A WORLD OF CHANCE

Although financial markets often try to distance themselves from gambling, the two have far more in common than is usually thought. When there were no financial institutions such as banks, people disposed of expensive items and governments raised money quickly through lotteries. Gambling tables fulfilled the roles that venture capital and banking do today. Gamblers created clearinghouses and sustained liquidity. When gamblers created prices in futures markets, they were redefined as speculators. Today they are hedge fund managers or bankers. Although the names have changed, the actions undertaken by these parties have essentially stayed the same. This book discusses chance, risk, gambling, insurance, and speculation to illuminate where societies stood, where society is today, and where we may be heading.

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Labyrinths of Prosperity (1994)

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A World of Chance

Betting on Religion, Games, Wall Street

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Dedicated to John Dobson

Passionate about freedom, about the country,

philanthropic,

a friend

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Preface

Which explains the unusual origins and approach of this book.

The next best thing to a guaranteed good future – if such a guarantee exists – is a chance to it.

How some societies created far more chances for their members than did others is the story that we tell in this book from an unusual, though to us logical, angle. That angle involves looking at the question through the prism of games of chance, of futures and of financial markets, and of the ways people have acted when facing a variety of risks and then deciding to leap into the unknown. It turns out that gamblers and risk-takers brought to life businesses and institutions that allowed the rest of society to have more options. It also turns out that though financial markets often tried to distance themselves from gambling, the two have far more in common than is usually thought. And there is nothing wrong with that.

When there were no financial institutions – as we view them today – such as banks, lotteries were the ways in which both relatively expensive items were disposed of and governments raised money quickly. Gambling tables often fulfilled roles similar to venture capital and banking today. Gamblers created the clearinghouses and also sustained liquidity. When they bet on price distributions, however, they were suddenly redefined as speculators. Today they are called hedge fund managers or bankers. Closer inspection reveals that though the words changed, the actions these parties undertook stayed the same.

At all times people have taken into account risk and uncertainty. Observers often have stated that people overestimate their chances of winning when gambling, that randomness fools them, that they are inconsistent in the ways they make their decisions when facing risks. We do not find that to be the case. Yes, people make mistakes, and, at times, many commit the same mistake, following conventional wisdom. We find that it is such conventional wisdom that fools them, leading them to believe that there is far less randomness than there actually is.

The vast majority of people have been betting with their heads and not over them. Neither randomness nor uncertainty have really fooled them. Rather, societies created institutions that stood for the belief that there is no randomness or mistakes to start with. Everything had to have a cause. At the dawn of history, when tribes were small and isolated, this even made sense. When people live in isolated, small communities, there can be no markets, no specialization, no pricing, and no formal insurance. There is no such thing as the law of large numbers in such societies. But people must decide. Beliefs and institutions bestow legitimacy on decisions, suggesting that things are "under control."

When populations grow and people move, they leap into the unknown and take chances by noticing emerging patterns – or what they think are patterns. This is when conflicts with those blinded by the past start and when debates about risk, chance, and gambling become more illuminating. Milan Kundera once observed that stupidity was not ignorance, but the nonthought of received ideas. This observation applies all too well to discussion surrounding gambling, speculation, and financial markets from antiquity to the present day.

Some societies end up sticking longer with the old beliefs and institutions, and others allow people to challenge their luck. Some societies stick with the principle of "everything is prohibited unless explicitly allowed," which fits an immobile world, whereas others move to the principle of "everything is allowed unless explicitly prohibited."

Unsurprisingly, it is the latter society that creates more options, more ways for its people to take chances. True, allowing such experimentation creates not only more trials but also more errors. But in order to move into the future, especially as each society adjusts to its increasing numbers and greater mobility, there is no other way. To do so, it must give scope to gambling and to speculation. Gamblers' and speculators' bets allow the pricing of what people want. It also turns out that there is a form of governance that draws on similar principles of trial and error (i.e., referenda and initiatives) wherein people can vote on what they want. In 75 percent of the cases in the United States, voters decided on the legalization of gambling through this process.

By examining what gamblers, risk-takers, and people financing them actually achieved, we get a better understanding not only of how to deal with risks, uncertainty, and ways to either price or otherwise deal with rare events but also of how societies leapfrogged one over the other. At the same time, we can also see how competitors spread false accusations against gambling and risk-taking – and why religious institutions and governments were often among these competitors. False languages covered these accusations, which shaped laws and regulations affecting a variety of companies associated with the risk business for decades and centuries, at times in unpredictable ways. The act passed on October 13, 2006, in Washington (the UIGEA, or Unlawful Internet Gambling Enforcement Act), prohibiting financial institutions from transfering payments to online gambling companies, is just the latest example.

John Gay's epitaph on his monument in Westminster Abbey is "Life is a jest, and all things show it; I thought so once, and now I know it." A mocking phrase? Perhaps. But we find that in societies that turned out to be successful, people acted as if life was a game, where they both played the game and, occasionally, changed the rules of the game by designing new institutions. We also find that a good way to understand why some societies thrived and others fell behind is by examining a variety of facts and sequences of events from this gambling angle. We find too that successful societies are those that became more tolerant toward risk-taking and betting, and that brought to life businesses and institutions allowing for "possibilities and probabilities to become the very guides to life" (to quote Bishop Butler).

As this observation is one of the conclusions of this book, it turns out that Gay's witticism is far more than that. Life *is* a jest. But to win this leapfrogging game among both people and societies, one should better learn how and when to take risks and how and when to leap into the unknown.

Our initial interest when writing a first book on this topic, twenty years ago (and parts of it even earlier), was neither gamblers, casinos, lotteries, and future markets nor philosophizing about chance and religion, and laws and regulation surrounding the gambling and futures business. We were just interested in solving a mathematical puzzle linked to gambling and insurance that economists and mathematicians have been struggling with for decades. It is the way that we refuted conventional approaches that led us both to articulate a unique view of human nature (summarized in the appendixes in this book) wherein one cannot distinguish between chance and necessity, and to examine in greater depth topics covered in this book and elsewhere.

Acknowledgments

Many people now take a partisan rather than an impartial view of issues covered in this book. We are in the fortunate position that the first book we wrote about them was set in the early 1980s (*Gambling and Speculation: A Theory, a History, and a Future of Some Human Decisions*, Cambridge University Press, 1990), before politics distorted the discussion.

In 1990 both Cambridge University Press and Princeton University Press wanted to publish the book. Some of the reviewers at the time renounced their customary anonymity and signed their reviews – among them was William McNeill, the great historian, to whom we are grateful for many insights. At the time we also received feedback from people in many fields and occupations. Among the many who commented, occasionally at great length on either the manuscript or, later, the 1990 book, were Milton Friedman; Gary Becker; Alan Blinder, the previous vice chairman of the Federal Reserve; Anna Schwartz; T. W. Schultz; Anatol Rapoport; William Eadington; Eugene Martin Christiansen; John Hey; David Hochfelder; Mark Perlman; and Jonathan Hughes. Irving Ebert and Stephen Shipman were among those who commented on this book. I expressed my gratitude to them all then, and I express my gratitude again here, to the anonymous reviewers too.

I single out Aaron Brown (the coauthor of Chapter 5) for special thanks, not only for the collaboration, but also for his comments on the entire book. The book would not have taken the shape it took without his meticulous feedback and his earlier writings on topics covered in this book.

Special thanks are also due to Claude Montmarquette, my former colleague at the Department of Economics of the Université de Montréal, for his contribution to the statistical examinations in the book.

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