

Alternatively, the subcommittee visualizes that an allowance for risk and uncertainty could be incorporated into interest rates used for discounting public investments.⁴⁰ The greater the degree of risk and uncertainty present in the project, the greater would be the adjustment made to the basic minimum-risk interest rate. Thus, starting from a given base rate, the interest rate used in discounting the benefits of low risk projects would require a minimum upward adjustment while the rate used to evaluate the output of a highly uncertain undertaking would be substantially above the base rate. The subcommittee realizes, however, that these adjustments for risk and uncertainty do not lend themselves to precise slide-rule evaluation.

In further analyzing the various types of investments undertaken by the public sector, witnesses distinguished between those investments that have no counterpart in the private sector and those investments which, when undertaken by the Federal Government, displace similar private investments.⁴¹ An example of the former would be the construction of a new weapons system; the public production of many research and development outputs exemplifies the latter. The suggestion was made that the analysis of those projects which displace no specific private sector alternative should be thought of as imposing a general opportunity cost over the economy as a whole equal to the value of private spending displaced. Projects which displace specific private investments should be evaluated by the rate of return prevailing in the sector from which the specific investment is displaced. The subcommittee finds this distinction to be a meaningful one and urges further study to refine this "two-part pricing" scheme.

The question of the influence of inflationary expectations on observed interest rates and the desirability of including this influence in the interest rate used to evaluate public projects is, in the subcommittee's view, one of the least settled technical issues pertaining to interest rate policy.⁴² This matter cannot be divorced from the question of which prices analysts of public investments employ in estimating future benefits and costs. While the current practice of using prices observed at the time the analysis is undertaken has substantial administrative merit, the subcommittee is aware of the position held by some that analysis should undertake the projection of future prices. This matter must be resolved prior to the development of sound and consistent evaluation policies. Again, further study seems in order.

⁴⁰ Ibid.

⁴¹ Ibid., pp. 27-29, 177-178.

⁴² Ibid., pp. 28, 33-34, and 40-41.