

ment bonds. Let us divide up the 15 into 8 which are taxes, 2 which are risk premium, if you like, and 5 which represents the cost of Government bonds.

Chairman PROXMIRE. When you say 8 are taxes, you are talking about the fact that you have a corporation income tax of 50 percent, roughly, and then, in addition to that, you have property taxes and other taxes?

Mr. HARBERGER. Right.

What I am saying is that in measuring the social opportunity cost of capital, if we start with the 15 and divide it up into those three segments—8 of taxes, 2 of risk premium, and 5 of the cost of Government bonds—the 2 of risk premium should not be counted as part of the opportunity cost of Government funds any more than the excess wages that are paid in an outlying mining district should be considered as a part of the true profit of that enterprise. The risk premium is a part of the after-tax supply price of capital, at which investors would voluntarily make their funds available for corporate investment.

Chairman PROXMIRE. I would like to ask you, Dr. Eckstein, to comment on this, the notion of the need for inclusion of foregone taxes.

Mr. ECKSTEIN. There are two ways of getting to the same point. If you start out with basic interest costs and then you want to get to the total return on capital, you have to build in all the individual components, risk, taxes, and so forth, that account for the difference. So you do have to track down all the miscellaneous taxes.

Another approach is to start out with a gross return on capital itself rather than the borrowing costs, which get you to the same place in one step. If you take the tax approach, which is the approach that I have used in the past, you do not go through all these questions about which taxes are forgone and where; this is a somewhat treacherous game, because it can also be played on the benefit side. You get to the return on capital in one step. But if you take the borrowing approach, you certainly have to include taxes.

Chairman PROXMIRE. Now, it seems there is this merit in taking the conceptual approach that Dr. Harberger takes here, from the political standpoint. That is that we now base the discount rate on the cost of borrowing. That is the justification used in Senate Document 97 and all the other documents that have been argued. It would seem perhaps easier to persuade Members of the Congress to recognize the forgone taxes than to move into a new area, which I find a little more congenial, frankly, but nevertheless, I am not sure other Members of the Congress would—but this new area of return on capital: How do you feel about that?

What is the difference?

You say you arrived—I can see that you seem to arrive at a fairly similar position. But why is your approach conceptually superior, other than, as you say, you do not have to worry about this variety of taxes?

Mr. ECKSTEIN. Let me deal with several of these questions systematically.

I think the tax approach is conceptually superior because, in fact, the bulk of Federal financing is tax financing, not borrowing. Even our \$25.4 billion deficit is only \$25.4 billion out of \$180 billion. That is point 1.