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RESEARCH IN THE HISTORY OF ECONOMIC THOUGHT
AND METHODOLOGY VOLUME 39C

RESEARCH IN THE HISTORY OF ECONOMIC THOUGHT AND METHODOLOGY: INCLUDING A SYMPOSIUM ON FRANK KNIGHT'S RISK, UNCERTAINTY AND PROFIT AT 100

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VOLUME INTRODUCTION

Volume 39C of *Research in the History of Economic Thought and Methodology* features a symposium marking the 100th anniversary of the publication of Frank H. Knight's *Risk, Uncertainty, and Profit*, edited by Ross B. Emmett. The symposium features contributions from Per Bylund and Richard E. Wagner, in addition to Professor Emmett's essay and a new essay from our own Carlos Eduardo Suprinyak, and his co-author, Thiago Oliveira.

Extending themes from the symposium, Volume 39B also includes a general-research contribution from David Coker, who considers the significance of Knight's work for John Rawls' famous *A Theory of Justice*.

The Volume also includes new general-research essays from J. Patrick Higgins, who reflects on the relationship between Walter Lippmann and the Austrian School of economics, and Charles R. McCann, Jr, who looks at a "Wisconsin Austrian" economist, William Amasa Scott.

The Editors of *Research in the History of Economic Thought and Methodology*
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PART I

A SYMPOSIUM ON FRANK KNIGHT'S RISK, UNCERTAINTY, AND PROFIT AT 100; ROSS B. EMMETT

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UNDERSTANDING THE LIMITS OF PURE THEORY IN ECONOMICS: KNIGHT AND MISES

Per Bylund

ABSTRACT

Knight's Risk, Uncertainty, and Profit *is, by the author's own account, "a study in 'pure theory'." From pure theory, the scientific method's "successive approximations" explain empirical phenomena. But Knight did not fully develop the boundary conditions for theory. In this chapter, the author elucidates the demarcation of pure theory in* Risk, Uncertainty and Profit. *For comparison and contrast, the author uses Mises's Austrian aprioristic methodology praxeology and its strict distinction between theory and thymology. The author finds that Knight and Mises largely agree on the nature and importance of pure theory but differ on its meaning and use. The author's findings suggest that Knight, while arguing for aprioristic pure theory, still places empirical observation first.*

Keywords: Frank Knight; pure theory; theoretical economics; methodology

Frank H. Knight's *Risk, Uncertainty, and Profit* ([1921] 1985) is perhaps best known for the distinction between probabilistic risk and non-probabilistic uncertainty. Although *Risk, Uncertainty, and Profit* (henceforth, "RUP") has become a standard citation to acknowledge that uncertainty is not risk (and vice versa), the work is arguably "much cited and little used," to borrow a phrase from Coase (1972, p. 63). The particulars and nuances of the theory are often overlooked, and

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sometimes even misunderstood, leaving the depth of Knight's scholarship without proper acknowledgement. This unfortunate fate for a scholar is still true for much of Knight's work, although there have been recent attempts to uncover his thinking and legacy, recount the historical and intellectual contexts, and retrace the evolution of Knightian thought (e.g., Emmett, 1990, 2009; Cowan, 2016).

I will here attempt to contribute to this recent literature on a small scale by taking a step back and looking deeper at Knight's view of method when writing RUP, which he refers to as "a study in 'pure theory'" ([1921] 1985, p. xi). While Knight later wrote specifically on the method for economics and the social sciences (Knight, 1924),[1] this is not my focus here. Instead, I examine the method that Knight subscribed to when writing his *magnum opus*: his view and understanding of "pure theory," its role and use in science. Pure theory, he argued, is one of the end points on the methodological continuum, the other being inductive research, and the *starting* point for economic science. My interest is not primarily Knight's definition of pure theory, but his demarcation of it. In other words, the role that aprioristic theory plays in economic science for Knight when writing RUP.

Knight strongly advocated for economic science (and, generally, *any* science) to find "a correct 'middle way'" ([1921] 1985, p. 6) between the deductive reasoning of pure theory and inductive reasoning from empirical observation (Hudik & Bylund, forthcoming). But this middle way is not merely the use of pure theory alongside inductive data analysis in the sense that it is used in modern science (including modern empirical economics) to produce testable hypotheses to uncover correlations, regularities, and "laws." It is also not part of a dialectic approach to learning about the world. To Knight, pure theory is "a small step, but the *first* step, toward a practical comprehension of the social system" (Knight, [1921] 1985, p. 6, emphasis in original), from which "the scientific method, the method of successive approximations" ([1921] 1985, p. 8) is relied on to find the "correct 'middle way'" ([1921] 1985, p. 6). In other words, for Knight, in economics pure theory *precedes* and informs applied research and inductive study of social problems. But it is limited in scope and explanatory power of empirical phenomena because it is too general and "approximate," and therefore economic science requires the successive addition of inductive reasoning from observations. To better understand the reasoning behind Knight's methodological middle way, we must understand his view of pure theory. We must also understand its limits, both epistemologically and in application, which determine the nature and implications of the method of successive approximations.

To illuminate the boundary conditions of Knight's pure theory, I use the formalized deductive framework of Ludwig von Mises's praxeology[2] ([1949] 1998, [1933] 2002) as comparison and contrast. While there are certainly differences between Knight, one of the founders of the Chicago school (Emmett, 2009, 2010; Van Horn & Emmett, 2015), and Mises's Austrian school approach ([1949] 1998, [1933] 2002), Knight's pure theory in RUP is in many ways similar to praxeology. In fact, as we shall see, Knight and Mises agree to a much greater extent about the nature and role of pure theory in economics than they disagree (if they at all disagreed in substance) and they both refer to how deductive reasoning is the traditional method in economics. However, Knight's theorizing, and especially

his understanding of the demarcation of pure theory in economics, differs from Mises's. Using praxeology as benchmark allows me to shed light on the nature, role, and boundary conditions of Knightian pure theory. My exposition can, in turn, help us better understand Knight's approach and, as a result, his theorizing in RUP.

In what follows I first briefly summarize the structure and bounds of Mises's praxeology, which will then serve as background and framework for understanding Knight's approach to economic methodology. Second, I discuss Knight's view of pure theory and its role in economic reasoning. Thereafter, I compare their respective approaches focusing on both how they compare and in what they disagree and differ. Finally, I elaborate on the meaning of these findings.

PRAXEOLOGY: THE LOGIC OF ACTION

Praxeology is Mises's ([1949] 1998, [1933] 2002) formalization of Menger's ([1883] 2009) method and is considered "the distinctive methodology of the Austrian school" (Rothbard, 1976, p. 19). It is a method of theoretical inquiry developed uniquely for the concepts and causalities studied in the social sciences. In contrast to the constant and comparatively simple cause-effect relations studied in the natural sciences, research in social science deals with fundamentally complex and endogenous causalities that include, and may even depend on, unobservable and unmeasurable variables like value, learning, economizing, and agency.

Praxeology takes its starting point in our abstract knowledge of human action as purposeful behavior (Mises, [1933] 2002): to take action is to attempt to attain some state-of-affairs we expect to be comparatively more valuable. Human agency is thus recognized as fundamentally causal as actors choose and use specific means to accomplish subjectively valued ends. As Menger opens his 1871 treatise:

> All things are subject to the law of cause and effect. This great principle knows no exception, and we would search in vain in the realm of experience for an example to the contrary. Human progress has no tendency to cast it in doubt, but rather the effect of confirming it and of always further widening knowledge of the scope of its validity. Its continued and growing recognition is therefore closely linked to human progress. (Menger, [1871] 2007, p. 51)

Causality in human action rests on the actor's understanding for the world and their identification of subjective value potentialities. Thus, action becomes the link between personal motivations and objective outcomes: the action taken is motivated by the person's subjective valuations (Bylund & Packard, forthcoming), given their perception and understanding of the world, and aims to attain this value by causing specific changes to the external world. Consequently, praxeology, derived from the action axiom, builds on this very bridge between the subjective and the intersubjective (or social). The action axiom states that:

> Human action is purposeful behavior. Or we may say: Action is will put into operation and transformed into an agency, is aiming at ends and goals, is the ego's meaningful response to stimuli and to the conditions of its environment, is a person's conscious adjustment to the state of the universe that determines his life. (Mises, [1949] 1998, p. 11)

Complex social phenomena arise in unique situations, the specifics of which praxeology does not and cannot address. It only establishes their *nature* and relationships. From the purposefulness of action is derived that, for example, means are scarce, or we would not need to choose, and also that we are not fully content, or we would not act (Mises, [1949] 1998, pp. 92–94; Rothbard, [1962] 2004, pp. 2–6). These truths are not, and should not be, expressed in mathematical notation, which can only capture a state and are therefore unsuitable for the dynamic nature of an economy (Mises, 1938). Praxeology is verbal theory and as all its deductions are similarly derived from the action axiom, which Mises and praxeologists argue is a necessarily true starting point, the deductions from it must themselves be *true* (to the extent the logic is not flawed). The method thereby establishes relationships "whose validity does *not* depend on historical experience but can be established *a priori*" (Hoppe, 2001, p. xv; emphasis in original). As Selgin (1988) notes, the nature of praxeological reasoning directs us with respect to how this theory can be critiqued and, ultimately, refuted:

> refutation of a praxeological theory requires discovery of a fault in the chain of reasoning employed by the praxeologist. Empirical evidence does not "falsify" a theory, but rather serves to establish the appropriateness of the theory's application to a particular, concrete event. (Selgin, 1988, p. 22)

To illustrate, Mises compares praxeology to geometry:

> Aprioristic reasoning is purely conceptual and deductive. It cannot produce anything else but tautologies and analytic judgments. All its implications are logically derived from the premises and were already contained in them. Hence, according to a popular objection, it cannot add anything to our knowledge. (Mises, [1949] 1998, p. 38)

In contrast, historical data and experience cannot capture understanding of the actions that took place in it, that occurred due to it, or that brought it about (Dimov, 2011), and also cannot determine causal relationships. The role of praxeology in economics is therefore to uncover the *structure* of action and to from it produce generalized conclusions that are core to but not directly observable in specific phenomena. Praxeology is applicable to, and sheds light on, specific situations through bringing to the fore their underlying nature and structure including their unobservable processes and mechanisms.

Praxeology is methodologically individualist in orientation (Nozick, 1977; cf. Hodgson, 2007; Schumpeter, [1911] 1934), since only individuals act and any "social collective has no existence and reality outside of the individual members' actions" (Mises, [1949] 1998, p. 42). However, because praxeology recognizes the fundamental causal nature of action it can also be used to explain aggregate patterns of (i.e., collective) behavior (see, e.g., Menger, 1892; Mises, [1936] 1951; Rothbard, [1963] 2000; Bylund, 2016).

Finally, praxeologists insist that theory cannot be informed by observation and, therefore, there can be no "middle way" between theory and empirical research. This is also not its purpose: praxeology is only used to uncover the *true* processes and mechanisms in what is observed. The specifics of any observed phenomenon are a result of both its true nature, which determines its essence, and the unique situation in which it arises, which determines the exact empirical

expression of it. This leaves the student of historical events (the field of study that Mises [1957] 2007, refers to as thymology) dependent on theory for understanding and on data for explaining the uniqueness of what is observed. To Mises, then, the scope of theory in the social sciences, with praxeology being a meta-theory applicable throughout, is very narrow. Theory in the natural sciences has a broader scope but is less reliable as it consists of the hypotheses that have not yet been disproven. In contrast, praxeological theory, because it is a priori and thus derived logically, is necessarily *true*; it cannot be disproven using data.

KNIGHT'S "PURE THEORY"

In RUP, Knight notes a role of pure theory in economics that is strikingly similar to Mises's praxeology. "Economics," Knight notes, "or more properly theoretical economics, is the only one of the social sciences which has aspired to the distinction of an exact science" ([1921] 1985, p. 3). It is the reliance on deductive pure theory that allows economic theorists, both in the present and historically, to pursue exactness in their study:

> Whether or not the use of the method of exact science is as necessary in the field of social phenonena [*sic*.] as the present writer believes, it will doubtless be conceded, even by opponents of this view, that it *has been* employed in the great mass of the literature since the modern science of economics was founded. (Knight, [1921] 1985, p. 13)

The "pure theorists," much like praxeologists, work from within "a closed system of deductions from a very small number of premises assumed as universal laws" ([1921] 1985, pp. 5–6). This is the proper approach to theorizing, Knight notes, because in

> the study of industrial society … we must [often] … rely upon intuitive knowledge of general principles and follow through the workings of individual chains of sequence by logical processes. ([1921] 1985, pp. 3–4)

Such deductive theory is the product of "careful, rigorous thinking" ([1921] 1985, p. xi) and can provide "a clear understanding of the nature and tendencies of the system" ([1921] 1985, p. xii).

Deductive theorizing allows us to generate abstract knowledge because it can "isolate and define the essential characteristics of free enterprise as a system" ([1921] 1985, p. 6). This allows us to gain an understanding for how the system works in essence, even though such knowledge is abstract. Economics, therefore, "becomes like physics or mathematics in being necessarily somewhat abstract and unreal" ([1921] 1985, p. 3). This is not a flaw of such theory, however, because "[t]he very conception of an exact science involves abstraction; its ideal is analytic treatment, and analysis and abstraction are virtually synonyms" ([1921] 1985, p. 3).

The reference to exactness is not meant to imply that such analysis must be mathematical and in numeric form, but that it must be deductive, logically stringent, and sufficiently specified. RUP is itself an example of a verbal, non-mathematical treatise – "a study in 'pure theory'" as Knight ([1921] 1985, p. xi)

puts it. He approvingly refers to other "'literary' pure theorists" in his discussion on method, mentioning Wicksteed and Schumpeter, with at least the former being "especially worthy of note" ([1921] 1985, p. 14). Knight, while appreciative of what the mathematical theorists have accomplished, is not convinced that mathematics has a large role to play in economic theorizing. States he: "mathematical economics in particular seems likely to remain little more than a cult, a closed book to all except a few of the 'initiated'" (Knight, [1921] 1985, p. 14).

What is of the essence to Knight is not the language or notation used for expressing pure theory, but that it is deductive: "*Thought* in the scientific sense, and *analysis*, are the *same thing*" ([1921] 1985, p. 17, emphasis in original). Nevertheless, Knight clearly has the then-state of the art "mathematical economic theory" of Pareto and others in mind when discussing the role and nature of exact pure theory (Knight, [1921] 1985, pp. 5–6, fn. 2).

Pure theory, Knight further argues, is "always very incomplete" ([1921] 1985, p. 4) in its application. While pure theory establishes general trends, it is – partly for this reason – insufficient to explain the particulars of observed phenomena. The value of the method comes from the fact that deductive laws "enable us to reach an *approximation* to the law of the situation as a whole" (emphasis added) by stating "what 'would' hold true under 'ideal' conditions." Theory thus guides the economist in the study of empirical economic phenomena in complex reality by indicating the tendency or would-be situation per "[t]he laws of these few elements." As in physics, economic laws "enable us to deal with practical problems intelligently because they are approximately true and we know how to discount their incompleteness" ([1921] 1985, p. 5). In this sense, then,

> it may be that a small step, but the *first* step, toward a practical comprehension of the social system is to isolate and follow out to their logical conclusion a relatively small number of fundamental tendencies discoverable in it. ([1921] 1985, p. 6, emphasis in original)

Theory consequently provides a starting point for making sense of the complexity of social systems, in which numerous elements may play a part, so that more specific phenomena can be identified and studied in greater detail. Or, to put it differently, "[b]y means of first showing what the system is, it is hoped that advance may be made toward discovering what such a system can, and what it cannot, accomplish" ([1921] 1985, p. xii). Pure theory is therefore necessary for science. It "is in fact the very essence of scientific procedure" ([1921] 1985, p. 6).

Unfortunately, Knight notes, the role of pure theory, and its necessity for science and scientific inquiry, is little understood – even by economists:

> In the great mass of economic literature there is certainly still wanting the evidence of a comprehensive grasp of general principles and even more of the meaning and importance of general principles in a scientific program. (Knight, [1921] 1985, p. 14)

For Knight, pure theory is a necessary starting point, but it is not sufficient for proper economic analysis. As an approximation that captures the general trends of the system, it is too far removed from the complex reality to provide sufficient insight into specific phenomena. More specificity must be added for the economist to fully explain a complex economic phenomenon and make specific