5 Risk, Uncertainty and Chance


Guil.: [flipping a coin] There is an art to the building up of suspense. Ros.: Heads.

Guil.: [flipping another] Though it can be done by luck alone. Ros.: Heads.

Tom Stoppard, *Rosencrantz and Guildenstern Are Dead*

Arthur looked up. ‘Ford!’ he said, ‘there’s an infinite number of monkeys outside who want to talk to us about this script for Hamlet they’ve worked out.’

Douglas Adams, *The Hitchhiker’s Guide to the Galaxy*

My good friend Jacques Monod spoke often of the randomness of the cosmos. He believed everything in existence occurred by pure chance with the possible exception of his breakfast, which he felt certain was made by his housekeeper.

Woody Allen, *My Speech to the Graduates*¹

The dual purpose of this chapter is to identify the basic nature of information problems and to suggest the types of information costs associated with respective forms of economic organisation. So far we have merely indicated the existence of possible cracks in the neoclassical construction of Nirvana. We continue the search here with a view to more fully identifying the nature and source of structural defects in the foundations of neoclassical theory, and the role of risk, uncertainty, and chance in this ill-designed disaster area.

In doing so, economics is interpreted as a social science. Such explicit perspective may appear unnecessary – after all the discipline occupies a nominal position within the social sciences, economics students are invariably enrolled in social science faculties. Why the need to confirm economics status as such?

The need arises from the axiomatic–deductive tradition in eco-

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nomics which uses neoclassical assumptions to examine real-world issues. One problem we have seen with this approach is that the firm is regarded as a black box. No consideration is given to the manner in which inputs are converted into outputs other than to assume that allocation is made according to rational profit-maximising criteria. The entrepreneur is the mechanism by which the process is executed, but these same assumptions result in the treatment of the entrepreneur as an automaton with no discretion over resource allocation. The assumption of rationality and the existence of marginalist profit-maximising rules couched in the perfect knowledge assumption, ensures that the entrepreneur has no real discretion over questions of resource allocation. Again, this leads to a tension between the formal and informal analysis of neoclassical theorists such as the Friedmans, who emphasise the entrepreneurial role of risk-taking and his due reward for opportunistic decision-making in their informal theory. The picture of the brave buccaneering entrepreneur painted by such as the Friedmans in their informal discussions, is curiously at odds with the limited role afforded to the entrepreneur in formal neoclassical theory. In the latter, the entrepreneur has no discretion over which actions to take; the choice is made for him by the rules and conditions of the neoclassical game. The chosen outcome, or group of outcomes, will be calculated as providing the greatest level of net income to the entrepreneur. The twin assumptions of rationality and perfect knowledge, when combined with the certain knowledge that these outcomes do represent the most profitable set, completely determine entrepreneurial action. The buccaneer of the Friedman analysis is reduced to an ordinary seaman, with no decision-making capacity, no requirement for initiative, and no discretion over choice of future action. The elimination of ignorance, risk and uncertainty similarly eliminates the need for decision, choice and entrepreneurship as defined by the Friedmans. As Shackle (1969, p. 4) confirms, perfect foresight renders decision-making empty. Again, we find the informal discussion of neoclassical theorists at odds with their formal analysis.

The formal neoclassical theory of the entrepreneurial firm as a rational maximising unit operating under conditions of perfect knowledge is paralleled on the demand side by the idea of the utility maximising consumer. Both supply and demand sides in the neoclassical equation perform no more than clerical functions in the resource allocation process, using pre-ordained rules to attain pre-determined solutions. Imagination, endeavour, opportunism, initiative, deceit,