

given interest rate only if his enjoyment of the return is at a rate at least as great as his interest payments. Thus, we can assume that a person who is willing to pay 12 per cent interest on the purchase of a car on credit, or a homeowner paying 5 per cent on the mortgage on his house, presumably is enjoying satisfaction from these assets at rates at least equal to these figures.

In order to determine the social cost of funds raised through taxation of an individual with given preferences about his saving-borrowing behavior (or with given opportunities for investing in durables), we must ascertain the interest rates which he faces. A dollar of taxation is a reduction of his current income. If we can assume that the marginal dollar an individual spends for present consumption, or the dollar he saves, would be worth a future annual income stream equal to his interest rate, then the same interest rate would apply to the dollar required to pay an increase in taxes. Conversely, a tax reduction of a dollar can be converted into a future income stream equal to his interest rate. Interpreting taxation for public investment as a compulsory loan for the sake of future benefits, the social cost of this investment is equal to the interest rate which the government would have to offer to the taxed individuals to induce them to grant the loan voluntarily. Our analysis does not assume that all of the taxed money would have been saved voluntarily; presumably part of it would have been consumed. We assume only that the decision about the fraction to be saved is made rationally and in the light of the opportunities for changes in future income which the interest rate measures. These assumptions are sufficient to derive the value of marginal income in terms of a future stream which can be expressed as an interest rate. We can then apply this reasoning to marginal changes of income which are caused by taxation.

A further requirement for the estimate of the social cost of marginal tax dollars is to discover how these dollars are apportioned among the major categories of decision-making units that face different interest rates. This means allocation of the taxes between businesses and households, between borrowers and lenders, between borrowers at high rates and borrowers at moderate rates, and so on. For households, we use three categories—lenders, borrowers at mortgage rates, and borrowers at short-term credit rates—combined with a breakdown by income class. In the case of business, we estimate the effect on investment and its potential return, in accordance with the size of assets of the taxpaying firms.