Preface

This book reflects the development of my thinking about economic and other social phenomena over the past 15 years. As a PhD student in the 1990s, my first encounter with economic theory was with spatial equilibrium models of real estate markets. I was struck by the simplicity and internal consistency of those models, and initially accepted them as an adequate representation of reality. But then I read Jane Jacobs’s book, *The Death and Life of Great American Cities* (1961), which presented a completely different image of the urban economy. Observing the city in which I lived at the time, it seemed that Jacobs was right and that neoclassical theory was wrong, at least if my perception reflected any kind of objective conditions. I preferred to conclude that I was not delusional. Land uses in real cities are not neatly separated into functionally specialized parts, as one would expect if firms minimized supposedly well-known transport costs per unit of land area. Notwithstanding their empirical richness and implicit critique of equilibrium theorizing, I was still not quite sure what theory would better account for Jacobs’s observations. It seemed to me as if Jacobs proposed a set of plausible hypotheses in search of an underlying theory.

Around 1995, I read Hayek’s *The Use of Knowledge in Society* (1945) for the first time. This was the key that unlocked the question of why Jacobs seemed right and equilibrium models seemed wrong. It was a question of dispersed local knowledge that could not be communicated to any one person at the centre. Knowledge is necessarily imperfect, and therefore people learn from one another; such interpersonal learning processes often require face-to-face encounters. Location matters apart from any transport costs, and the transport costs themselves are only imperfectly known.

My reading of Hayek made me curious about his background, and led me to discover the Austrian school of economics, whence I discovered the focus on entrepreneurial market processes in the writings of Kirzner, Lachmann and others. Another aspect was the importance of reliable institutions for the exchange of property rights and the superiority of decentralized markets over central planning for the discovery and dissemination of dispersed knowledge.

There was, however, one thing that I looked for in vain among the Austrian economists. There was much discussion of planning and markets, but not much discussion of varieties of planning and varieties of markets. I also

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thought that the question of how institutions themselves evolve and how they shape individual values and preferences was a very interesting question that was inadequately studied within the Austrian school. For example, why do most people in some cultures prefer being employees of large firms, while in other cultures it is more common to aim for self-employment? And why do the institutions of some societies and organizations exhibit emergent properties that only seem to be discoverable at an aggregate level? For this reason, I became interested in institutional-evolutionary approaches to the economy, as developed by a succession of (old and new) institutional economists from Thorstein Veblen to Douglass North.

Consequently, I think of this book as being based on a substantial modification of Austrian economics that includes a partial rejection of strict methodological individualism. Entrepreneurial discovery and judgement reflect individual subjectivity, and in that context the Austrian precepts are relevant. But for the study of institutions, the Austrian approach requires that institutions are treated as constraints on – rather than shapers of – preferences, which makes the treatment of institutions rather static. The multiple-level (agent-structure) approach of modern institutional and evolutionary economics should therefore yield greater insight into institutional, as opposed to entrepreneurial, evolution. I therefore also consider this book an exercise in institutional economics with Austrian microfoundations. What both the Austrian and institutional aspects have in common is a focus on evolutionary, path-dependent processes rather than hypothetical end-state equilibria.

Many of the theoretical questions that I introduce in the course of this book have been treated before, but most of the time at a very general and abstract level. The usefulness of a theory is, however, frequently revealed by its ability to increase our understanding of specific well-known phenomena. I use the production and consumption of various goods and services – construed as bundles of valued attributes – as instances that allow me to both illustrate and test the compatibility of various (infrequently combined) theories that I consider both interesting and persuasive when applied in isolation from one another. The selected goods and services are mostly location-specific bundles such as apartments and hotels. This empirical bias was difficult to avoid, owing to my previous preoccupation with analysing spatial aspects of various real estate markets. Fortunately, markets for goods with several location-specific attributes provide excellent arenas for explaining the processes of entrepreneurial and institutional evolution. This should, though, not be interpreted as implying that such processes are absent from other markets. All goods and services consist of open-ended sets of attributes, which entrepreneurs continually reconfigure, and institutions always both influence and constrain human action. 