowing displaces private investment, which is determined by the relative sensitivity of different types of investment—and possibly of saving—to changes in the degree of tightness of the capital market. On this ground alone we have a basis for preferring the opportunity cost of borrowed funds to an unknown and unstable mix of opportunity costs of tax funds—or to a weighted average containing such a mix—as the relevant discount rate.

This brings us to question (a), since if the opportunity cost of borrowed funds can be defended as being superior to that of tax funds we should, given our answer to (b), be willing to opt for the former as the discount rate. I perceive two related grounds on which the superiority of the opportunity cost of borrowed funds can be claimed. The first is that, in any given situation, more taxation means less borrowing associated with given Government expenditures. This means that when an extra dollar is raised via taxation, it can release to the private sector capital funds that will have a social yield equal to the social opportunity cost of Government borrowing.

To calculate the social yield of taxation, therefore, we simply go through the above Government borrowing exercise in reverse, and obtain the saving in interest costs on account of having less debt plus the incremental tax revenues derived from the extra private investment that a lower level of Government borrowing generates.

The second ground for preferring the opportunity cost of borrowing is that it can appropriately serve as a guide to tax decisionmaking. We are accustomed to seeing and discussing benefit-cost analyses of public expenditures; perhaps the idea of benefit-cost analyses of public revenue raised in particular ways is less familiar, but it is equally sound.