Insights

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 em-

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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 seul 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
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. ■

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 socialist, 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. ■

—Risk, Uncertainty and Profit, 19–20

—On the History and Method of Economics, 225–26

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. Over the ensuing decades, economists questioned in detail all cases of claimed
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.³

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.”⁴

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.

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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).

Sources and Suggested Reading


