Chapter 6

Frank Knight. Intuition, Risk and Uncertainty

6.1 Introduction

Frederich Kershner, President of Milligan College and Professor of Frank Knight, said of Knight, "From the standpoint of quickness of perception, or of that rare capacity, which enables a person to 'see through things' almost at a glance, he is the best student I have had" (Howey, 1983, p. 165). That rare capacity is what we call intuition.

6.2 Knight's Methodology

Frank Knight wrote at a time when economics gave more credence to qualitative and philosophical dimensions than it does today. Knight, says James Buchanan, was the "economist as philosopher, not the economist as scientist" (Buchanan, 1968, p. 426). At the same time, he was a founder of the Chicago School of Economics, and hence it should probably come as no surprise that he considered the problems of life as economic problems. In "The Limitations of Scientific Method in Economics," Knight says that "From a rational or scientific point of view, all practically real problems are problems in economics. The problem of life is to utilize resources 'economically,' to make them go as far as possible in the production of desired results. The general theory of economics is therefore simply the rationale of life" (Knight, 1999, p. 1). As such he considered economics to be based on the abstract assumption of rationality and focused on the determination of prices. In *Risk, Uncertainty, and Profit* he said, "It is not the province of economics to determine the value of life in 'hedonic units' or any other units, but to work out, on the basis of the general principles of conduct and the fundamental facts of the social situation, the laws which determine the prices of commodities and the direction of the social economic process" (Knight, 1965, p. 71).

Thus, Knight's writings show that he 'preached' aspects of both the neoclassical canon and a canon that more fully includes philosophical and psychological elements. There are several examples of this duality in Knight's approach. First, Knight defines economics as a <u>science</u> of human behavior and founded in the psychology of human behavior. Yet, similar to Harvey Leibenstein, Knight maintained that rationality is one possible form of human judgment. Another form of human judgment is "metaphysical-linguistic fuzziness" which "enshrouds the human mind" (Buchanan, 1968, p. 427). Second, a scientific study of human behavior depends on human behavior being grounded in stable and conscious motives. Yet, he also recognized that human behavior is governed by impulse and is fickle. In an essay titled,

"Economics," Knight says that "Applied economics must try to take account of the role in business life of error and motives (good or bad), such as prejudice, curiosity, and the various forms of play interest, which do not conform to the pattern of economic rationality. Competition itself, in the psychological meaning, is a non-economic interest" (Knight, 1956, p. 26). Thus, while other economists accepted scientific psychology or behaviorism as a model for scientific human behavior (Giocoli, 2002), Knight found behaviorism to have limited use in understanding human behavior and hence economics.

Third, Knight contributed to economic theory and emphasized equal returns at the margin, and opportunity costs. Yet, similar to Marshall and Keynes, and (other) American Institutionalists, Knight was skeptical that economic theory could be applied widely. The applicability of economic theory would be enhanced if it incorporated other social sciences such as history, psychology, and statistics. These other social sciences are complementary and, "All are needed to supply data and interpretation, to put content and definiteness into the valid but highly abstract 'laws' of economic choice and of market phenomena. Without such supplementation economic laws have little value for prediction, since the essential factor of wants is not open to sense observation and any course of events that occurs can be fitted into the theoretical pattern" (Knight, 1956, p. 26).

Fourth, he rejects the presumed first principle of science - knowledge is based on empiricism or observation. But he also rejects our ability to directly know any realities beyond our ability for observation. Fifth, his most famous book, *Risk, Uncertainty, and Profit* includes a discussion about consciousness and intuition. Yet, he also states in the book that he is not interested with "the ultimate nature of reality" or any other philosophical position. In other words, intuition as a tool for decision making is important, but the link between the two does not require any belief or study of any ultimate nature of reality. Knight thus separates intuition from metaphysics and 'spirituality.' Sixth, Knight gives a positive nod to the French philosopher Henri Bergson, whose writings on intuition made it fashionable to question the validity of logical processes. Yet, while Knight was not sure that the world is understandable to any great extent, to the extent that it is understandable it is through logical processes. In other words, logic, economic theory, and human rationality have limits.

In his duality, Knight was "swimming" against the tide of the rising neoclassical canon. T.W. Hutchison's 1938 book, *The Significance and Basic Postulates of Economic Theory*, presented what is considered a significant statement of economics as a science (canon). One of Hutchison's claims is that all scientists have "definite, agreed, and relatively conclusive criteria for the testing of propositions, solutions, and theories" (Hutchison , 1938, p. 7), these being empiricism and logic. This one-method-fits-all is not only what