

SUBJECTIVE POLITICAL ECONOMY

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ABSTRACT

We extend the Institutional Possibility Frontier (IPF) – a theoretical framework depicting the institutional trade-offs between the dual costs of dictatorship and disorder (Djankov et al. 2003) – by incorporating the notion of subjective costs. The costs of institutional choice are not objectively determined or chosen by a society; rather, they are subjective to the political actor that perceives them. Our methodologically individualist approach provides a new, highly adaptable extension of the IPF enabling examination of the political bargaining process between dispersed actors, the bounds and evolution of institutional innovation and discovery, and follower-leader dynamics in long-run institutional changes. Our new Subjective Institutional Possibility Frontier (SIPF) helps to integrate ideas into the economics of political systems, creating the foundations for a more subjective political economy.

KEYWORDS

Institutional Possibility Frontier, Political Economy, Subjective Costs, Austrian Economics, New Comparative Economics

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1. INTRODUCTION

Choices have costs and those costs are subjective to the individual making the choice (Buchanan 1969). Furthermore, given that the economic and political spheres of activity are entangled, individuals must make choices both about the goods and services they consume and the institutional framework in which those exchanges occur (Smith et al. 2011; Wagner 2014; Wagner 2016). While economists have had much to say about the factors that determine the set of choices available, they have had comparatively less to say about what influences the final preference among that set.³ This paper integrates preference formation into a new framework of political economy that, through the lens of Austrian subjective costs, enables analysis of political choice over institutional constraints.

An individual's institutional preferences are underpinned by their ideas and beliefs about the material, physiological, and emotional costs of institutions to themselves and to social groups (e.g. families, ethnic blocs, fellow citizens) that they believe have a just stake in their institutional choice. Yet institutional analyses of politics lean heavily on the construct of rational utility maximising agents (McCloskey 2010; McCloskey 2016; Smith 2012). While "ideology" has been part of positive political economy at least since Downs (1957), and ideas—'shared mental models' of norms and custom—have been a part of institutional economics since its conception (Denzau and North 1994; North 1993), their integration into analysis is tentative at best. Indeed, most institutional analyses rely on explanations for political action grounded in the material interests of the relevant agents, rather than seeking to uncover the underlying ideological contests.

McCloskey (2016) writes that economists ought to pay more attention to the "ideas, rhetoric, ideology, ceremonies, metaphors, stories, and the like" that influence and direct human behavior within a given institutional framework. For Rodrik (2014), "context, honor, glory, reputation, respect, income, power, durability in office, and 'good of the country'" all drive agent preferences. López and Leighton (2012) argued that ideas shape the institutions in which political action occurs, while Tarko (2015) recently outlined that the direction in which institutions change depends on the ideas, beliefs, and values of those who change them.

Our framework is based on the new comparative economics of the institutions of capitalism developed by Djankov et al. (2003) (see also Shleifer 2005; Shleifer and Vishny 2002). In the Institutional Possibility Frontier (IPF) framework, institutional choices are depicted as a trade-off between dictatorship costs and disorder costs. Given that institutions comparatively economize on those costs, and that they do so in imperfect ways, the entire suite of institutional possibilities can be arrayed graphically along a convex function, the IPF. The IPF represents institutional trade-offs, and thus choices, in a world of imperfect

3 Hausman (2011), for instance, identifies four sources of preferences: a) means-ends reasoning, b) attribute-based reasoning, c) emotional influence, which directs and motivates information acquisition at the individual level, and d) physiological needs.

property rights. The IPF has variously been applied to policy settlements around productivity and red tape (Berg forthcoming; Davidson 2013), the environment (Davidson 2014), media regulation (Berg and Davidson 2015), freedom of speech (Berg and Davidson 2016), innovation (Davidson and Potts 2015; Davidson and Potts 2016), education (Lane 2017), democracy (Allen et al. 2017), and tobacco control (Davidson 2016).

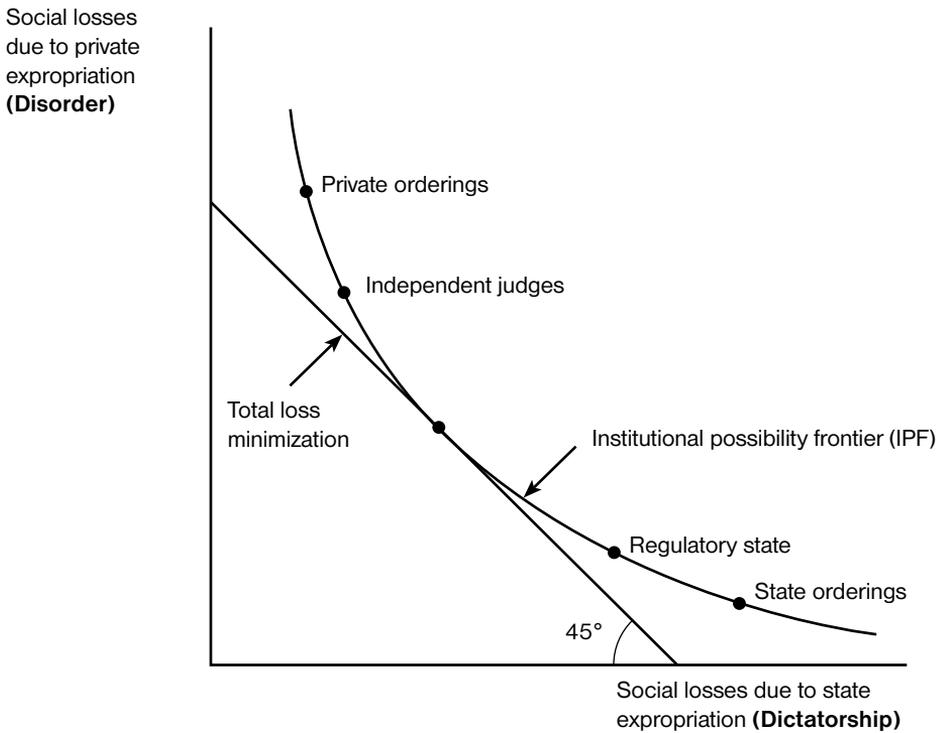
In this paper we extend the IPF framework in two ways. First, we acknowledge and incorporate the reality that institutional dictatorship costs and disorder costs are *subjective* to the actors which impose them and to the societies which endure them. Characterizing the costs underpinning the IPF as subjective helps avoid the hand-waving and often tautological reasoning about norms and customs characterizing much contemporary comparative political economy. But introducing subjective costs must be coupled with a second extension—*disaggregating* institutional choices down from the level of society to groups, factions, parties, and ultimately individuals. Given that costs are subjective, societies do not make institutional choices, individuals do. The dynamics of individual disagreement and bargaining over institutional costs ought to be front and center of any institutional analysis.

The resulting subjective and disaggregated framework – which we call the Subjective Institutional Possibility Frontier (SIPF) – can be applied to a large range of political and economic phenomena. It is sufficiently flexible, nuanced, and adaptable to describe and explain institutional changes over time, the function of ideas on policy settlements, political bargaining, and the effect of institutional knowledge. By allowing the ideas and knowledge production of intellectuals to be explicitly included in an analysis of institutional choice we have developed an “Austrian” approach to new comparative economics based on institutional processes, methodological individualism, and knowledge coordination. This paper is not meant as a critique of the IPF framework in the same line as other critiques (e.g. Rosser and Rosser 2008; Dallago 2004; Van de Klundert 2010), but to resolve some of their critiques and extend the explanatory power of the framework.

2. THE INSTITUTIONAL POSSIBILITY FRONTIER

The IPF was first offered by Djankov et al. (2003) as the analytic framework of an institutional theory of regulatory choice. The authors begin by assuming that “society” wishes to control the activity of a private firm and then considers the alternatives – ranging from social or market discipline to nationalization – arrayed along a spectrum of control. Institutions structure human interaction and pull us out of the nasty, brutish, and short life of Hobbesian anarchy. Institutional controls are implemented because the perfect application of property rights does not exist. However, institutional controls also bring with them the threat of government expropriation and coercion. The underlying premise of the IPF framework is both that all institutions impose social losses to some degree – because no institution perfectly prevents social losses – and that all institutions control the dual costs of dictatorship and disorder in comparatively effective ways.

FIGURE 1: THE INSTITUTIONAL POSSIBILITY FRONTIER



Costs of *dictatorship* arise from state-based expropriation. In the words of Djankov et al. (2003, p. 598) this is the “risk to individuals and their property of expropriation by the state and its agents in such forms as murder, taxation, or violation of property.” Some dictatorship costs are obvious, such as an oppressive regime, but also include more subtle forms of using the power of state coercion to control others through regulatory capture. Costs of *disorder*, in contrast, are the costs private individuals impose upon each other. Djankov et al. (2003) describe disorder costs as the “risk to individuals and their property of private expropriation in such forms as banditry, murder, theft, violation of agreements, torts, or monopoly pricing.” The common elements of the costs of disorder are private appropriation stemming from too much power combined with the threat of opportunism.

The IPF depicts the trade-off between the costs of disorder and dictatorship as a convex function (see Figure 1). The central benefit of the IPF framework is that it allows comparative institutional analysis around the focal point of an economic problem (such as the regulation of business shown in Figure 1 above), rather than beginning with the nature of an institution (e.g. top-down or bottom-up). For instance, in Davidson and Potts (2016) and Allen (2017) the institutions of innovation are depicted through the IPF framework, ranging from the private orderings of innovation commons all the way down to public science. In this way, all institutional possibilities - including organizations such as firms, markets, clubs, hybrids, and commons, and other institutions such as social norms - can

be represented as points within the IPF space. Furthermore, the convexity suggests a point where the costs of dictatorship and disorder are minimized. This cost-minimizing point of institutional efficiency is found where the IPF is tangent with a 45-degree line because this represents the efficient cost-minimizing institutional solution closest to the origin.

In the short run, the location and shape of the IPF is fixed. In a longer historical context, however, the location and shape of the IPF is influenced by changes in civic capital, technology, and institutional and economic constraints. Shifts in the IPF, in the same way as the more widely understood Production Possibility Frontier, are a result of multiple complex factors, many of which are out of our control (Boettke et al. 2005). For example, prior institutional choices constrain and direct future institutional choices. Glaeser and Shleifer (2002) and La Porta et al. (2008) look at the economic significance of legal traditions as those traditions are transplanted through colonization or conquest. There is a recognized tension in Djankov et al. (2003) between the argument that societies choose an efficient control strategy on the IPF and that legal origins explain why some societies choose certain strategies over others. It is here that an Austrian subjectivist approach to the IPF bears fruit.

3. The idea of subjective institutional costs

At first it is unclear what value a subjectivist approach adds to the context of institutional choice. But as Hayek (1955) once wrote, “it is probably no exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism.” What we find below is that many of the analytic shortcomings of the IPF, such as the supposed lack of applicability to real-world institutional scenarios, can be ameliorated through a central insight of Austrian economic theory: that value and costs, including opportunity costs, are *subjective* perceptions (Buchanan and Wagner 1977; Menger 1871; Stringham 2010; Yeager 1987).

Methodological subjectivism is well known to be the bedrock of the Austrian tradition (Boettke 2002b; Vaughn 1998). A subjectivist understanding of human action rejects the claim that the criteria on which choices are made are externally objective.⁴ Subjective costs have broad implications for perspectives on the economic system (DiLorenzo 1990) because it forces the scholar to focus on the interactions of exchange between individuals (Buchanan 1979). Indeed, social phenomena derive meaning from the mental states of participants in that society (Lachmann 1990), which plays out through time and in ignorance (O’Driscoll et al. 1996).

While the claim that institutional costs are subjective is a simple observation, it has major implications for the application of the theory and for the usefulness of the new comparative economics approach more generally. Across the IPF literature the idea that the costs of dictatorship and disorder are centered on preferences is only mentioned once, to the knowledge of the authors. That is, in Whitford and Lee (2012, p. 8) when they attempt

4 While of course the level of subjectivism adhered to by the scholar changes the scope of application (for instance, see radical subjectivist accounts including Lachmann 1976; Shackle 1983; Shackle 1992), the “degree” of subjectivism is not relevant for our purposes here.

an empirical analysis of the perception of government effectiveness and state: “We want to be very clear that this indicator measures subjective perceptions regarding government effectiveness in different countries.” While some of the literature, such as Rosser and Rosser (2008, p. 87), attribute some cross-country differences to preferences within those countries and allude to subjectivity, the remainder of the literature proceeds either assuming some objective optimum institutional set, or assumes objective costs for tractability.

In mainstream economics, subjective preferences are usually treated as both fixed and exogenous. But preferences should not be treated as an unexaminable black box (Hausman 2011). For example, Becker (1996) emphasizes that future consumption is closely related to past consumption. The marginal analytical point is that a preference for wine on Sunday is related to the consumption of wine on Saturday. A preference for a variety of wine is dependent on past experiences with that variety, and strength of expectation that those past experiences provide information about future satisfaction. Rather than been seen as fixed, preferences can be seen as an evolutionary information discovery mechanism.

Indeed, as Buchanan (1969, p. 43) taught us, cost “exists in the mind of the decision maker and no-where else.” That is, by the subjective stock of knowledge by the individual acting in a social world (Schutz and Luckmann 1973). It follows that the dictatorship and disorder costs underpinning the IPF are subjective by their very nature because they rely on opportunity costs of institutional implementation as perceived in the minds of the individual agent, and are revealed by their action. They are not objectively determinable by an external observer or external criteria. Those costs consist of the alternative institutions foregone.

Dietrich and List (2011) offer a critique of the rational choice approach to preference change – which sees observed preference changes as simply a reflection of new information on fixed, underlying preferences – by offering an alternative where preference change is the result of shifts along motivationally salient dimensions. Agents have different ideas about the relative importance of the characteristics of the objects of their choices. Observed preferences change when some characteristics become more or less salient – when a wine drinker becomes a wine connoisseur, and they move from a preference for red over white, to a preference for pinot noir over merlot, from a preference for New Zealand pinot noir over Napa Valley pinot noir. Dietrich and List argue these shifts are distinct from the Bayesian information approach, as the existence of New Zealand pinot is known to the wine drinker but they lack the motivation salience to appreciate it. But in a subjective framework, this distinction isn’t clear.

While information reduces uncertainty (Shannon 1948), that uncertainty relates to mental states, not objective truths. Our drinker has still experienced a process of information discovery and learning – not about the existence of New Zealand wines – but of the relative subjective benefits of choosing to consume wine from that region. Likewise, for Dietrich and List’s capitalist businessman who lives through a plane crash and then devotes his life to charitable works, it is not that he has necessarily abandoned his affection for wealth, but the near-death experience has given him more information about the desirability of a life dedicated to altruism.

This information approach has particular importance when we apply it to institutional preferences. What is usually reduced to “ideology” is in fact a complex set of normative and positive perceptions about the world. Indeed, there are a large number of definitions of ideology, with one survey identifying 27 distinct definitions (Hamilton 1987). Downs (1957, p. 97) began the study of the economic function of ideology as purely normative, describing “a verbal image of the good society and the chief means of constructing such a society.” Ideologies reduce transaction costs for voters facing a large number of possible issues on which political parties might disagree (see also Hinich and Munger 1996; Laborit 1996). However, ideologies also have a descriptive function. A model of the ideal society is by necessity a critique of the current order – of the costs of the institutional status quo and alternative institutional arrangements. In the moral foundations theory, an individual’s ideology is constructed by that individual’s intuitive response to mixture of five values and their opposites – care/harm, fairness/cheating, loyalty/betrayal, authority/subversion, and sanctity/degradation (Federico et al. 2013; Haidt 2012; Haidt and Joseph 2004). Each value pair can be seen as costs on a dictatorship/disorder axis.

From the perspective of moral foundations theory, the subjective approach to dictatorship and disorder costs can be intuitive and aesthetic. Consider the ideological politics of urban planning. Individuals will have different perspectives as to the desirability of a clean, rationally planned model of the urban environment – represented at its extreme by Le Corbusier’s planned cities of Ville Radieuse, Brasilia, or Chandigarh – as compared to the messy, unplanned, and evolutionary urban orders elucidated by Jane Jacobs. Le Corbusier was “offended by [the] disarray and confusion” (Scott 1998, p. 106) he saw in unplanned urban environments, and saw linear symmetry as not merely practically but aesthetically superior. Jacobs reaction against high modernist urban design was, at least in small part, a reflection of her anti-authoritarian preferences (Kanigel 2016).

Individual institutional preferences reflect in part different intuitive preferences (or, to put it another way, intuitive tolerances) for disorder or dictatorship costs. This is one vector through which one can see McCloskey’s rhetoric, ceremonies and metaphors – as mechanisms through which societies make sense of, communicate, and coordinate beliefs about the dictatorship and disorder costs of social institutions.

While dictatorship and disorder costs are subjective in our analysis they are held by the agents themselves to be reasonable representations of the world around them. At the first instance, events, ideas, or experiences affect perceived dictatorship and disorder costs. For example, the Global Financial Crisis of 2007–2009 provided information about the subjective disorder costs of the financial regulatory framework. Richard Posner (2010) and Alan Greenspan both subsequently said they had been mistaken to support banking deregulation in the lead-up to the crisis, based on information they had now acquired from observing events. The evolution of ideas can likewise be seen as an exogenous event that feeds into subjective costs. The sustained disequilibrium posited in Keynes’ General Theory can be seen as increasing knowledge about the disorder costs of the free market in employment and production, and the socialist calculation debate can be seen as increasing knowledge about the dictatorship costs of a planned economy.

3.1 SUBJECTIVE COSTS AND THE PROBLEM OF MOTIVE

The basic public choice critique of economics is that it treats the state as a unit outside the analysis – as a benevolent and omniscient external force that can be deployed to resolve market failures, rather than a human organization subject to the same incentive and agency problems as an organization operating in the market. Contrasting the romantic “public interest” motivation where political action is driven by notions of the greater good, they provide a public choice motivation where human action in the political sphere is shaped by institutional incentives (Buchanan and Tullock 1962). However, as Boettke and Lopez (2002) note, while the public choice school has relaxed the benevolence assumption embedded in much economic policy analysis, it has been reluctant to relax the assumption of omniscience – that is, to integrate the subjective analysis of the Austrian school into its approach. Austrian economics has, for its part, been reluctant to abandon the benevolence assumption. Programs like robust political economy (Boettke et al. 2007; Leeson and Subrick 2006; Pennington 2011) and Wagner’s entangled political economy (Becchio 2014; Wagner 2014; Wagner 2016) sought to relax both assumptions, building a program that is compatible with both Austrian subjectivism and public choice analytic. However, the rational actor model that underpinned the public choice critique of the benevolent state has meant that the strength of its critique was dulled. Both public interest and public choice models have at their base the assumption of an externally-verifiable objective ideal of action. Yet what an observer might consider to be publicly interested political action or self-interested political action by an agent is in fact a reflection of the mental state of the observer. While Pareto efficiency is commonly used as a criterion by which publicly interested motives can be judged, it is not necessarily the case that the agents charged with public interest institutional choices share that criterion. Observing that banking regulation differs substantially between jurisdictions, Barth et al. (2006, p. 19) point out that the “social efficiency” implied by a public interest argument for banking regulation does not necessarily mean Pareto efficiency. Rather, “national tastes determine the degree to which the specific focus is on output maximization, variance minimization, or broadening access to capital.” Some defenses of the public interest model have explicitly made the claim that public interest action is subjective. For example, Mikva (1988, p. 173) argues that the public interest is “fashioned by people...who are thinking of the public interest (as they see it)” (see also Udehn 1996). Both agents and observers have a positive description of the world that may differ from others’ descriptions, and have a normative vision of what institutions would maximize social welfare. Their institutional preferences could be starkly different while the intellectual coherence of the public interest model is maintained.

The significance of this is clearer if we add a temporal dimension to our positive analysis of political action. The analytic challenge is not to explain political choice in equilibrium, but to see how political choices are made in historical time. Pareto improvement cannot be a threshold for publicly interested action before the publication of Pareto ([1906] 2014). Levy and Peart (2009) have shown that the analytical egalitarianism underpinning economic analysis is one which was developed in historical time. What agents have conceived as the public interest has variously focused on individual happiness, social welfare, national

glory, racial dominance, imperial expansion, and civilizational virtue. Those normative ideals form institutional preferences long before any public choice analyses of incentives and rational irrationality. If voters vote expressively, then what are they trying to express? It is recognized in market analyses that individuals have different preferences as to aesthetics and that these preferences are both meaningful and are shaped by exogenous and endogenous forces. The same is surely true of institutional preferences.

Public choice models fare little better when they turn to self-interested motivations. The neoclassical public choice position is that political agents are maximizers constrained by bounded rationality. This skips over what agents seek to maximize when they engage in the political system. Self-interest is mediated through ideas about what forms that self-interest (Boettke 2002a; Evans 2014; Mises 1957). For example, it is not clear what the relevant unit of analysis is when accounting for self-interested institutional preferences. Do individual agents seek to maximize the welfare of themselves, or of groups they form a part of? There is a non-trivial distinction between maximization strategies focused on individual welfare and the welfare of that individual's family. Likewise, agents could be seeking to maximize the welfare of an organization or an ethnic bloc. At some margin this self-interest becomes hard to distinguish from the "public interest" if the unit of analysis is drawn wide enough. The function of ideas about what constitutes self-interest in the formation of self-interested behavior is key.

If the hard core of public choice analysis is the observation that the agents are subject to incentives in both the economic and the political sphere, then the subjectivity of preferences is no challenge. In a market transaction, the price system reduces complex changes in the factors of production and in individual taste to a single end-user price (Hayek 1945). Similarly, the subjective "costs" of an institution of social control reduces complex ideas about how the preferred institution will benefit the chooser as an individual and any group – their family, their neighbourhood, their ethnic bloc, their (or *a*) economic strata, the aggregate inhabitants of the political jurisdiction, the global citizenry, etc. – that they deem ought to have a call on the benefits of the institutional framework. While this approach might seem reductive, it has a number of distinct advantages over the traditional public choice approach. The degree to which preferences are self-interested or public-interested is neither objectively determined nor objectively verifiable. Self-interested institutional preferences are rarely publicly admitted. While it is tempting to peer inside announced preferences and seek underlying motives for those preferences, this can only be accomplished with attention to a broader appreciation of the function of ideas. The famous claim that what is good for General Motors is good for the country and vice versa is only explicable within a framework of Austrian knowledge constraints and McCloskeyian rhetoric and metaphors.

Djankov et al. (2003) note that exogenous factors, such as technology and social trust, will shift the shape of the IPF, but it is not immediately obvious how this happens given that the curve is fixed in the short run. Our explanation is that these factors change the subjective perception of costs, and therefore shift the range of institutional possibilities. High social capital lowers subjective disorder costs as individuals are less fearful that their neigh-

bors will expropriate their wealth. The development of technology enabling more stringent government surveillance raises dictatorship costs as individuals become more fearful about the possible loss of their privacy. Such a change may also decrease disorder costs by increasing the transparency of state institutions. Likewise, changes in ideas about the role of the state and civil society alter the institutional trade-off. It is possible to explain the rise of religious toleration, for example, as a shift in perceived dictatorship costs.

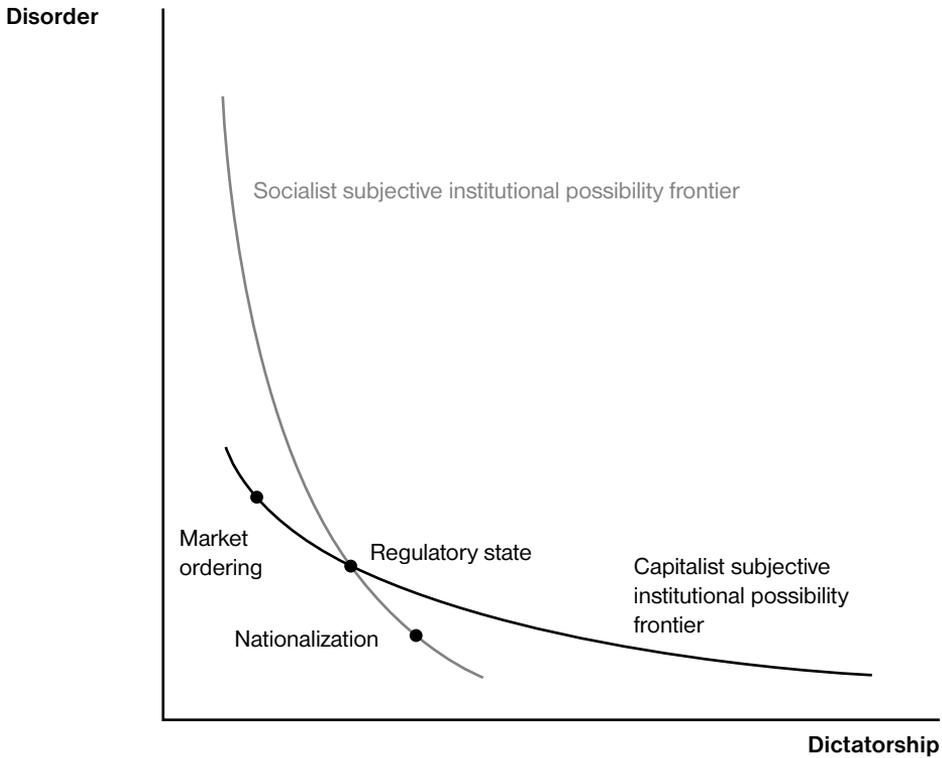
4. DISAGGREGATING THE INSTITUTIONAL POSSIBILITY FRONTIER: INTRODUCING POLITICS AND SOCIAL CHOICE

In Djankov et al. (2003) society “chooses” the point on the IPF that minimizes institutional costs. Readers attuned to a methodological individualist approach will object that society does not consciously choose anything. Brada (2009, p. 11) notes that the framework of new comparative economics “take(s) no account of policy differences. Outcomes are largely explained by institutional differences, themselves the relatively immutable forces such as colonial past, location, etc.” This objection to the IPF framework is fundamentally an aggregation problem. As Hayek (1945) argued, aggregate measures (and indeed any aggregate representations) lose the detail of individual preferences.

The Austrian subjectivist approach is particularly fruitful in examining such problems because of its focus precisely on how individuals with *different* preferences and perceptions *coordinate* their actions (Horwitz 1994). By introducing subjectivism into the IPF, new comparative economics can be based on a disaggregated SIPF down to the level of the individuals who make up the polity. Each agent has a subjective view of the costs trade-off of a given institution (i.e. of the position of points within the IPF space in Figure 1), and therefore each agent has an SIPF with a different shape and slope. While in aggregate this appears to be a single, society-wide IPF, the IPF observed by Djankov et al. (2003) is in fact the outcome of an inter-agent bargaining coordination process.

Almudi et al. (2015) describe civilization as the result of a contest between competing utopian visions. Consider for example a society made up of two individuals, Capitalist and Socialist, with equal political power and a fully-formed and ordered SIPF representing their different ideas about the costs of various institutions. Each conceive of the cost-minimizing institution as “market ordering” and “nationalization,” respectively. Figure 2 shows their two SIPFs. In this highly stylized example, their SIPFs cross at the regulatory state, providing a potential institutional compromise between the Capitalist and Socialist. As this shows, what Djankov et al. (2003) claim to be the cost-minimizing position might well in fact be a compromise position solely created as a function of the relative subjective costs of two individual SIPFs. As there are no “real” dictatorship and disorder costs – institutional costs are mental states rather than objective facts – any observed institution “emerges” as a function of both a diverse range of ideas about the costs of those institutions and a social bargaining process.

FIGURE 2: THE SUBJECTIVE INSTITUTIONAL POSSIBILITY FRONTIER WITH TWO AGENTS WITH EQUAL POLITICAL POWER



In this depiction, neither Capitalist nor Socialist are completely happy with the institutional compromise, seeing the regulatory state as imposing more costs than their preferred institution. Their dissatisfaction can be shown as the distance between their perceived cost-minimization lines and their 45-degree line that intersects the regulatory state. (The two 45-degree lines have been removed from Figure 2 above.) In this highly stylised example, market ordering and nationalization are equidistant from the regulatory state. Both Capitalist and Socialist are equally dissatisfied with the compromise position. Institutional stability is only maintained to the extent that they continue to have equal influence over the choice of institution, that the relative perceived costs of the institutional set are stable (unaffected by exogenous or endogenous changes), that the costs of dissatisfaction are less than the benefits of maintaining the constitutional order, that alternative institutions are not invented which would change the relative perceived costs and therefore the shapes of the SIPFs, and that the number of participants in the decision making group are stable. Relaxing these stabilizing assumptions produces an evolutionary framework of institutional choice.

For example, how close the observed institution is to an agent's institutional optima will be a function of the political power they wield and the institutional framework in which decisions are made. The observed social institution need not be the intersection between

the two SIPFs. Rosser and Rosser (2008) object that the IPF is unable to account for institutional differences between North Korea and South Korea. Our SIPF is easily able to accommodate these differences. It could indeed be true that there are different underlying preferences between the two polities – that state control is less costly in the North than the South. Alternatively, and more likely, North Korea’s institutional form can be seen as the result of the political “bargaining” regime in that hereditary dictatorship results in an institution being “chosen” that is far from the compromise intersection. For example, in a two-agent political system where the Socialist holds absolute political power, nationalization will be the chosen institution. For the Capitalist this will represent a substantial institutional inefficiency. How high do dictatorship costs have to be for the Capitalist to reject the constitutional order? In a $n > 2$ system the transaction costs of institutional change will differ agent by agent, and suffer from Olson’s collective action problem.

One of the costs of dictatorship is the distribution of political rents and concentration of political power. Rent-seeking behavior – such as regulatory capture (Dal Bó 2006; Laffont and Tirole 1991; Stigler 1971) – is an endogenous dynamic that influences the social choice of institutions, pushing it the right on the SIPF. Similarly, in a market order private interests might be able to wield disproportionate influence over the system of social choice through political donations or the buying of votes.

The subjective political economy framework is neutral as to the system of social choice. The starting point is that individuals have individualized preferences about what institutions of social control they believe society should adopt. The method of aggregating those preferences through politics is itself an institutional choice. The process of choosing institutions of social control can itself be seen through an institutional lens, with (for example) direct democracy and totalitarianism providing the outlying institutions.

Likewise, institutional costs can be seen as partly endogenous in the subjective political economy framework. Ideas are fundamentally sociable. Mill’s (1859) argument for freedom of speech is that ensuring the truthfulness of an idea requires testing against other ideas. Collins (2009) goes further by arguing that an “idea” is only meaningful if seen in the context of communicating that idea. Individuals do not enter the system of social choice with a fixed set of preferences and perceived institutional costs. We are not born with fixed notions of the harm of disorder and dictatorship. These are worked out through interaction with other individuals within that system, and subject to continuous adjustment. The acquisition of information about institutional costs is not truly exogenous – it has to be learned and interpreted through social interaction (Berg 2017; Searle 1995).

5. INNOVATION AND IGNORANCE

Knowledge of institutional costs exists in relation to time (Loasby 2001), and for analytic purposes can be sequenced in relation to other knowledge and possibilities. As new knowledge emerges it changes the institutional choice structure, that is, changes the shape of an

individual's SIPF and the relative costs of alternative institutions. However, the curve as depicted in the Djankov et al. (2003) IPF is complete and well-ordered. Agents know and can assess the relative subjective costs of each institutional arrangement. Figure 1 shows the cost-minimization curve at a halfway point between independent judges and regulatory state. But this raises an important question: what institution does society choose under such circumstances? Likewise, under our subjective approach, the point of intersection between the Capitalist's curve and the Socialist's curve might not have a corresponding institution. If the institutional set is static – in an equilibrium outside historical time – the prevailing institution (assuming that each agent has equal political power) will be that which is closest to the intersection. To the extent that the chosen institution is not equidistant from the intersection, one agent will perceive higher subjective costs than the other agent.

The discontinuity of the SIPF provides opportunities for endogenous institutional innovation. The choice of institutions is not fixed. New forms of social control can be invented or adapted through intellectual and ideological endeavor. It is not solely that the need for social bargaining is a spur to institutional innovation – it is that institutions are not conceivable without that underlying bargaining process in the first place. Buchanan et al. (1982) argued that the market order emerges from the process of its generation – that is, the voluntary interaction of individuals. Likewise, institutions as social facts are only created in the context of a bargaining process around diverse perceptions of the costs of the existing institutional set. Given that choices along the SIPF are relative to each other, the creation of new institutional alternatives will likely have an effect on the subjective costs of legacy institutions. Further, the process of political secession to private governance mechanisms (e.g. Stringham 2015; Leeson 2014) or collective action in the commons (Ostrom 1990, 2005) can similarly be seen as a process of institutional evolution over subjective costs. In this view, the process of secession is a process of interaction between individuals with similar perceptions of the IPF and the loss-minimizing institutional solution.

One further consequence of viewing institutional costs as socially formed is the function of ignorance and certainty. In Djankov et al. (2003) the IPF is convex toward the origin, reflecting society's knowledge about the costs of the institutions on the curve. However, it has been observed that agents are not always well-informed about policy alternatives (Caplan 2011; Somin 2013). Of course, in a subjective political economy all agents are equally ignorant of "true" or "objective" costs. Not all agents may feel they are able to produce a well-formed, well-ordered, and complete ranking of institutional alternatives in the SIPF space relative to other agents. The convexity of the SIPF curve is a function of the relative certainty of subjective costs. The perfectly uncertain agent is unable to distinguish any difference in disorder and dictatorship costs between market ordering and nationalisation. Their "curve" in that case is perfectly straight and perfectly equal to the cost-minimization line. Convexity increases as agents more intensely distinguish the costs of institutional choices and are spread institutions across the space.

Agents are keen observers of the preferences of other agents (Earl and Potts 2004). There are transaction costs incurred while spreading ideas – that is, perspectives about the subjective costs of a given institution – from agent to agent. The spread of an idea is a func-

tion of the influence of the agent that holds it. In this sense social learning would be shown by the movement of the SIPFs of followers toward the SIPFs of leaders. A stylized two-party democracy can be seen as clustered SIPFs where subjective costs are aligned by the need to maintain in-group solidarity. The persuasive technique of exaggerating the subjective costs of the institutional preferences of an opponent is self-reinforcing to the extent that agents come to believe their own rhetorical claims. This conception allows for the framework to integrate our emphasis in the previous section on the production of new institutions with the social diffusion of those institutions. The lessons of the Global Financial Crisis were not immediately obvious to all actors in its aftermath. The institutional settlement which emerged in its wake was the result of social learning and persuasion. Multiple possible explanations for the crisis and multiple possible policy responses competed among each other. The diversity of SIPFs is a function of the influence and persuasiveness of idea entrepreneurs (López and Leighton 2012).

The SIPF provides a complex and adaptable framework through which to understand political disagreement and institutional change over time. By recognizing that costs are subjective the SIPF resolves the problems raised by critics of Djankov et al. (2003). It also helps more deeply integrate ideas into political economy while still enabling the analytical constructs of cost and trade-offs to be utilized. In the following section we apply the SIPF approach to the deregulation of the financial sector and the rise of the regulatory state.

6. APPLYING THE SIPF: THE DEREGULATION MOVEMENT IN AUSTRALIA

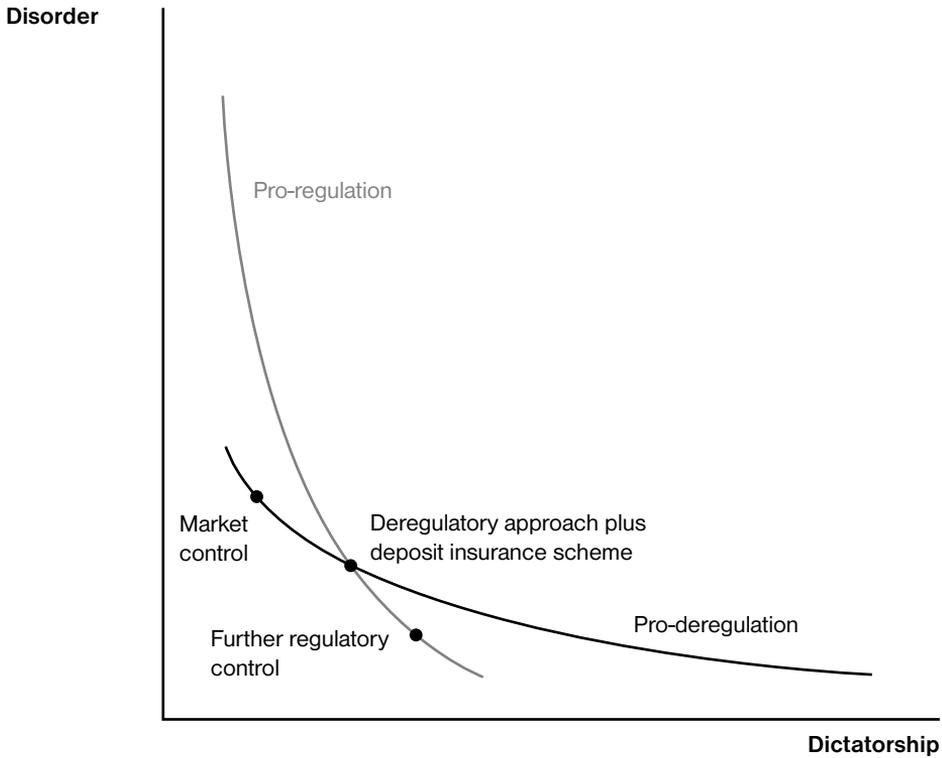
As Kroszner (1999) notes, economists have used the insights of public choice to explain the existence of heavy regulation in the developed world, but have struggled to apply the economic theory of regulation to the deregulation movement that swept the developed world since the 1970s and 1980s (see Keeler 1984). In those decades, developed countries such as the United States, United Kingdom, New Zealand, and Australia reduced legacy regulatory controls – such as fixed prices and restrictions on competition – on sectors such as transport, energy, telecommunications, and finance, privatized government-owned businesses, and reduced centralized industrial relations power. Peltzman (1989), applying the economic theory of regulation, concludes that deregulation was caused by changes in the “politics” and “economics” of economic control, where politics describes the relative balance of interest group power and economics describes the gap between the regulated equilibrium and a *laissez-faire* alternative and the wealth available for redistribution. However, the political economy regime that replaced the heavy state intervention of the mid-20th century was not a *laissez faire* one, but what has been described as a “regulatory state,” where social control is wielded still by regulation, but increasingly through “arms-length” independent regulatory agencies that were intended to approach policy questions from a pro-competition perspective (Berg 2008; Braithwaite 1999; Glaeser and Shleifer 2003; Moran 2003). The Djankov et al. (2003) IPF is well suited to describe the institutional set available

to policy makers and describe the trade-offs faced by society before and after the deregulation movement. While each sector differs in the detail and effect of state control, in broad strokes, the political economy changes in these decades represented a shift along the IPF to the left, trading off the dictatorship costs of nationalization and direct regulation against the disorder costs of more competitive service and goods provision. This trade-off is shown in Figure 1. Djankov et al. (2003) also provide some tools to explain the shift. Exogenous changes in civic capital, particularly that of technology and organizational innovation, create inefficiencies that undermine the existing institutional control. In their description of the rise of the first regulatory state in the United States at the end of the 19th century, they describe how industrialization and commercialization made litigation through the courts an inefficient mode of social control, driving the shift toward regulation. A similar explanation is often advanced for regulatory reform in the at the end of the 20th century – the combination of technological change and macroeconomic factors meant that the regulatory framework no longer functioned efficiently (Kasper and Stevens 1991). Regulatory reform disrupted the institutional equilibria and necessitated further regulatory reform, with a cascading effect through the economy.

However, societies do not move seamlessly from one mode of social control to another. Alternative institutional choices have to be identified, negotiated, and implemented. Djankov et al. (2003) allow for political factors and path dependency to account for observed institutional inefficiencies in the real world. The subjective approach focuses on the act of institutional choice and the subjective and intersubjective ideas of institutional costs as they affect the choices faced by policymakers.

Berg (2016a) offers an account of the early institutional choices made during financial liberalization in Australia. A crisis in the Australian building society sector between 1974 and 1976 caused, for the most part, by the macroeconomic upheavals of those years, presented the Commonwealth government with demands for reform of building society regulation, as the IPF framework would predict. However, the Commonwealth government was faced with two distinct reform directions. It could increase regulatory controls on building societies so that they were aligned with the heavy regulation imposed on the private banking sector, or it could move the entire financial system toward market control. The private banks were noncommittal on whether they would rather be freed from restrictions or whether they would prefer their more-nimble competitors to be restrained (Pauly 1987). The eventual choice of deregulation was not foreordained. Cabinet documents show that Prime Minister Malcolm Fraser favored the former option. This choice, the debate surrounding the choice, and the final institutional settlement, are readily comprehensible through a subjective frame.

FIGURE 3: APPROACHES TO REGULATORY REFORM IN BANKING, AUSTRALIA 1976-78



There were two distinct perceptions of the costs of the regulatory choices within the Fraser cabinet. The *pro-regulation* advocates understood the costs of the existing institutional structure to suffer from sub-optimally high disorder costs – the relatively light-touch regulatory control imposed on building societies and other non-bank financial intermediaries were attracting business away from the highly regulated banks. This both encouraged risky financial practices and led to unacceptably high interest rates. In this perspective, any reduction of control would increase those disorder costs. The *pro-deregulation* advocates understood the current institutional settings to have high dictatorship costs, that the institutional differences between banks and non-banks were a problem brought about by financial repression, and that Australia’s financial sector was inefficient. The resulting institutional arrangement brought about the introduction of a deposit-insurance scheme for building societies (the short-lived Australian Building Societies Share and Deposit Insurance Corporation) and the development of a more general program of deregulation in line with “the government’s free enterprise objectives” (Committee of Inquiry into the Australian Financial System 198, xxiii). This institutional arrangement was a compromise between the two conceptions about institutional costs rather than a coherent statement about the efficiency of that arrangement. Analyzing this institutional choice through an objective, society-wide IPF both misses the substance of the decision and would impose a coherence that the final settlement lacked.

Thus, the SPIF, in this case, introduces both politics – the foremost advocate of the deposit insurance scheme was Prime Minister Fraser – and the content of that political clash (the different ideas about institutional costs). The result is more than just a fall-back onto “ideas” as a catch-all explanation for change (Kroszner 1999). Support for deregulation was not uniform and the resulting settlement was not uniformly deregulatory. Likewise, any account of the rise of financial regulation – particularly focused on prudential regulation – after the deregulation period requires both a recognition of the institutional demands of new competition and the enduring perception, which dated back until at least the Second World War, that depositors required a safe haven for their deposits (Berg 2016b). The resulting rise of the regulatory state was not “chosen” but was the result of a diverse range of changed and fixed perceptions about institutional costs.

8. CONCLUSION

The costs of dictatorship and disorder, which are inevitable in implementing institutional controls on society, are subjectively perceived by individuals within a society. We extended the Institutional Possibility Frontier from new comparative economics by incorporating this Austrian notion of subjective costs. This forms what we called the Subjective Institutional Possibility Frontier, a framework enabling the dynamics of ideas and politics, and schools of thought underpinning them, to be explained from a base of methodological individualism. In addition, such an approach incorporates the potential for institutional entrepreneurship as discovering previously untested points within the SIPF space. We demonstrated the applicability of the SIPF framework through an application to the deregulation movement in Australia.

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