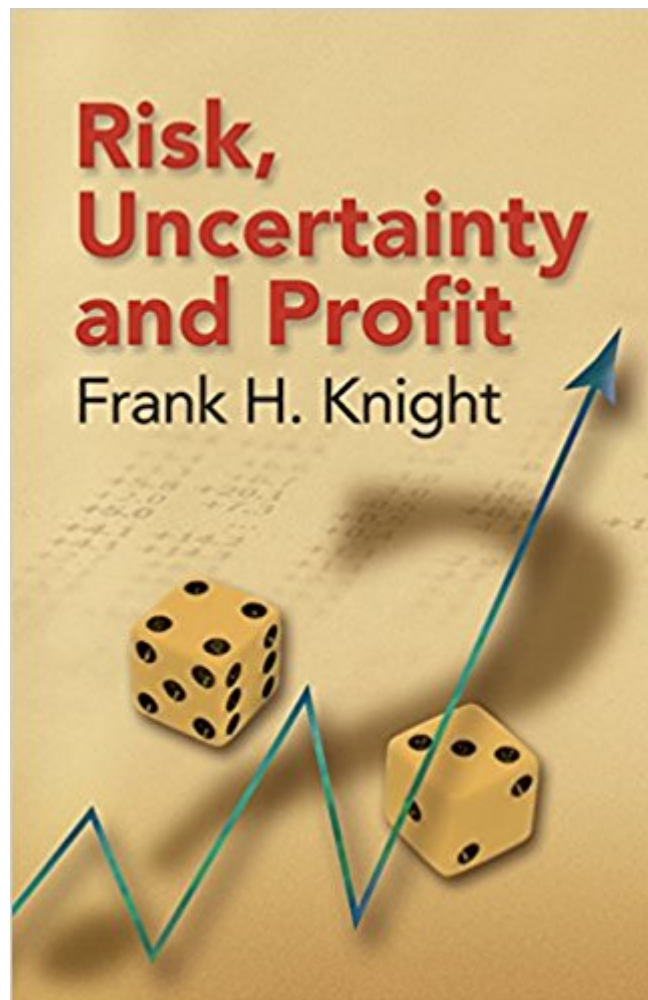




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# Risk, Uncertainty And Profit (Dover Books On History, Political And Social Science)



## Synopsis

One of the twentieth century's most influential economics texts, *Risk, Uncertainty and Profit* provided the theoretical basis of the entrepreneurial American economy during the post-industrial era. This revolutionary work taught the world how to systematically distinguish between risk (randomness with knowable probabilities), and uncertainty (randomness with unknowable probabilities), in order to accurately and properly ascertain a venture's potential profitability. Author Frank H. Knight's methodology served as the foundation of the Chicago School of Economics, maintaining that competition in a free market economy is the best method for achieving economic health. In this 1921 book, Knight explains why perfect competition would not necessarily eliminate profits, because of "uncertainty," rather than "risk." He contends that even in long-run equilibrium, entrepreneurs would earn profits as a return for their toleration of uncertainty. Knight's reasoning remains valid in the twenty-first century, and his definitions of risk and uncertainty continue to be taught in modern economics classes. Sociologist Edward Shils declared *Risk, Uncertainty and Profit* "a brilliant book," noting its interest not only to economists but also to social philosophers, sociologists, game theorists, and other specialists in social science.

## Book Information

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## Customer Reviews

A timeless classic of economic theory that remains fascinating and pertinent today, this is Frank Knight's famous explanation of why perfect competition cannot eliminate profits, the important differences between "risk" and "uncertainty," and the vital role of the entrepreneur in profitmaking.

Based on Knight's PhD dissertation, this 1921 work, balancing theory with fact to come to stunning insights, is a distinct pleasure to read. --This text refers to the Hardcover edition.

FRANK H. KNIGHT (1885-1972) is considered by some the greatest American scholar of economics of the 20th century. An economics professor at the University of Chicago from 1927 until 1955, he was one of the founders of the Chicago school of economics, which influenced Milton Friedman and George Stigler. --This text refers to the Hardcover edition.

This is a very academic textbook, suitable mostly for the undergraduate level in economics (I can not imagine an advanced degree candidate not already being familiar with Prof Knight's expositions not only having read Knight for themselves, but for the inclusion of Knight's work in other more up-to-date material). I had not read Knight before, notwithstanding that I have a BA degree in economics, but my studies were from the era of "early Samuelson". Knight treats his subject exhaustively because it was groundbreaking theory and practice in his time. A lot of progress has been made since then. I still find that there is not a lot of attention paid by journalists and even academics as to the important difference between RISK and UNCERTAINTY which bears upon PROFIT. For the uninformed, risk is measurable and uncertainty is not. Thus, risk can be accepted or declined (for instance by hedges or insurance) by the party at risk. Uncertainty offers no such alternative. That is why uncertainty in public policy, such as tax changes, regulatory action and entanglements with the judiciary are anathema to business. This results in an impediment to investment, and thus to growth of GDP. Congress does not seem to understand and no one points this out -- to the Congress or the public. We have almost total ignorance in one political party about the results of progressivism, which is dangerous all by itself.

This is one of the most important books on economics written in the 20th century. Frank Knight was tasked by his PhD advisor to sort out the differences between risk and uncertainty and how they related to entrepreneurship and firm management. He did. Nobody has surpassed this treatment in the century since Frank Knight penned it in 1917 as his doctoral dissertation. This is verbal treatment of the subject, not a mathematical treatise. The argument is sound, but often subtle. The current volume that I am reviewing is the sixth or seventh time I have read the book and, as always, I found something new to take away. I teach entrepreneurship to undergraduates and to graduate students and i enjoy bringing Knight's insights into the classroom.

I have to admit this was a hard book to read. Partly because of the old fashioned language, but largely because it challenges popular beliefs that have continued to plague economics since the time of this writing almost a century ago. The mental rigor demonstrated by the author is extraordinary in presenting a working model of the social world we live in; tying economics, epistemology and politics together. This is not light-reading, but the effort is justified for anyone interested in the workings of the socio-economic fabric of our society.

After reading Rita Gunther McGrath's "End of Strategy" and re-reading Drucker's "Innovation and Entrepreneurship" it became clear to me they are both talking about "uncertainty". Not the kind that can be quantified with a probability distribution (and hence insured against) but the kind that cannot. Which brought me to Frank Knight and his analysis of the relationship among risk, uncertainty and profits. It is an excellent book and very rewarding to read - but the early 20th century style of prose is hard to read and requires quite a bit of concentration.

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 entrepreneur 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 entrepreneur 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,  $c$ . This coefficient allows a decision maker to incorporate uncertainty and nonadditive probabilities into a technical analysis of decision making. The only author who comes close to Keynes is D. Ellsberg with his practically identical index to measure ambiguity called  $\rho$ . There are still some unanswered questions that can be asked in this area of economic thought. Why didn't Knight cite the earlier work of Joseph Schumpeter on the risk versus uncertainty distinction? Further, why didn't Keynes cite both Knight and Schumpeter in his chapters 12, 17 and 22, where he discussed the issue of the effect of uncertainty on investment in new capital goods and on stock market speculation?

I am about halfway through this book and I'm enjoying it as much as anyone who enjoys books they HAVE to read for school. But - it's important to note Knight is a genius and he makes several points in this book.

This is a masterwork of economic theory. I have read it a number of times and now am rereading it on my Oasis. It builds from a few simple assumptions, but the author constantly reminds us that it is a useful guide to examining the real world but is not a description of the real world.

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