Frank Knight’s first appointment at the University of Chicago began in 1917. He replaced Jacob Viner as an instructor for two years, teaching statistics and economics. Viner returned the favor in 1919 (Irwin and Medema 2013, 3), coming back to Chicago as Knight left for a position at the University of Iowa. During the two years he was initially in Chicago, Knight worked with John Maurice Clark, Chicago’s only economic theorist at the time, to complete the revisions his Cornell University doctoral dissertation needed for publication. The dissertation, “A Theory of Business Profit,” had won second prize (under the title “Cost, Value, and Price”) in the Hart, Schaffner and Marx Economics Essay competition in 1917. It was eventually published in 1921, bearing the now famous title, Risk, Uncertainty, and Profit (Knight 1921).

In the mid-1920s, at about the same time that Clark departed to take over his father’s position at Columbia University, the Chicago department changed its name from Political Economy to Economics and revised its curriculum. Between 1926 and 1930, the core of the curriculum became three course sequences in Price Theory, History of Economic Thought, Political Economy, and Theory of Finance. The curriculum and faculty formed what became known as the Chicago School of Economics.

1 Previously, Knight had attended the University of Chicago as an undergraduate student in the summer of 1906, taking two physics courses with Robert Millikan, future Nobel Prize winner. Until 1912, he had planned on a career in the sciences.
and Money and Banking. Viner was the primary professor in price theory, and Lloyd Mints was the primary professor for the money and banking sequence. Following on the heels of his translation of Max Weber’s *General Economic History* (1927), Knight rejoined the department in 1928 to assume responsibility for the sequence in the history of economic thought and to teach “institutionalism.”

Because Viner was absent from time to time during the early 1930s, Knight also began to teach the price theory sequence. Against the backdrop of his newly acquired Weberian perspective, the teaching the history of economic thought and price theory courses led him to completely rethink his approach to economic theory between 1930 and 1935 (Emmett 2006). The changes can be seen in the comments inserted into *The Economic Organization* at the end of chapter 2 (Knight 1933); in “Statics and Dynamics: Some Queries regarding the Mechanical Analogy in Economics,” first published in German (Knight 1930) and then in English as part of *The Ethics of Competition* (Knight 1935d); in “Notes on Utility and Cost,” published in German as a two-part article (Knight 1935a; 1935b), with the English translation circulating among students as a pamphlet throughout the latter part of the 1930s and the 1940s; in another two-part essay on “The Ricardian Theory of Production and Distribution” (Knight 1935d; 1935e); and in the string of articles comprising his capital controversy with the Austrian economists during the 1930s that culminated in yet another two-part article, “The Quantity of Capital and the Rate of Interest” (Knight 1936a; 1936b).

Obviously, the early 1930s would have been an engaging time to be a student at Chicago, with Knight re-thinking his understanding of price theory from cost theory to capital theory in front of your eyes. Fortunately, there was a group of students and

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2 Knight taught at the University of Chicago during the summers of 1920 and 1921, and at Northwestern University in the summer of 1926. Chicago’s department chair, Leon C. Marshall, approached Knight in March 1927 about returning to Chicago permanently. Knight moved to Chicago at the end of the University of Iowa’s 1927 spring semester, teaching in the summer and autumn quarters of that year at the University of Chicago. In early 1928, he returned to Iowa City to teach one final semester and settle his affairs. He returned to Chicago permanently in the summer of 1928 (Nordquist and Emmett 2011, xxxviii-xl). Details about the courses he taught related to institutionalism can be found in Emmett (2006).

3 The insertion in Knight (1933) was very short. Longer versions of Knight’s explanation for his disagreement with the theory expressed in second chapter of *The Economic Organization* can be found in the appendixes to chapter 2 in Knight (2013).

4 The English translation was published as the second half of Knight (1951).
colleagues there to appreciate what they were witnessing. Some of this group continued their conversations with Knight outside class; in his office, at the Quadrangle Club, and at his home. Henry Simons, Milton Friedman, George Stigler, Aaron Director, W. Allen Wallis, Rose Director, Homer Jones, Alice Hanson, and Lloyd Mints regularly joined the Knights for dinner and conversation on Sunday evenings. Among others who interacted with this group during the early 1930s, Albert G. Hart deserves mention for his participation in the formation of “The Chicago Plan” for banking reform (Phillips 1994), and Paul Samuelson for his admiration of Knight early in his career.

After the mid-1930s, Knight published only a handful of articles in economic theory; his attention had turned to the broader intellectual project that had brought him into economics in the first place. That broader project was focused on the role of social scientific inquiry in the defense of a free society. George Stigler once described Knight’s project this way:

For most present-day economists, the primary purpose is to increase our knowledge of the working of the enterprise and other economic systems. For Knight, the primary role of economic theory is rather different: it is to contribute to the understanding of how by consensus based on rational discussion we can fashion a liberal society in which individual freedom is preserved and a satisfactory economic performance achieved. (Stigler 1985)

In Knight’s estimation, economics played a limited, but important role in that project. The most important task of the economists was to assist society in understanding the essential core of price theory (a Weberian ideal type). Equally important for a free society would be a comparative analysis of political and social institutions, and a social decision regarding the society’s dominant ethical system. Knight’s own comparative institutional analysis appeared in “Economic Theory and Nationalism” (Knight 1935c), and his evaluation of competing ethical systems in the three-part article “Ethics and Economic

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5 Milton Friedman married Rose Director; Homer Jones married Alice Hanson. Friedman, Stigler, Wallis, and Jones selected the essays that comprise The Ethics of Competition (Knight 1935e) – a gift on their mentor’s fiftieth birthday. Hanson prepared the bibliography of Knight’s work up to 1935 that was included in the compilation.

6 In the early 1940s, an entirely different circle of conversation among Knight, Robert Hutchins (the University’s President), Richard Redfield (anthropologist and head of the Division of the Social Sciences), and John Nef (economic historian) led to the creation of the Committee on Social Thought (Emmett 2010; 2013).

7 The last was Knight (1944).
Reform” (Knight 1939c; 1939b; 1939a). Needless to say, neither article provided an encouraging picture of the prospects for liberal democracy. The appeal that Americans in the early 1930s had found in the European emergence of collectivism, in both its fascist and communist versions, made Knight despair for the future of freedom. Indeed, on the eve of the 1932 election, he delivered an address here at the University entitled “The Case for Communism: From the Standpoint of an Ex-Liberal”. For the subsequent ten years, Knight railed against collectivism in almost every venue possible (Knight 1946). Following the end of World War II, he continued his pursuit of a general defense of a free society (Knight 1960). He retired in 1952, and was retained for the remainder of his life as a Professor of Philosophy and the Social Sciences, associated with both the economics department and the Committee on Social Thought.

My brief overview of Knight’s career in economics and social philosophy suggest that his legacy for the Chicago School is mixed. The remainder of the paper considers two aspects of that mixed legacy.

The Knight Circle and the Chicago School

By my reckoning, the Chicago School was not founded in the 1930s. True, the teaching of price theory and the history of economic thought by Viner and Knight laid the foundations for what was to come around 1950. And Viner’s approach to teaching theory, as Friedman tells us, left no doubt “that economics really had something to say about real problems” (quoted in Hammond 2010, 14), a comment that might not be said about Knight’s Crusonia plant, but would describe well Simons’ course in the law school (Simons 1983). But post-war Chicago economics reflected an empirical and methodological approach lacking in the 1930s (Hammond 2010), and the development of the workshop system entrenched the new Chicago approach for students and faculty (Emmett 2011).

Nevertheless, it is fair to say the post-war School emerged from the circle of students and colleagues who gathered around Frank Knight in the early 1930s – what we might call the “Knight Circle.” Of particular importance to the School’s formation at the end of the 1940s and beginning of the 1950s were three of those individuals: Friedman, Wallis, and Director. Friedman returned to Chicago as a professor in 1946, assuming Jacob Viner’s mantle teaching price theory and Lloyd Mints’ mantle teaching Money and Banking.

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8 Key methodological statements of the Chicago approach are Friedman (1953) and Stigler and Becker (1977).
Allen Wallis was also appointed at the University in 1946 as Professor of Statistics and Economics (and eventually Chair of the Statistics Department). He was Dean of the University’s Graduate School of Business from 1956 to 1962, formative years for the adoption of the Chicago approach there. Aaron Director taught courses for the economics department during the 1930s and 1940s, and was hired as the Director of the Free Market Study, with an appointment in the University’s Law School, following the death of Henry Simons in 1946. The growth of Chicago law & economics followed from Director’s appointment. Thus from the Knight Circle was the Chicago School borne, reaching across economics, the business school, and the law school from its beginning.

But, perhaps, the most important person in the institutionalization of the Chicago School was not a member of the Knight Circle, although he deeply admired Knight’s work. T.W. Schultz arrived at the University in the mid-1940s and assumed the role of Chair of the Department of Economics soon after. It was Schultz’ administrative acumen that soon provided a unified structure to the School’s educational and research activities. In tandem with Friedman, H. Gregg Lewis, D. Gale Johnson, Schultz set in motion the workshop system that became the School’s hallmark by the 1960s (Emmett 1998). The workshops provided the space within which price theory was combined with a growing empirical tradition to recreate Chicago economics as an applied policy science.

*The Price Theory Legacy*

Between the late 1920s and the 1990s, the teaching of price theory at Chicago was primarily entrusted to five “masters” – Viner, Knight, Friedman, Al Harberger, and Gary Becker. Knight’s place among the Chicago masters is secure, for several reasons. He laid the foundation for Chicago’s approach to price theory with his demonstration in *The Economic Organization* of the way in which prices simultaneously coordinate the activities of buyers and sellers across markets to fulfill without centralized control the social functions that every economy is called to perform. The point was illustrated by his “wheel of wealth” (circular-flow) diagram, which Paul Samuelson put to macroeconomic use two decades later. His Weberian methodology led him to emphasize the relevance of basic economic principles to real world analysis while denying the necessity of providing theory with realistic assumptions (Knight 1944b). He unified utility and cost theory in the notion of opportunity cost, and

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9 An argument that Friedman maintained albeit with an instrumentalist defense (Friedman 1953; Boland 1979)
then eliminated the differences among the “ultimate” factors of production by focusing the theorist’s attention on marginal cost analysis in an equilibrium context—all aspects of analysis that became a hallmark of Chicago economics. His choice of “capital” as the name for the single factor of production, as well as his argument that consumption and production were simultaneous events—no waiting time between the production of a stream of services and their consumption—enabled Chicago to side-step the morass of capital theory controversies that economists at the two Cambridges—England and Massachusetts—sunk into during the 1960s (Valiente 1980), and also set the stage for the development of human capital theory by T.W. Shultz and Becker. Surprisingly, one could argue that Knight also helped to set the tone for Chicago’s move to an applied policy science (Emmett 2009, 149). No social problem could be viewed as out of bounds for economic investigation, because one could not say in advance what knowledge might be generated. Intelligent social action required, he argued, both education in price theory among the citizenry and the economics profession’s commitment to keep their policy discussion open until a fair degree of common agreement within the profession was reached (Knight 1924; 1935c; 1960).

And yet, post-war Chicago School price theory was decidedly Marshallian, while Knight’s price theory was closer to the Austrians. While Knight was busy in the early 1940s helping to create the Committee of Social Thought—an alternative within the University to the increasing specialization of knowledge in departments, his students were narrowing the focus of economics as a social science in ways that lent them a focus different than Knight’s. Unlike their mentor, who saw economics as part of a broader approach to intelligent social action that required a theory of politics and ethics, they were reshaping economics to be an applied policy science.

Reshaping economics required the members of the Chicago School to overturn systematically the assumptions that Knight used to undergird his understanding of the relation of price theory to the defense of a free society. On the methodological front, Friedman (1953) made predictive power the measure of theory success. Confronting theory with evidence became the focus of a Chicago economist’s research, and the excitement of empirical studies from development to public finance, and monetary policy to regulatory rules replaced the excitement Knight had evoked for theoretical analysis. And then Stigler and Becker (1977) brushed aside Knight’s concerns about changing values and tastes by assuring Chicago economists that it was always acceptable to look first at changes in cost

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10 Knight substituted Weberian analysis for Ludwig Mises’ praxeology.
structures before resorting to “tastes or values must have changed” as an economic explanation. When “The Methodology of Positive Economics,” and “De Gustibus Non Est Disputandum” were combined with the empirical techniques developed by Chicago’s econometricians, an applied policy science emerged that was, in many senses, a rejection of Knight’s vision for social science (Emmett 2009).

REFERENCES


