
13 Cost

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The doctrine of the subjectivity of costs is clearly tied to that aspect of economics which seeks to understand the causes of and obstacles to choice rather than its consequences. Since these causes are the desires and beliefs of individuals (see Cowan's entry on causation), they are found among the contents of the human mind. The distinction between causes and consequences is obscured by the assumption of perfect foresight characteristic of the fundamental neoclassical economic theory. It is still further obscured by the compression of time into a single period *à la* Walras and Pareto. Not only are all intended consequences (causes) realized under perfect foresight, but they are *instantaneously* realized in the single-period formulation.

The Austrian view of cost is that it is a subjective, forward-looking and ephemeral phenomenon tied inextricably to the moment of choice. This is in sharp contrast to the traditionally objectivist conceptions that are found in the major textbooks, even at the graduate level. Observe that Henderson and Quandt (1980, p. 74) treat costs simply as money outlays made by the firm under perfect competition. McCloskey (1982, p. 10), on the other hand, rejects the direct-outlay view but focuses on alternative output producible by the given employment of factors. Geometrically, this is portrayed as the slope of the budget line. In the famous Smithian example, one hour's labor can produce either one beaver or two deer. So the cost of beaver is deer, and the cost of deer is beaver. In either of the above cases, cost is an objective thing – a sum of money in the first case or an animal in the second. The objectivity displayed here is plausible only in perfectly competitive equilibrium where the trade-off is certain and the same for all traders. There is no question of any important subjectivity in these conceptualizations.

The early Austrians, particularly Friedrich von Wieser (1893), wrote ambiguously about cost being the 'value' of the alternative product. Whether they meant subjective value or market value was often unclear. It is clear, however, that they were *interpreted* as meaning market value. To that extent, the early Austrian view is only partially subjectivist. It is subjectivist insofar as market values are determined by marginal utilities, but it is objectivist because these values are set in markets and can be objectively measured in the form of a money price. In more recent years, Ludwig von Mises (1949, p. 97) wrote of costs as 'equal to the value attached to the satisfaction which one must forego in order to attain the end aimed at'. Unfortunately, this is not

adequate as a strict definition because it leaves too much of a critical nature unsaid. The ambiguity present in the work of the early Austrians is still here. Does Mises mean market value or personal subjective value? Equally important, the uncertain, forward-looking quality of costs is absent. Costs must refer, not to what *has been* given up, but to what the agent *expects* to give up if a certain course of action is followed. Thus we ought to define costs in the following way: the cost of adopting a course of action is the expected want satisfaction that is perceived to be sacrificed by forgoing the next most highly-valued course of action.

The process of determining costs is another aspect of the process of determining value. Consider that an individual has a rank ordering of prospective want satisfactions. Each of these satisfactions is causally related to a particular course of action. The individual will value, that is, rank order, these courses of action in accordance with the satisfactions they are expected to produce. In establishing this value scale the individual is valuing expected want satisfaction *A* most highly, *B* the next most highly, and so on. So if only one course of action can be chosen (owing to limited means) the individual will choose the course that results in *A* at the expense of the course that results in *B*. Just as determining which alternative is chosen involves valuation, so determining which is rejected involves the same overall process of valuation.

The static conception of valuation entails a view of costs as given or 'out there' simply to be computed in the determination of choice. Nevertheless, cost, like value, must be discovered (Thirlby, 1973a, p. 140; Kirzner, 1973, pp. 32-7): that is, in both cases, the agent must discover which courses of action lead to which results in terms of want satisfaction. The discovering of costs is a part of the general entrepreneurial view of economics obscured by equilibrium analysis.

In order to appreciate fully the meaning of subjectivism in the theory of costs, it would be useful to state some of its primary theoretical implications. These were stated by James M. Buchanan (1968, p. 43) roughly as follows:

1. Cost exists only in the mind of the decision maker.
2. Cost is forward-looking, based on anticipations.
3. Cost can never be realized (or, in some sense, achieved).
4. Cost can never be measured by an outside observer (nor ever really by the individual himself – how can want satisfaction be measured?).
5. Cost can be dated only at the moment of choice.
6. Cost must be borne exclusively by the decision maker.

The reader should note that most, perhaps even all, of the above are obscured in competitive equilibrium. Although costs still exist only in the decision

maker's mind, the presence of perfect knowledge means that there is never any uncertainty about them. Secondly, the forward-looking quality of costs lacks real meaning when past, present and future are the same. Furthermore, while costs still cannot be realized, agents in perfect competition have perfect hypothetical knowledge. They know what *would have been* the case if an alternative course of action had been chosen. Additionally, the impossibility of measuring costs loses some of its force when a money 'equivalent' is measurable. Finally, the existence of cost only at the moment of choice is now uninteresting, since the moment of choice and the moment of consequences are collapsed into each other in a one-period Walrasian model.

The subjectivism of costs is most clearly distinguished from the conventional view in the theory of the firm. Here matters are not in principle different from the characteristics described above. In practice, however, they appear somewhat different because of a simplifying assumption. Traditionally, we assume that the firm (or its decision maker) simply wishes to maximize net revenue. We do not inquire about any other goals or the want satisfactions the firm owners seek in their capacity as consumers. We put to the back of our minds the fact that utility is the ultimate motive. If we imagine the firm outside of long-run equilibrium, then cost is the 'entrepreneur's *own valuation* of a course of action he rejects. And because, as a first approximation, money revenue is regarded as the entrepreneur's single aim, this outcome would be an alternative money revenue' (Thirlby, 1973c, p. 277, emphasis added).

Let us now examine Buchanan's implications of the subjectivity of costs in the context of the theory of the firm. First, cost exists only in the mind of the entrepreneur–decision maker. It is not the consumer's or anyone else's valuation of the displaced course of action that can be considered an obstacle to the decision taken. Furthermore, cost is not an outlay by the firm but, in disequilibrium, the alternative perceived profit opportunity. Second, cost is based on anticipation. In the theory of the firm Keynes's idea of 'user cost' is a clear reflection of this: 'User cost is the reduction in the value of ... equipment due to using it as compared with not using it [now] and preserving it to be used later' (1936, p. 70). Third, cost is never realized. The decision maker never knows for sure whether he has covered costs. Remember that to cover costs is the same as maximizing revenue. Can we ever be sure that we have maximized revenue? Obviously not. Fourth, cost cannot be measured by an outside observer. As Thirlby reminds us, 'reckoning [cost] is dependent for what it is upon the unique knowledge and attitude (towards uncertainty or risk) of the unique and uniquely situated individual who calculates it' (1973c, p. 281). This places a limit on economic regulation. Suppose a public utility regulator wanted to ensure that the firm operated at the point where total costs equal total revenue. He could not do this simply by announcing the

appropriate rule. He would have to become the firm's entrepreneur and estimate the relevant costs. Fifth, cost exists only at the moment of choice. This means that costs are incurred only during the firm's planning stage. Furthermore, there are no costs during the equilibrium implementation of a plan, or what Thirlby calls 'production under standing orders' (1973b, p. 175).

We have in the course of this entry referred to three value notions of cost. Consider, explicitly: (1) the entrepreneur's own valuation of the course of action he rejects; that is, his estimate of the alternative money revenue, including profits (Thirlby's formulation); (2) the market value of the entrepreneur's resources themselves; that is, the outlays on the factors of production (the Henderson-Quandt definition); and (3) the consumers' valuations of the displaced product (the standard interpretation of Wieser). In competitive equilibrium the *measures* of all three converge (although they remain distinct conceptually). The entrepreneur's own estimate of alternative money revenue will equal his outlays on the factors of production. This is because the prices of the factors are determined by the market values of alternative product, and are equal to them in equilibrium. Furthermore, the outlays on the factors of production will equal the consumers' valuations of displaced product because there are zero profits in equilibrium.

The discussion above about the convergence of various cost measures should not mislead the reader into thinking that the subjectivity of costs is absent in competitive equilibrium. Nevertheless, much of what is *interesting* and *useful* about the subjectivity of costs manifests itself in disequilibrium. To the extent that we are interested in economic processes or economic 'dynamics', the subjectivity of the entrepreneur-agent's estimates of cost cannot be ignored.

See also:

Chapter 3: Subjectivism; Chapter 2: Methodological individualism; Chapter 12: Marginal utility; Chapter 4: Market process; Chapter 21: Profit and loss

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