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Chapter 1 : Vernon Press - Risk, Uncertainty and Profit [Hardback]

Part III, Chapter VII The Meaning of Risk and Uncertainty Starting with the individual psychology of valuation and adding new factors step by step, we have now built up a competitive industrial society involving valuation and distribution under the highly simplified conditions necessary to perfect competition.

Part III, Chapter VII The Meaning of Risk and Uncertainty Starting with the individual psychology of valuation and adding new factors step by step, we have now built up a competitive industrial society involving valuation and distribution under the highly simplified conditions necessary to perfect competition. The drastic assumptions made were necessary to show the operation of the forces at work free from all disturbing influences; and impossible as the presuppositions have been, the principles involved have not been falsified or changed, but merely exhibited in purity and isolation. Chief among the simplifications of reality prerequisite to the achievement of perfect competition is, as has been emphasized all along, the assumption of practical omniscience on the part of every member of the competitive system. The task of the present chapter is to inquire more fully into the meaning of this assumption. We must take a brief excursion into the field of the theory of knowledge and clarify our ideas as to its nature and limitations, and the relation between knowledge and behavior. On the basis of the insight thus gained, it will be possible to illuminate that large group of economic phenomena which are connected with the imperfection of knowledge. In chapter II it was pointed out that the failure of competition and the emergence of profit are connected with changes in economic conditions, but that the connection is indirect. For profit arises from the fact that entrepreneurs contract for productive services in advance at fixed rates, and realize upon their use by the sale of the product in the market after it is made. Thus the competition for productive services is based upon anticipations. The prices of the productive services being the costs of production, changes in conditions give rise to profit by upsetting anticipations and producing a divergence between costs and selling price, which would otherwise be equalized by competition. If all changes were to take place in accordance with invariable and universally known laws, they could be foreseen for an indefinite period in advance of their occurrence, and would not upset the perfect apportionment of product values among the contributing agencies, and profit or loss would not arise. Hence it is our imperfect knowledge of the future, a consequence of change, not change as such, which is crucial for the understanding of our problem. But, as expressly stated, this assumption was made because it follows from it as a corollary that the future will be foreknown, and not for the sake of the proposition itself. It is conceivable that all changes might take place in accordance with known laws, and in fact very many changes do occur with sufficient regularity to be practically predictable in large measure. Hence the justification and the necessity for separating in our study the effects of change from the effects of ignorance of the future. And chapter V was devoted to a study of the effects of change as such with uncertainty absent. Here it was found that under such conditions distribution or the imputation of product values to production services will always be perfect and exhaustive and profit absent. Even though the business man could not know in advance the results of individual ventures, he could operate and base his competitive offers upon accurate foreknowledge of the future if quantitative knowledge of the probability of every possible outcome can be had. For by figuring on the basis of a large number of ventures whether in his own business alone or in that of business in general the losses could be converted into fixed costs. Such special costs would, of course, have to be given full weight, but they would be costs merely, like any other necessary outlays, and would not give rise to profit, which is a difference between cost and selling price. Such situations in more or less pure form are also common in everyday life, and various devices for dealing with them form an important phase of contemporary business organization. Some of the more important of these devices will come up for brief discussion later. At present we are concerned only to emphasize the fact that knowledge is in a sense variable in degree and that the practical problem may relate to the degree of knowledge rather than to its presence or absence in toto. It is a world of change in which we live, and a world of uncertainty. We live only by knowing something about the

future; while the problems of life, or of conduct at least, arise from the fact that we know so little. This is as true of business as of other spheres of activity. The essence of the situation is action according to opinion, of greater or less foundation and value, neither entire ignorance nor complete and perfect information, but partial knowledge. If we are to understand the workings of the economic system we must examine the meaning and significance of uncertainty; and to this end some inquiry into the nature and function of knowledge itself is necessary. Apparently the higher mental operations of reason are different only in degree, only elaborations of what is inherent in the first spark of "awareness. Life has been described as internal adaptations to external coexistences and sequences. On the vegetable or unconscious plane, the internal changes are simultaneous with the external. The fundamental difference in the case of animal or conscious life is that it can react to a situation before that situation materializes; it can "see things coming. The readjustments by which the organism adapts itself to the environment require time, and the farther ahead the organism can "see," the more adequately it can adapt itself, the more fully and competently it can live. An explanation of the readjustment necessarily runs in terms of stimulus and reaction, in this temporal order. Yet in our own experience we know that we do not react to the past stimulus, but to the "image" of a future state of affairs; and for common sense, consciousness, the "image," is both present and operative wherever adaptations are dissociated from any immediate stimulus; i. It is evident that all organic reactions relate to future situations, farther in the future as the type of life and activity is "higher. For all we can see or for all that science can ever tell us, we might just as well have been unconscious automata, but we are not. We perceive the world before we react to it, and we react not to what we perceive, but always to what we infer. It involves perception and, in addition, twofold inference. We must infer what the future situation would have been without our interference, and what change will be wrought in it by our action. Fortunately or unfortunately, none of these processes is infallible, or indeed ever accurate and complete. We do not perceive the present as it is and in its totality, nor do we infer the future from the present with any high degree of dependability, nor yet do we accurately know the consequences of our own actions. In addition, there is a fourth source of error to be taken into account, for we do not execute actions in the precise form in which they are imaged and willed. The presence of error in these processes is perhaps a phase of the fundamental mystery of the processes themselves. It seems to be an earnest of their non-mechanical character, for machines, generally speaking, do not make mistakes. Though it may not be legitimate to draw inferences from the crude machines of our own construction to the infinitely more sensitive and intricate physico-chemical complexes which make up organic systems. In any case the fact of liability to err is painfully familiar and is all that concerns us here. It is interesting to note that the perceptive faculties seem often to be less acute and dependable in the higher forms of life than in some of the lower. At least civilized man is often weak in this respect in comparison with primitive man and the higher animals. Higher powers of inference may take the place of perceptive faculties to a large extent, and we have undoubtedly developed reasoning power and lost ground with respect to keenness of sense. Our perceptive faculties are highly educated and sophisticated, and what is present to consciousness in the simplest situation is more the product of inference, more an imaginative construct than a direct communication from the nerve terminal organs. A rational animal differs from a merely conscious one in degree only; it is more conscious. It is immaterial whether we say that it infers more or perceives more. Scientifically we can analyze the mental content into sense data and imagination data, but the difference hardly exists for consciousness itself, at least in its practical aspects. Even in "thought" in the narrow sense, when the object of reflection is not present to sense at all, the experience itself is substantially the same. The function of consciousness is to infer, and all consciousness is largely inferential, rational. By which, again, we mean that things not present to sense are operative in directing behavior, that reason, and all consciousness, is forward-looking; and an essential element in the phenomena is its lack of automatic mechanical accuracy, its liability to error. Hence, as already pointed out, it is always theoretically possible to ignore the form of the conscious relation, and interpret the reaction as a mechanical effect of the cause actually present. But it remains true that practically we must regard the situation present to consciousness, not the one physically present, as the controlling cause. In spite

of rash statements by over-ardent devotees of the new science of "behavior," it is preposterous to suppose that it will ever supersede psychology which is something very different or the theory of knowledge, in something like their historic forms. This postulate of all knowledge and thought has been variously formulated as the "law" or "principle" of "causality," and "uniformity" or "regularity" of nature, etc. Remembering that we are speaking of the surface facts, not metaphysical interpretations, we may say that all reasoning rests on the principle of analogy. We know the absent from the present, the future from the now, by assuming that connections or associations among phenomena which have been valid will be so; we judge the future by the past. Experience has taught us that certain time and space relations subsist among phenomena in a degree to be depended upon. This dogma of uniformity of coexistence and sequence among phenomena is a fairly satisfactory statement of the postulate of thought and forward-looking action from the standpoint of the philosopher. But from the more superficial standpoint of common sense and hence of an inquiry such as the present the term "phenomenon" is rather vague and elusive, and a more serviceable formulation seems possible. Common sense works in terms of a world of objects or merely "things. This may be unsatisfactory to the philosopher, who will protest at once that the thing is merely a sum of its modes of behavior, that no such separation is really possible. It is the ancient riddle which so puzzled Locke, of the attribute and substratum, the substratum, of course, tending to evaporate under critical scrutiny. But this weakness may prove rather a source of strength for the use which we intend to make of the notion, as will be argued. The practical problem of inference or prediction in any particular situation centers around the first two of these three factors: From knowledge of these two sets of facts it must be possible to say what behavior is to be expected. The chief logical problem, as already noticed, lies in the conception of a "thing. The assumption that under the same circumstances the same things behave in the same ways thus raises the single question of how far and in what sense the universe is really made up of such "things" which preserve an unvarying identity mode of behavior. It is manifest that the ordinary objects of experience do not fit this description closely, certainly not such "things" as men and animals and probably not even rocks and planets in the strict sense. Science has rested upon the further assumption that this superficial divergence of fact from theory arises because the "things" of everyday experience are not the "ultimate" things, but are complexes of things which really are unchanging. And the progress of science has consisted mostly in analyzing variable complexes into unvarying constituents, until now we have with us the electron. There are far too many objects to be dealt with by a finite intelligence, however unvarying they might be, if they were all different. We require the further dogma of identical similarity between large numbers of things. It must be possible not merely to assume that the same thing will always behave in the same way, but that the same kind of thing will do the same, and that there is in fact a finite, practically manageable number of kinds of things. For our limited intelligence to deal with the world, it must be possible to infer from a perceived similarity in the behavior of objects to a similarity in respects not open to immediate observation. That is, we must assume that the properties of things are not shuffled and combined at random in nature, but that the number of groupings is limited or that there is constancy of association. This is the dogma of the "reality of classes," familiar to students of logic. If the classification of objects be restricted to the grouping of things in all respects similar or substantially identical, there would still be a quite impossible number of kinds of things for intelligence to grasp. Even in the sense of practical degrees of completeness of similarity, identity to ordinary observation, our groups would be far too small and too numerous. It is questionable whether classification would be carried far enough on this basis to be of substantial assistance in simplifying our problems to the point of manageability. It is not that kind of a world. And even abstracting from mere differences in degree such as size and the like, for which intelligence readily makes allowance, the same would still hold true. We cannot make an exhaustive classification of things, but must take various and shifting groupings according to the purpose or problem in view, assimilating things now on the basis of one common property mode of behavior and now on the basis of another. The working assumption of practical inference about the environment is thus a working number of properties or modes of resemblance between things, not a workable number of kinds of things; this latter we do not have. That is, the

properties of things which influence our reactions toward them must be sufficiently limited in number and in modes of association for intelligence to grasp. The world is made up of objects which are practically infinite in variety as aggregates of sensible qualities and modes of behavior not immediately sensible. And when we consider the number of objects which function in any particular conduct situation, and their possible variety, it is evident that only an infinite intelligence could grasp all the possible combinations. Finite intelligence is able to deal with the world because a. The number of distinguishable properties and modes of behavior is limited, the infinite variety in nature being due to different combinations of the attributes in objects. Because the properties of things remain fairly constant; and c. Such changes in them as take place occur in fairly constant and ascertainable ways. The non-sensible properties and modes of behavior of things are associated with sensible properties in at least fairly uniform ways. The quantitative aspect of things and the power of intelligence to deal with quantity is a fundamental element in the situation.

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Chapter 2 : Risk, Uncertainty and Profit (ebook) by Frank H. Knight |

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Knight sets out in this, his first book, have become an integral part of modern economic theory. Still readable today, it was included as a classic in the Forbes reading list. In it, he examined the relationship between knowledge on the part of entrepreneurs and changes in the economy. He, quite famously, distinguished between two types of change, risk and uncertainty, defining risk as randomness with knowable probabilities and uncertainty as randomness with unknowable probabilities. Risk, he said, arises from repeated changes for which probabilities can be calculated and insured against, such as the risk of fire. Uncertainty arises from unpredictable changes in an economy, such as resources, preferences, and knowledge, changes that cannot be insured against. Uncertainty, he said "is one of the fundamental facts of life. It was thought that competition would reduce profits to zero across a sector because any profits would attract more entrepreneurs into the sector and increase supply, which would drive prices down, resulting in competitive equilibrium and zero profit. Knight argued that uncertainty itself may allow some entrepreneurs to earn profits despite this equilibrium. Entrepreneurs, he said, are forced to guess at their expected total receipts. They cannot foresee the number of products they will sell because of the unpredictability of consumer preferences. Still, they must purchase product inputs, so they base these purchases on the number of products they guess they will sell. Finally, they have to guess the price at which their products will sell. These factors are all uncertain and impossible to know. Profits are earned when uncertainty yields higher total receipts than forecasted total receipts. Thus, Knight postulated, profits are merely due to luck. Such entrepreneurs who "get lucky" will try to reproduce their success, but will be unable to because their luck will eventually turn. At the time, some theorists were saying that when this luck runs out, entrepreneurs will then rely on and substitute improved decision making and management for their original entrepreneurship, and the profits will return. Knight saw entrepreneurs as poor managers, however, who will in time fail against new and lucky entrepreneurs. He concluded that economic change is a result of this constant interplay between new entrepreneurial action and existing businesses hedging against uncertainty by improving their internal organization. Knight has been called "among the most broad-ranging and influential economists of the twentieth century" and "one of the most eclectic economists and perhaps the deepest thinker and scholar American economics has produced. At the University of Chicago, Knight specialized in the history of economic thought. He revolutionized the economics department there, becoming one the leaders of what has become known as the Chicago School of Economics. Under his tutelage and guidance, the University of Chicago became the bulwark against the more interventionist and anti-market approaches followed elsewhere in American economic thought. He died in Model of how economic problems should be analyzed, March 8, Reviewer: Com This is the best work of economic theory I have ever read. There is no work in economics that evinces better judgment on the main issues or that does a better job of balancing theory with a sense for the facts. Knight begins by defending theoretical that is, deductive economics. Unlike the economic rationalists, however, Knight does not believe that theoretical economics can lead to precise results. The application of the "analytic method" must always be "incomplete," he argues. It is better to stop dealing with elements separately before they get too numerous and deal with the final stages of the approximation by applying corrections empirically determined. Knight had a keen sense of human nature and how human beings behave in the real world of fact. He knew that most economists had made men out to be far more rational than they really were. Businesses, he argued, did not merely seek to meet the needs of the consumers; no, they sought to create new needs through innovation, advertising, and even a sort of manipulative hypnotism. In this, Knight argued, we find both progress and abuse, civilization and fraud. Knight also brings a good deal of sense to the problem of interest, demonstrating the psychological inadequacy of all time-preference theories of interest. Risk, Knight argues, is a measurable

probability that something could happen, like the probability that an individual will be struck by lightening or hit by a car. Uncertainty is a kind of immeasurable risk--e. Derivatives attempt to insure uncertainty, which is immeasurable, as if it were risk which is measurable. Com This is the standard work in the field, give or take some stuff Keynes wrote on risk and capital. Knight was one of the founders of the so-called Chicago school of economics, of which Milton Friedman and George Stigler were the leading members from the fifties to the eighties. Knight made his reputation with his book Risk, Uncertainty, and Profit, which was based on his Ph. In it Knight set out to explain why perfect competition would not necessarily eliminate profits. His explanation was "uncertainty," which Knight distinguished from risk. According to Knight risk refers to a situation where the probability of an outcome could be determined, and therefore, the outcome could be insured against. Uncertainty, by contrast, referred to an event whose probability could not be known. Knight argued that even in long-run equilibrium, entrepreneurs would earn profits as a return for their putting up with uncertainty. Knight made three other important contributions to economics. One was The Economic Organization, a set of lecture notes originally published in ; his famous article, "Some Fallacies in the Interpretation of Social Cost; " and his work on capital theory in the thirties. Knight was an economics professor at the University of Chicago from until , after which he was emeritus professor until his death.

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Theoretically, this means that buyers and sellers not only know the full array of prices being charged for goods and services, but they also know the production capabilities of sellers and the utility preferences of buyers. As part of that discussion, we noted that this assumption is not fully satisfied in real markets, yet sellers and buyers may have a reasonably complete understanding of market conditions, particularly within the limits of the types of products and geographic areas in which they normally participate. Imperfect information Ignorance or uncertainty about the prices being charged for goods and services or the utility preferences of buyers, or uncertainty about the outcome of events. If the market participant is aware that better information is available, information becomes another need or want. Information may be acquired through an economic transaction and becomes a commodity that is a cost to the buyer or seller. Useful information is available as a market product in forms like books, media broadcasts, and consulting services. In some cases, uncertainty can be transferred to another party as an economic exchange. Insurance is an example of product where the insurance company assumes the risk of defined uncertain outcomes for a fee. Still, there remain circumstances where ignorance or risk is of considerable consequence and cannot be addressed by an economic transaction. One such instance is where one party in an economic exchange deliberately exploits the ignorance of another party in the transaction to its own advantage and to the disadvantage of the unknowing party. This type of situation is called a moral hazard A circumstance in which one party in an economic exchange deliberately exploits the ignorance of another party in the transaction to its own advantage and to the disadvantage of the unknowing party.. For example, if an entrepreneur is raising capital from outside investors, he may present a biased view of the prospects of the firm that only includes the good side of the venture to attract the capital, but the outside investors eventually lose their money due to potentially knowable problems that would have discouraged their investment if those problems had been known. In some cases, the missing information is not technically hidden from the party, but the effective communication of the key information does not occur. For example, a consumer might decide to acquire a credit card from a financial institution and fail to note late payment provisions in the fine print that later become a negative surprise. Whether such communication constitutes proper disclosure or moral hazard is debatable, but the consequences of the bad decision occur nonetheless. Exchanges with moral hazard create equity and efficiency concerns. However, the inadequate disclosure results in a market failure when the negative consequences to the ignorant party more than offset the gains to the parties that disguise key information. This is an inefficient market because the losing parties could compensate the other party for its gains and still suffer less than they did from the incidence of moral hazard. Further, the impact of poor information may spread beyond the party that makes a poor decision out of ignorance. As we have seen with the financial transactions in mortgage financing in the first decade of this century, the consequences of moral hazard can be deep and widespread, resulting in a negative externality as well. Market failures from imperfect information can occur even when there is no intended moral hazard. In Chapter 5 "Economics of Organization" , we discussed the concept of adverse selection, where inherent risk from uncertainty about the other party in an exchange causes a buyer or seller to assume a pessimistic outcome as a way of playing it safe and minimizing the consequences of risk. However, a consequence of playing it safe is that parties may decide to avoid agreements that actually could work. For example, a company might consider offering health insurance to individuals. An analysis might indicate that such insurance is feasible based on average incidences of medical claims and willingness of individuals to pay premiums. However, due to the risk that the insurance policies will be most attractive to those who expect to submit high claims, the insurance company may decide to set its premiums a little higher than average to protect itself. The higher premiums may scare away some potential clients who do not expect to receive enough benefits to justify the

premium. As a result, the customer base for the policy will tend even more toward those individuals who will make high claims, and the company is likely to respond by charging even higher premiums. Eventually, as the customer base grows smaller and more risky, the insurance company may withdraw the health insurance product entirely. Much of the regulation to offset problems caused by imperfect information is legal in nature. In cases where there is asymmetric information Something that is known to one party but not to another party in a transaction. For example, truth-in-lending laws require that those making loans clearly disclose key provisions of the loan, to the degree of requiring the borrower to put initials beside written statements. The Sarbanes-Oxley law, created following the Enron crisis, places requirements on the conduct of corporations and their auditing firms to try to limit the potential for moral hazard. When one party in an exchange defrauds another party by providing a good or service that is not what was promised, the first party can be fined or sued for its failure to protect against the outcomes to the other party. For example, if a firm sells a defective product that causes harm to the buyer, the firm that either manufactured or sold the item to the buyer could be held liable. A defective product may be produced and sold because the safety risk is either difficult for the buyer to understand or not anticipated because the buyer is unaware of the potential. Governments may impose safety standards and periodic inspections on producers even though those measures would not have been demanded by the buyer. In extreme cases, the government may direct a seller to stop selling a good or service. Other regulatory options involve equipping the ignorant party with better information. Government agencies can offer guidance in print or on Internet websites. Public schools may be required to make sure citizens have basic financial skills and understand the risks created by consumption of goods and services to make prudent decisions. Where adverse selection discourages the operations of markets, regulation may be created to limit the liability to the parties involved. Individuals and businesses may be required to purchase or sell a product like insurance to increase and diversify the pool of exchanges and, in turn, to reduce the risk of adverse selection and make a market operable.

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Chapter 5 : Risk, Uncertainty and Profit

Part III Imperfect Competition through Risk and Uncertainty www.nxgvision.com The Meaning of Risk and Uncertainty www.nxgvision.com Structures and Methods for Meeting Uncertainty.

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Sociologist Edward Shils declared Risk, Uncertainty and Profit "a brilliant book," noting its interest not only to economists

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but also to social philosophers, sociologists, game theorists, and other specialists in social science.

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Uncertainty however, stems from events that are unpredictable and as such cannot be prepared against. According to Knight, it is the interplay between risk and uncertainty on the one hand and competition between incumbent and new entrepreneurs that accounts for the enormous variation in profitability across firms and, for the same firms, over time.