

Chapter 4

Subjective Costs

Cost is that which the decision-taker sacrifices or gives up when he makes a choice.

—James M. Buchanan, *Cost and Choice: An Inquiry In Economic Theory* (1969)

Cost is, as Buchanan explains in the above quotation, the direct result of making a choice. When someone makes a choice, that person incurs a cost in the form of the value, to him or her, of what he or she forgoes as a result of making that choice. Someone who spends \$15 to go to a theater to watch a movie forgoes the opportunity to spend that \$15 to go to a restaurant to have lunch. Costs are often summarized in monetary terms, which obscures the fact that the true cost is not giving up the money itself, but, rather, giving up what else could have been purchased with the money. It's easy, as a shorthand expression, to say that the cost of the movie is \$15. The actual cost, however, is the satisfaction the person expects he or she would have enjoyed had he or she chosen instead to have lunch.

The fact that cost is often expressed in terms of money allows people to make quick comparisons. For the same amount of money, the individual could watch a movie *or* go to a restaurant for lunch *or* buy a few gallons of gasoline. Once an individual chooses how to spend the \$15, the cost incurred is the foregone experience of the most highly-valued alternative that the individual gives up. After the choice has been made to spend the \$15 on a movie, the individual can evaluate the enjoyment from watching the movie, but he or she can only *conjecture* about how much enjoyment he or she would have experienced from the meal or from putting \$15 worth of gasoline into the car's tank.

Cost is subjective. One person might choose to spend the money to watch the movie while another might decide that having lunch at a restaurant would yield more satisfaction. In making these assessments, both individuals could be correct, but there's no way to know for sure. Individuals know how satisfied they are with the choices they actually make, but they can only guess about how satisfied they would have been had they chosen differently. An individual might have enjoyed the movie, but how much that individual would have enjoyed the lunch instead can only be a conjecture because the individual did not actually experience the lunch.

You can surely identify with this description of cost from your own personal experience. Haven't you done some things that, after the fact, you enjoyed much more than you expected? Similarly, haven't you done other things that, after the fact, you found to be less satisfying than you expected? And either way, no matter how much or little you ended up enjoying the movie that you chose to watch, you can only conjecture about how much you would have enjoyed the lunch that you chose to forgo.

Cost is incurred at the time a choice is made

If someone is in a situation in which he or she has no choice, then no cost is incurred, because that person is giving nothing up. Consider the straightforward example of someone who signs an unbreakable lease for an apartment, agreeing to pay \$1,000 a month for 12 months. To keep the example simple, assume that there is indeed no way to get out of the lease.

A few months into the lease the individual would like to move, but thinks, "If I move, it will cost me \$1,000 a month in rent for the apartment that I would no longer occupy." Yet further reflection shows that this conclusion is incorrect. Because of the unbreakable lease, the individual has no choice but to pay that \$1,000 every month. So by choosing to move the renter does not forgo this \$1,000. This \$1,000 must be paid every month regardless of what the individual does. The cost was incurred at the time the choice was made to sign the lease when the renter agreed to give up \$1,000 every month for 12 months. The day the lease is signed, the renter incurs the \$12,000 cost, to be paid in 12 monthly installments of \$1,000.

One reason a renter might decide to move despite such a lease is that the renter has received an offer for a much better job in another city. The renter weighs the costs and benefits of moving, including having to rent another apartment in the other city, and might decide that the benefits of moving exceed the costs. But the renter will still have to pay \$1,000 a month for the old apartment whether or not the renter moves. The renter cannot escape the obligation to pay rent by choosing either to move or not to move, so the obligation to pay this rent is not a cost of moving.

The renter might be able to sublet the old apartment for \$750 a month to another person, but if so, wouldn't the renter lose \$250 a month on the apartment? No. That's because the renter has to pay the \$1,000 in rent in any event, so subletting would *gain* the original renter \$750 a month over what the renter otherwise would have had.

Should the renter move? Given the choice, some people would take the job in the new city; others would remain in the old job and current apartment, perhaps because the new job did not look like such a good opportunity after all, or perhaps because of connections and friendships that the renter values more highly than the new job. Or perhaps the new job won't pay enough to enable the person to afford to pay rent on two apartments, even for a few months. Regardless of the reason, because costs are subjective, there is no way for an outside observer to say which is the better option.

Costs are unseen

Because each cost is the subjectively experienced value of a forgone alternative when a choice is made, costs are difficult to perceive. This is true even for the chooser. The person watching the movie experiences the pleasure of seeing it, but that person does not experience the pleasure that would have come from eating the forgone lunch.

It's easy, for example, to see that a tariff on imports of wheat causes increased wheat production at home and higher employment and wages on wheat farms. But these benefits are not free. They come at a price, which in this case (because the purpose and effect of the tariff is to raise the price of wheat at home by reducing the supply available to consumers) includes reduced availability at home not only of wheat but also of other goods and services. The

resources that the tariff draws into wheat production at home are no longer available to produce the rye, the roads, and the other goods and services that these resources would otherwise have been used to produce. And because the very purpose of the tariff is to make wheat at home scarcer, home-country residents also have less wheat to consume.

While all choices have costs, to insist on the reality and recognition of costs does not, of course, argue against actions that have costs. To do so would be also to argue against actions that have benefits. Inaction itself has costs—namely, the forgone benefits that would otherwise have been enjoyed by taking action. But the inescapable reality of scarcity means that if our well-being is to be enhanced rather than lessened, we should strive to act only in ways that yield benefits greater than costs. To the extent that we succeed in this endeavor, our well-being improves. We benefit on *net*. We benefit on net not by avoiding costs, which is impossible, but by choosing actions that we anticipate will yield benefits greater than costs.

Costs arise because of scarcity

James Buchanan insisted that the common practice, even among modern economists, of reckoning costs in physical or monetary terms or—as some older economists did—in terms of “pain,” is often misleading. In his 1969 book *Cost and Choice*, which separates him most radically from mainstream economists of his day, Buchanan argued that costs are purely subjective, unmeasurable, encountered only by individuals rather than by groups, and exist only at the moment of choice.

In the first two paragraphs of the Preface to this slim volume Buchanan nicely summarized his understanding of cost:

You face a choice. You must now decide whether to read this Preface, to read something else, to think silent thoughts, or perhaps to write a bit for yourself. The value that you place on the most attractive of these several alternatives is the cost that you must pay if you choose to read this Preface now. This value is and must remain wholly speculative; it represents what you now think the other opportunity might offer. Once you have chosen to read this Preface, any chance of

realizing the alternative and, hence, measuring its value, has vanished forever. Only at the moment of choice is cost able to modify behavior.

If you decided a few moments ago that your valuation of the alternative exceeded that expected from reading this Preface, you will have missed this economist's pedestrian prose. But, having rejected it at the outset, you can never know what you will have missed. The benefits that you are now securing from reading the Preface are not comparable with the costs that you would have suffered on choosing the most attractive alternative. These benefits, if there are any, exist. They can be evaluated *ex post*. Costs that are influential for behavior do not exist; they are never realized; they cannot be measured after the fact. (Buchanan, 1969: vii)

Buchanan's readers could have used their time to do something other than read his Preface. But time is scarce and the time used to read the Preface remains forever unavailable to be used to do something else.

Consider again the person who gives up a restaurant lunch to watch a movie. The cost of one is the forgone value of the other. If the person could both watch the movie *and* have the lunch, then obviously the lunch would not have to be forgone in order for the person to watch the movie. But the world doesn't afford us unlimited opportunities. Even people who have lots of money have limited amounts of time, and choosing to watch a movie, or choosing to have lunch at a restaurant, always means forgoing the opportunity to do something else instead.

In short, costs are the consequence of making choices. Costs are the chooser's anticipated benefits of the alternatives that are sacrificed. These anticipated benefits exist only in the mind of the chooser; they cannot be seen or otherwise sensed by outside observers. Costs are subjective, not objective. And not being objective means that costs are not measurable on some external scale as, say, is someone's height or weight and, hence, cannot be determined objectively.

Individuals incur costs

Because only individuals make choices, only individuals experience costs, and then only those individuals who make the choices that yield the costs. But as mentioned earlier, even the individual who incurs a cost by choosing option A rather than option B can never know for certain if it was worthwhile to incur the cost. This person will experience whatever benefits flow to him or her as a result of having chosen option A. Yet because option B is forever lost, this person cannot objectively know what would have been the benefits that he or she would have enjoyed had he or she instead chosen option B.

Groups can be said to make collective choices—for example, by voting. But the group *as such*, the group as an entity, makes no choices, for the group as such—we say yet again—has no brain. The collective choice is arrived at by each individual in the group voting and then having these votes processed into an outcome through some voting rule. The collective decision is determined by aggregating individual choices. Groups do not take actions. Only individuals do—a reality that doesn't change when individuals join together into a group.

Here's Buchanan's own summary of the implications of what he calls a "choice-bound conception of cost":

- 1) Most importantly, cost must be borne exclusively by the decision-maker; it is not possible for cost to be shifted to or imposed on others.
- 2) Cost is subjective; it exists in the mind of the decision-maker and nowhere else.
- 3) Cost is based on anticipations; it is necessarily a forward-looking or *ex ante* concept.
- 4) Cost can never be realized because of the fact of choice itself: that which is given up cannot be enjoyed.
- 5) Cost cannot be measured by someone other than the decision-maker because there is no way that subjective experience can be directly observed.
- 6) Finally, cost can be dated at the moment of decision or choice.
(Buchanan, 1969: 43)

Buchanan's radically subjective conception of cost is fully shared almost exclusively by Austrian economists (including F.A. Hayek (1899–1992)) and by economists who taught in the early and mid-twentieth century at the London School of Economics, the LSE. It is not now and never has been fully embraced by mainstream economists, partly due to its subtlety, but mostly due to some unwelcome implications it has for standard economics and for economic policy.

If costs are subjective and borne only by individuals, it is not possible to aggregate costs and benefits across individuals in order to come up with some measure of social welfare, or to objectively identify “the” public interest. Experts cannot truly “scientifically” discover welfare-maximizing policies. Buchanan was interested in identifying ways of aggregating individual preferences to make collective choices that enhance the individual welfare of those who make the choices. Public policies, in his view, should be the result of collective choices made by individuals affected by those policies, rather than by policy experts.

The choices of some affect the opportunities of others

By insisting that cost is borne only by the decision-maker at the moment of choice and can never be shifted to or imposed on others, Buchanan was *not* saying that a decision made today by Jones will have no negative impact on third parties Smith and Jackson. Choices affect the course of events both for the chooser and for many others. Choices made by Jones indeed can affect the options and well-being of others.

Further, Buchanan explicitly acknowledged that individuals can, when making choices, attempt to take into account the consequences their choices are likely to have for other people. Buchanan recognized that in fact individuals make such attempts quite often. Yet the reality remains that no one can read another person's mind or experience another person's subjectively felt sensations. When Jones is choosing between option A and option B, he might sincerely attempt to account for how his choice will affect Smith. But this attempt by Jones is not Smith participating in Jones's choice; it is Jones *imagining* how Smith might feel. Ultimately, Jones has only his own subjectively felt assessments to guide him in choosing. This fact is so regardless of how sincerely and carefully Jones attempts to take into account the interests of others when making choices.

The obvious impact that our choices have on others as well as on our future selves led Buchanan to distinguish between “choice-influencing costs” and “choice-influenced costs.” Choice-influencing costs operate at the moment of choice in each decision-maker’s mind, leading that decision-maker to choose one option over another. Choice-influenced costs are existing constraints that were created by choices made in the past. A hypothetical illustration will be useful.

Jones is today considering whether or not to buy a pet dog. He imagines, to the extent that he can and that he believes worthwhile, all of the benefits (for him) of owning a dog and all of the costs. These costs include not only the purchase price of the dog but also his expectation of what he likely must sacrifice in the future as a consequence of owning the dog—for example, how much he’ll have to pay for dog food and veterinary services, as well as whatever inconvenience might be in store for him, such as when he must walk the dog on bitterly cold mornings.

If Jones chooses to buy the dog, he is aware that this choice will entail him incurring costs (and enjoying benefits) in the future. And indeed in the future such costs emerge. While walking his dog on a frigid January morning Jones will likely feel some discomfort from having made the choice to buy the dog. This discomfort—the inconvenience, irritation, and other downsides that Jones experiences as a result of walking the dog—is an example of “choice-influenced costs.”

Jones might well discover that the costs of owning a dog are higher than he anticipated when he chose to buy it. By owning the dog, he discovers that he must give up more valued opportunities than he anticipated. As a result, Jones might now choose to sell or to otherwise get rid of the dog. But his experience with the dog—these choice-influenced costs—cannot undo Jones’s earlier choice to buy the dog. All costs that *influence* choices are anticipations of imagined forgone benefits; such costs are not the actual experiences that the chooser later encounters as a result of having made the choice.

Unlike choice-influencing costs, choice-influenced costs can fall not only on the chooser but also on other persons. If the barking of Jones’s dog irritates Jones’s neighbor Smith, Smith experiences a negative impact of Jones’s choice to buy the dog. Upon hearing Jones’s barking dog, Smith must make

choices that she would otherwise not have to make. Complain to Jones or not? Build a sound-absorbing fence or not? Summon the police or not? Move to a different neighborhood or not? Jones's choice to buy the dog clearly influences the choices that Smith must make and, hence, influences the costs that Smith incurs.

To the extent that a decision-maker accurately accounts for future consequences, the choice made now will lead to fewer "regrettable" choices having to be made later by him and by other individuals. If Jones takes account of the annoyance that Smith would suffer from hearing his dog bark, Jones might make a different decision. He might choose to buy a dog from a breed less likely to bark, or to buy a dog more suitable for living indoors, or perhaps to not buy a dog at all.

Profit maximization

Economists often assume that firms maximize profits, but there is no way to tell whether firms actually succeed at doing so. The individuals who run firms make choices, and those choices might turn out to be profitable. But it's impossible to tell whether those choices have *maximized* profits, because it's impossible to identify the value of forgone alternatives.

Consider the hypothetical example of an entrepreneur who wants to open a bakery and is deciding between two locations to rent as a storefront. The baker could rent a location on Elm Street that has high visibility for \$2,000 a month, or a lower-traffic location on Oak Street that would get fewer walk-in customers, but that rents for only \$1,000 a month. Which location is the profit-maximizing one?

Assume that the baker believes the Elm Street location to be not worth the higher rent, so he instead rents the Oak Street location for \$1,000 a month. The business is successful and the baker earns a profit. But did the baker choose the profit-*maximizing* location? It's possible that the additional business the baker would have enjoyed in the other location would have more than compensated for the higher rent. Yet there's no way to tell because the baker didn't choose the other location. One can only speculate about whether that other location would have been more profitable.

An implication of the subjective nature of cost is that one can never know whether firms are actually maximizing profits because one cannot know how profitable firms would have been had their managers made different choices. One can tell whether or not a firm is profitable, that is, whether or not a firm earns enough revenue to survive, but one cannot tell whether a firm's profits are at a maximum.

Some implications

As mentioned, economists often assume that that firms maximize profits and that individuals maximize utility—that is, seek maximum satisfaction from their actions. But one clear implication of the subjective nature of cost is that no one can tell whether this is the case—not outside observers making those assumptions or even the individuals who are making the choices themselves. The cost of a choice is the value of the highest-ranked *forgone* alternative. Yet precisely because that alternative is forgone, there is no way to know how much utility or how much profit it would have yielded had it been chosen. Individuals realize the utility they get from the options that they choose. But these same individuals can only *conjecture* about the utility they would have received had they chosen differently. Firms can tell whether they are profitable, but they cannot know whether they would have been more (or less) profitable had their managers made different decisions.

Because cost is subjective, different individuals might make different choices in the same situations, and both could be the best choices for those individuals. To take a trivial example, when offered the choice between vanilla or chocolate ice cream, two individuals could make different choices, each of which might be best choice for the individual who makes it. The principle applies to more complex decisions, such as whether to rent or buy a home, whether to take a higher-paying but more stressful job, or whether or not to get married.

Similar implications apply to public-policy measures. The impossibility of observing and objectively measuring costs means that the kinds of corrective taxes that most economists recommend to deal with carbon emissions and other such externalities cannot be conclusively justified. Consider a smoke-emitting factory polluting the air of those who live nearby. Some people

might view the smoke as a major imposition while others barely notice it. Any external cost is purely subjective.

It's important to note that the impossibility of objectively measuring costs didn't lead Buchanan to throw his hands up in despair and conclude that we should not act in the face of externalities. He did not believe that we can never sensibly judge whether one policy is better or worse than any other. Among the policies that he supported are those that enhance the ability of all affected parties to bargain with each other, with each party possessing the right to reject offers that that party finds unappealing. Such bargaining allows each affected individual to reveal, through his or her own choices, whether or not he or she finds some cost to be worth paying.

Put differently, the important implication of Buchanan's theory is that, whenever possible, disputes and conflicts are best handled by having affected individuals bargain among themselves rather than by having third parties—in practice, by having government officials—impose “solutions.” This recommendation that individuals bargain amongst themselves raises the question of how they can actually do so in order to resolve conflicts and to produce collective goods. Much of Buchanan's research dealt with exactly this challenge.