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FRANK H. KNIGHT

Origins of the Chicago School of Economics


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Frank Knight

Frank Knight is one of history's most influential economists. A cofounder of the famous Chicago school (with Jacob Viner), Knight had a profound influence on those who studied with him regardless of whether they agreed with his ideas. That is the primary legacy of any great teacher—that his teachings live on in the work of not just his followers but even his critics.

A crusty old skeptic with no particular compelling classroom skills, Knight yet managed to question just about everything his students, and all visiting speakers to Chicago, claimed to believe. His support for the free market was based not on some utopian ideology of the perfection of human institutions but rather on the reverse premise: We simply are not smart enough to control one another's economic choices. Ever the pragmatist, and like Adam Smith before him, Knight had little faith in the power of human reason to improve the human condition. He did, however, trust in the outcomes produced by freely interacting individuals to further societal welfare.

Few economists have achieved Knight's pedagogic impact. For that reason, we explore his life and work in this latest Economic Insights *and hope that it might be a point of departure for readers who wish to examine more closely this remarkable man and his ideas.*

— **Bob McTeer**
President, Federal Reserve Bank of Dallas

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Economists use a shorthand method to identify one another. They divide economic theory—and its practitioners—into various "schools" of thought.[1] One of the most famous collections of thinkers and theoreticians is the Chicago school, housed at the University of Chicago. The cofounder of this school, along with Jacob Viner, was Frank Hyneman Knight. Because of his position at Chicago and the quality of his students, Knight became quite influential, although today his name is generally unknown to the public.

Knight was born in southern Illinois in 1885, the first of 11 children. He attended several small Southern schools before enrolling at the University of Tennessee, where he earned his bachelor's and master's degrees in two years. He then entered Cornell University in 1913. After a year in the philosophy department, he switched to economics because his professors decided that his extreme skepticism would be more profitably employed there. His economics dissertation—"A Theory of Business Profit," completed in 1916—was revised and published in 1921 under the title *Risk, Uncertainty and Profit*. It has become a classic in the field.

From his earliest days as a teacher, Knight's defining approach to economic theory—and most everything else—was a hard-nosed, often entertaining skepticism. Despite his idiosyncrasies and curmudgeonly demeanor, Knight's students continually bestowed on him the distinction of having greatly influenced their thinking. Among these students were empiricists Milton Friedman and George Stigler, whose own approaches to economic problem solving were often attacked by their mentor. Knight was opposed to the use of mathematical models stuffed with real-world data. He did not believe that prediction in economics was the benchmark against which theories ought to be judged. However, he did agree with one of his most famous students—Friedman—that theoretical assumptions were, by necessity, unrealistic. Many of his students disagreed with him on this and other points; yet as a teacher Knight must be judged a great success if for no other reason than that he taught four future Nobel Memorial Prize winners in economics: Friedman, Stigler, James Buchanan and Paul Samuelson. Knight himself would probably have gotten the award had he not died shortly after it was added in 1969. The recipient must be living when the award is made.

Knight and the Free Market

Knight leveled some corrosive criticisms at capitalism and, simultaneously, punctured Marxist and institutionalist anticapitalist economic theory. He was especially sarcastic when criticizing egalitarian claims because he viewed society as a complex game in which there would always be winners and losers.[2] But he also believed that, in the long run, income disparities would widen under capitalism. Although he sometimes backed down when pressed on the point, especially by Friedman, he never changed his mind about this important tendency of capitalism, at least as he saw it. Being suspicious of reform and all alternative systematic thinking about the economy, he finally defended capi-

Knight's Personal Oxymoron: Principled Pragmatism

I also spoke earlier of philosophizing, or preaching, in contrast with more objective discourse. A sermon should have a text, and I have found a suitable one in the gospel according to "Saint" the Marquis de Talleyrand-Périgord: The only good principle is to have no principles (*le seule bon principe est de n'en avoir aucun*). Talleyrand, to be sure, is not regularly listed among the evangelists. But he was in fact a bishop in the Church, and another churchman, of the civilized eighteenth-century French pattern, the abbot Galiani, had earlier stated the same creed. And anyhow, the saying suits my purpose as a text. It is, no doubt, usually enjoyed and dismissed as a witty cynicism; but I propose to treat it quite seriously, as a starting point. Not literally, I admit. It is an epigram; and an epigram has been defined as a half-truth so stated as to be especially annoying to those who believe in the other half. I wish to stress both halves, the value of principles as well as their limitations. Accordingly, I must reword the text into one of rather the opposite literal import. The right principle is to respect all the principles, take them fully into account, and then use *good judgment* as to how far to follow one or another in the case in hand. All principles are false, because all are true—in a sense and to a degree; hence, none is true in a sense and to a degree which would deny to others a similarly qualified truth. There is always a principle, plausible and even sound within limits, to justify any possible course of action and, of course, the opposite one. The truly right course is a matter of the best compromise or the best or "least worst" combination of good and evil. As in cookery, and in economic theory, it calls for enough and not too much, far enough and not too far, in any direction. Moreover, the ingredients of policy are always imponderable, hence there can be no principle, no formula, for the best compromise. That laws must be stated in sentences partly accounts for the familiar "principle," "the law is an ass." And if people don't have good judgment, or won't use it, it is "just too bad," for themselves and for others over whom they have power. ■

—*On the History and Method of Economics*, 256

Is Economics a Science?

In spite of all the foregoing, there is a science of economics, a true, and even exact, science, which reaches laws as universal as those of mathematics and mechanics. The greatest need for the development of economics as a growing body of thought and practice is an adequate appreciation of the meaning, and the limitations, of this body of accurate premises and rigorously established conclusions. It comes about in the same general way as all science, except perhaps in a higher degree, i.e., through abstraction. There are no laws regarding the *content* of economic behavior, but there are laws universally valid as to its *form*. There is an abstract rationale of all conduct which is rational at all, and a rationale of all social relations arising through the organization of rational activity. We cannot tell what particular goods any person will desire, but we can be sure that within limits he will prefer more of any good to less, and that there will be limits beyond which the opposite will be true. We do not know what specific things will be wealth at any given place and time, but we know quite well what must be the attitude of any sane individual toward wealth wherever a social situation exists which gives the concept meaning. In the same way we know that in any productive operations on this earth there are some general relations between quantity of resources used and quantity of product turned out.

These principles are only less abstract than those of mathematics. It is never true in reality that two and two make four; for we cannot add unlike things and there are no two real things in the universe which are exactly alike. It is only to completely abstract units, entirely without content, that the most familiar laws of number and quantity apply. Yet no one questions the practical utility of such laws. They are infinitely more useful than they could be if they ever did fit exactly any single concrete base, since all that they lose in literal accuracy they gain in generality of application. By not being strictly true in any case they are significantly true in all. ■

—*Selected Essays by Frank H. Knight*, Vol. 1, 28–29

Risk and Uncertainty Lead to a Theory of Profit

Our preliminary examination of the problem of profit will show, however, that the difficulties in this field have arisen from a confusion of ideas which goes deep down into the foundations of our thinking. The key to the whole tangle will be found to lie in the notion of risk or uncertainty and the ambiguities concealed therein. It is around this idea, therefore, that our main argument will finally center. A satisfactory explanation of profit will bring into relief the nature of the distinction between the perfect competition of theory and the remote approach which is made to it by the actual competition of, say, twentieth-century United States; and the answer to this twofold problem is to be found in a thorough examination and criticism of the concept of Uncertainty, and its bearings upon economic processes.

But Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The term "risk," as loosely used in everyday speech and in economic discussion, really covers two things which, functionally at least, in their causal relations to the phenomena of economic organization, are categorically different. The nature of this confusion will be dealt with at length…but the essence of it may be stated in a few words at this point. 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 phenomenon depending on which of the two is really present and operating. There are other ambiguities in the term "risk" as well, which will be pointed out; but this is the most important. 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. We shall accordingly restrict the term "uncertainty" to cases of the non-quantitive (sic) type. It is this "true" uncertainty, and not risk, as has been argued, which forms the basis of a valid theory of profit and accounts for the divergence between actual and theoretical competition. ■

—*Risk, Uncertainty and Profit*, 19–20

talism on the completely pragmatic grounds that it may not be perfect, but it was better than all the alternatives suggested by its critics.

As Breit and Ransom (1971, 197) put it:

> Like David Hume, he rejected the view that the solution of social problems is to be found by the direct approach to them. And like Adam Smith, he had little hope that social reformers or "do-gooders" would solve problems and he thus was willing to allow the markets to solve them.

Knight's attitude of allowing markets to work out economic problems led him not only to criticize avowedly antimarket theorists such as Marx but also to respond to other types of market critics. One of his most famous responses was to the doctrine of market failure developed in A. C. Pigou's famous 1920 book *The Economics of Welfare*. In that work, Pigou argued that examples of market failure were easy to find because of the pervasiveness of external costs and benefits that "spilled over" from market transactions. Pigou did not argue that each of these instances of presumed externalities automatically called for government to step in and regulate the market.

However, many economists who came after him enthusiastically used Pigou's idea to push for more government market interventions. But Knight was not among them, and he responded to one of Pigou's alleged examples of market failure so persuasively that Pigou removed it from subsequent editions of his book. In this case, Knight proved that Pigou's road use example wasn't a failure of the market at all but a failure of government to specify accurate property rights for scarce resources.[3] Over the ensuing decades, economists questioned in detail all cases of claimed

Socialism as an "Answer" for Business Cycles

With reference to the use of the cyclical tendency as an argument for collectivism, however—or any sweeping action by government outside the monetary field—two very important sets of facts should be pointed out. In the first place, with negligible exceptions, the business cycle does not work to the advantage of any significant group or interest in "capitalistic" society. On the contrary, practically everyone suffers heavily from it, incurring serious economic loss, if not privation. Hence the problem of cycle analysis does not arise out of and does not involve conflict of interest. This means that remedial action is a matter of economic understanding and of political intelligence and administrative competence, in matters of an essentially technical character. The situation would hardly seem to call for solution along lines which would involve the most intense conflicts of interest and would raise the most serious political problems in that regard, while, in addition, the technical organization problems in connection with establishing and operating a collectivist economy would presumably be of infinitely greater magnitude than those involved in the control of one detail of it, the monetary system.

The second set of facts relates to the nature of the problem as it would present itself to the government of a collectivist society. If a collectivistic, or socialistic, state is to preserve any of the traditional economic liberties of individuals, it also must operate on the basis of money and market transactions, with prices of products and of productive services controlled by competition, in essentially the same manner as in the enterprise system. The fact that the government would be the chief owner of productive wealth, and the "entrepreneur" in the great bulk of economic activity, would not change things in that regard….In any other sense, the argument for collectivism from the standpoint of the problem of the business cycle does not seem to have much force. The general presumption is that, as already suggested, the control of all features of a national economy by a central authority would present much greater difficulty than the control of one feature. ■

—*On the History and Method of Economics*, 225–26 market failure and began to search for examples of government failure as well.

Knight stood almost alone among his contemporaries in his eclectic support for the market process and in his position on what economics was ultimately about. He rejected the simple, utility-maximizing, libertarian–utilitarian approach to economic theorizing that characterized the majority view during his lifetime, especially at the University of Chicago. For Knight, the central issue was how freedom can be maintained given that people, using a highly flawed technique they call reason, continually develop alleged scientific utopias against which they measure actual outcomes. Knight's critical arrows were aimed at not just Marxists but any thinker—especially an economist—who approached economic questions from any viewpoint other than Knight's quasi-theological one.

For Knight, a sort of economic Calvinist, labor was not a mere disutility but gave life purpose. People did not always act out of self-interest, nor were their preferences somehow generated internally, nor were those preferences consistent over time. Where he and so many others saw a breakdown in the market order, or of "bourgeois society," Knight alone attributed it to a breakdown in people's morals. To him, social problems are almost always moral in nature, not structural or political. Ultimately, Knight supported the market on moral grounds, not efficiency ones; he believed freedom was itself the ultimate good, enabling people to trade with one another irrespective of their religious or cultural differences, based on their reasoning as to what is important and worth pursuing. What was missing from defenses of free markets, he thought, was a fundamental, moral brief supporting this social arrangement. He believed economists had failed to provide one because their concerns and methods did not allow them to see that their attempt to be "value free" was a sophisticated delusion driven by scientism.[4]

As Stigler writes about the place of economics in Knight's view of the world, its primary function "is to contribute to the understanding of how by consensus based on rational discussion we can fashion liberal society in which individual freedom is preserved and a satisfactory economic performance achieved. This vast social undertaking allows only a small role for the economist, and that role requires only a correct understanding of the central core of value theory."[5]

Legacy of the Chicago School

Knight is clearly the intellectual godfather of the Chicago school. Even students who disagreed with him on many issues relate that he was the professor who most influenced them during their days at the University of Chicago. The Chicago school is far from some monolithic set of beliefs to which all its members subscribe. Knight's extreme skepticism and lack of slavish deference to authority became the twin pillars of the school's long and storied approach to theory and policy, and that is Knight's enduring legacy. ■

—Robert L. Formaini
Senior Economist

Notes

[1] Alternatively, after Thomas Kuhn, economists refer to paradigms. A paradigm is a disciplinary matrix by which a group of people interpret the world around them. See Kuhn (1996).

[2] Formaini (1999).

[3] The details of the exchange can be found in Breit and Ransom (1971, 192–96).

[4] On scientism, see Hayek (1988), especially chapters 1, 4 and 5.

[5] Stigler (1987, 58).

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