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Risk Uncertainty And Profit

Synopsis

2014 Reprint of 1921 Edition. Full facsimile of the original edition, not reproduced with Optical Recognition Software. In economics, "Knightian uncertainty" is risk that is immeasurable, impossible to calculate. Knightian uncertainty is named after University of Chicago economist Frank Knight (1885-1972), who distinguished risk and uncertainty in his work "Risk, Uncertainty, and Profit": "Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated.... The essential fact is that 'risk' means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating.... It will appear that a measurable uncertainty, or 'risk' proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all." Knight's works remains a classic text to this day.

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Customer Reviews

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. Theoretical economics thus can only deal with "tendencies," that is, "with what 'would' happen under simplified conditions never realized, but always more or less closely approached in practice."

This methodology Knight describes as "the method of successive approximations." Knight also warns of the dangers of rationalism and the necessity of constantly checking one's results against the facts. "When the number of factors taken into account in deduction becomes large, the process rapidly becomes unmanageable and errors creep in... 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."Armed with the method, Knight proceeds to tackle several important problems in economics, especially dealing with the theoretical construct of "perfect competition." By always keeping his head firmly within the empirically real, Knight is able to bring a great deal of sound judgment to a number of issues. 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.

Knight's Risk,Uncertainty and Profit(RUP) is a classic work ,especially with respect to Knight's analysis of the distinction between risk and uncertainty and the role each plays in the decision making calculus of the entreprenuer or the firm.For instance,Knight recognized that the negative impact of uncertainty could be reduced for those firms that were able to increase their size and get larger and larger over time.Advertising would allow firms to deal with the uncertainty of consumer responses to the introduction of new products over time ,as well as to changes in consumer preferences.Knight was the first to clearly recognize that economic profit is the return to the successful entreprenuer or owner of the firm to compensate them for the bearing of uncertainty.Knight's analysis of the connection between uncertainty and economic profit corrected the errors of Ricardo and Marx,who regarded economic profit as an unearned surplus .Keynes's integration of expected economic profit into the specification of his aggregate supply function,Z,where Z =P+wN(P equals expected economic profit),can be traced back to Knight's earlier discussions.It is strange that economists still are having trouble specifying Keynes's Z function nearly 70 years after the publication of the General Theory in 1936.However,Knight's theoretical analysis of uncertainty at both the micro and macro level is not as impressive as Schumpeter's analysis of uncertainty in his Theory of Economic Development(1912)or of the path breaking analysis of John Maynard Keynes in chapters 6 and 26 of the A Treatise on Probability(1921).In this latter book,Keynes operationalized a quantitative method of dealing with uncertainty(insufficient weight of the evidence,w)by means of his conventional coefficient of risk and weight,c.

Even though the recent research in microeconomic theory has paid attention (somewhat reluctant in my opinion) to the topic of the "uncertainty", i.e. the Knightian uncertainty, it has not been successfully incorporated in the main theoretical framework, yet. The one of the evidences may be that we still cite D. Ellsberg’s paper in QJE as the one of the most important work in this field: it is like citing Keynes’ "General Theory" in every microeconomic paper as in 1950s and 1960s. The book is pleasant to read: it is full of insights, usually forgotten by now, including the complemental tendency of the theoretical and empirical works in economics. The most important accomplishment is that he argued that the exisence of the "uncertainty", the event whose probablity cannot be estimated priori or from empirical data, explains the instablity of the perfect competition, the (lucklustre) justification for the monopoly and the oligopoly, and the superiority of the private property system (capitalism). It is noticable that many phenomenons metioned in the book can be still applicable now, and the last part implies the author’s thought regarding to the path of the capitalism, which is explored in more depth in Schumpeter’s work despite the differences in two economists’ predictions. Knight is one of the economist who lived in the transition of classical into neoclassical economics. The book predicts the emergence of more mathematical economists, but cannot escape from the influence of the former. The same thing can be said of the works of Schumpeter, Viner, and Veblen.

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