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J. Patrick Raines
University of Richmond

Clarence R. Jung Jr.
University of Richmond

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THE NEGLECTED INSTITUTIONALISM OF
SCHUMPETER'S AND KNIGHT'S VIEWS OF RATIONALITY

J. Patrick Raines

Clarence R. Jung

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by

J. Patrick Raines
University of Richmond
and
Clarence R. Jung
University of Richmond

INTRODUCTION

The concept of rationality is both the origination point and the Achilles' heel of the study of human behavior in economics. The rationalist view of human nature is arguably the most pressing issue facing contemporary economics.¹ Fields of knowledge other than economics have developed alternative theories of human activity to the neoclassical's pure economic man. They include Abraham Maslow's hierarchy of needs, Kenneth Boulding's "grants economy," and John Rawls' original position doctrine. Within economics, the Institutionalists have been the leading critics of the assumption that behavior in the economic sphere is rationally directed.

A consensus view of rationality does not exist among Institutionalists. However, a synthesized Institutionalist conception of rationality would include the effects of culture, habit, social structure, and psychological makeup on individual and collective decisions. Additionally, an essential component of such a conceptualization would be the evolutionary aspect of rationalism, or how it develops throughout the life-process. These precepts are widely associated with the work of Thorstein Veblen and J. M. Clark.

¹James R. Wible, "Towards a Process Conception of Rationality in Economics and Science," Review of Social Economy, Vol. 42, No. 2 (October 1984): 89.

Veblen primarily espoused a deterministic or "efficient cause" theory of human behavior, whereby class consciousness and anthropogenic factors are the forces of economic activity.² His denial of hedonistic calculation and implicit rejection of neoclassical utility functions are demonstrated by his statement:

The hedonistic conception of man is that of a lightening calculator of pleasures and pains, who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact.³

In his "Economics and Modern Psychology," J. M. Clark held that monetary interests and impulses drive economic decisions much more than anticipated increments of marginal satisfaction. Further, he questioned the costless assumption of the rational choice process and argued that the cost of intellectual effort is so great that individuals limit their exercise of free choice and defer to custom or habit.⁴

This work is not designed to show that Schumpeter and Knight belong to the Institutional school of thought. Rather, Institutionalism provides a meaningful framework to compare their concepts of capitalistic and democratic rationality. Generally, both were dissatisfied with the assumption that individuals engage in rational calculation to satisfy wants of an unexplained origin. Their highly developed views of rationalistic civilization facilitate analysis of the considerable concordance as well as the conceptual differences which exist in their views of rationality.

²Floyd B. McFarland, "Clarence Ayres and His Gospel of Technology," History of Political Economy, Vol. 18 (Winter, 1986): 618-21.

³Thorstein Veblen, The Place of Science in Modern Civilization and Other Essays (New York, 1919): 73-74.

⁴J. M. Clark, "Economics and Modern Psychology," Preface to Social Economics (New York: Farrar and Rinehart, 1936): 100-102.

This essay examines their views of rationality through an exegesis of their writings in order to clarify a conception of rationality for modern economic science. It begins, therefore, by briefly discussing the intellectual sources and definitions of rationality according to Schumpeter and Knight. Then, a separate explication of the views Knight and Schumpeter held on capitalist and democratic rationality is presented. Finally, a synthesis of the methodological implications for economics is examined.

SCHUMPETER ON CAPITALIST AND DEMOCRATIC RATIONALITY

Rationality in Capitalism

To avoid confusion when using the verb "to rationalize," Schumpeter explains rationalizing as supplying ourselves and others with reasons for an action which satisfy our standard of values.⁵ It is not necessary in his view that such reasons take into account the true impulses for the action. Actions which satisfy moral values, for an example, may actually be undertaken because economic benefits outweigh economic costs.

He describes rationality in Marxian terms as the socio-psychological superstructure of capitalism. It is the mentality which characterizes capitalist society and particularly the bourgeois class. He argues that primitive human economic necessities forced rationality upon the human mind and explains; "it is the everyday economic task to which we as a race owe our elementary training in rational thought and behavior."⁶ Further, he does not hesitate to say that all logic is derived from the pattern of economic decisions. A phrase which Schumpeter is

⁵Joseph A. Schumpeter, Capitalism, Socialism and Democracy (New York, N.Y.: Harper and Row, 1942), p. 143

⁶Ibid., p. 122

particularly fond of is: "the economic pattern is the matrix of logic."⁷ Consequently, as the unending rhythm of economic wants is satisfied, the rational thought process spreads and becomes ingrained in the decision making process. Thus, rationality is a learned response as opposed to innate, natural behavior.

It is not Schumpeter's view that materialistic rationalism is new to capitalist activity. In fact, he suspects that pre-capitalist man was no less "grabbing" than capitalist man. However, he contends that capitalism has been the propelling force of the rationalization of human behavior.

A capitalist institution which develops rationality is the exaltation of the monetary unit. The importance of money as a unit of account and as a measure in capitalist social stature systems facilitates rational cost-profit calculations. Cost-profit calculations, in Schumpeter's view, crystalize and define numerically economic rationality--in short, they "powerfully propel the logic of enterprise."⁸ Once rationality pervades the economic sector it influences and indeed subjugates everything from man's outlook on life to his concepts of beauty and justice. Even his spiritual ambitions are affected by the rationalizing propensity: the perceived benefits of the hereafter exceed the human costs of the here-and-now.

Once capitalism produces the rationalist mental process, the institution of democratic politics provides the means for nurturing society's rationalizing capabilities -- legislation. Schumpeter contends that capitalism produces both the means and the will to spread capitalist rationality. The spectacular increase in the modern standard of living for the masses, Schumpeter argues, encourages the development of more pervasive social programs. Perhaps, incidentally but

⁷Ibid., p. 123

⁸Ibid.

unquestionably, twentieth century public policy has simultaneously promoted social well being and facilitated the capacity to act rationally. Schumpeter asserts that the accompanying technological advances of modern science are the recognizable results of the rational-profit economy. He writes:

Not only the modern mechanized plant and the volume of output that pours forth from it, not only modern technology and economic organization, but all the features and achievements of modern civilization are, directly or indirectly, the products of the capitalist process.⁹

Clearly Schumpeter is arguing that the institutional arrangements of the capitalist economic system require, promote and develop rationality. If rational human behavior takes place, then it is more the result of economic structure considerations than advanced calculations of anticipated benefits and pleasures.

Interestingly, rationalism--the cost-profit calculus of capitalism--does not insure the survival of market systems. Instead, it produces an "antiheroic" civilization; a society which pragmatically accepts the world this side of the grave. As capitalism exalts the rationalization process, the entrepreneurial spirit, which is imperative for the survival of the capitalist order, withers. Schumpeter holds that the material success of the capitalist economy favors the status quo. Thus, the revolutionary pattern of entrepreneurial activities will be replaced by logical bureaucratized management.

In such an environment, innovation will be the responsibility "of teams of trained specialists who turn out what is required and make it work in predictable ways."¹⁰ This, of course, is in many ways similar to Veblen's prediction of a "soviet of technicians." The renowned economic progress of capitalism inspired by individual entrepreneurship will become depersonalized and automatized.

⁹Ibid., p. 125

¹⁰Ibid., p. 132

Vision will be replaced by rationalized and specialized office work. Schumpeter summarizes the dangers of these developments as follows: "Since capitalist enterprise, by its very achievements, tends to automatize progress, we conclude that it tends to make itself superfluous--to break to pieces under the pressure of its own success."¹¹

Intellectuals account for much of the criticism of the capitalist order, according to Schumpeter. He blames this situation on the emphasis on and the accessibility of higher education in the later stages of capitalist civilization. University education produces a surplus of quasi-professional intellectuals who may be simultaneously too ill-trained for professional employment and physically unemployable in manual occupations. Given this set of circumstances, employment may require acceptance of unsatisfactory working conditions and/or wages below skilled manual workers. This unemployed or unsatisfactorily employed population develops a thoroughly discontented attitude. In effect, the intellectual's indignation about the wrongs of capitalism represents a rationalization of his personal situation.

Ultimately, discontented, employable intellectuals express their hostility through political party activities, staffing government agencies and acting as advisors to elected officials. In this way, Schumpeter asserts, as intellectuals impress their mentality on almost everything that gets done, public policy grows more and more hostile to capitalist interests.¹² The modern propensity for well-

¹¹Ibid., p. 134

¹²Warren J. Samuels points out in "A Critique of Schumpeter," contained in Capitalism and Democracy Schumpeter Revisited (Notre Dame Press, 1985), that Schumpeter's prediction of the demise of capitalism is much more complex and subtle than his scapegoating of intellectuals. Specifically, Samuels argues, his criticism of rationalism and intellectuals is a stratagem for criticizing the corporate system's replacing individualist entrepreneurial capitalism as a system of economic control.

meaning social legislation may be indicative of this trend.

The point is, rationality spawned by capitalism generates progress which ultimately creates a logic that undermines the essence of the system. In the face of spreading rationalism, capitalism cannot endure. In working so well, capitalism generates expectations based upon a rational belief in the possibility of a superior system. Ironically, when society behaves rationally and accepts the efficiency of an automated, bureaucratized production process, the results are perverse; the entrepreneurial spirit is undermined and the advance of socialism is hastened. In essence, rationalism, which is promoted by capitalism, leads to the acceptance of institutions which foster the development of socialism.

Rationalism and Democracy

The view of society's rationality held by Schumpeter is surely elitist and cynical. Most likely it is a product of his aristocratic, Austrian rearing.¹³ He seems to have perceived only two types of man, the ordinary variety and the uncommonly gifted person. The former may behave rationally in daily matters at home and in business, but as voters, often prove themselves bad and indeed corrupt judges of their own interests. He contended: ". . . the great political questions take their place in the psychic of the typical citizen with those leisure-hour interests that have not attained the rank of hobbies, and with the subjects of irresponsible conversation."¹⁴ Schumpeter's fundamental assumption regarding the relationship between the rational attitude and the State is that the capitalist process undermines its own institutional framework. Throughout his

¹³L. A. O'Donnell, "Rationalism, Capitalism and the Entrepreneur: The Views of Veblen and Schumpeter," History of Political Economy, Vol. 5, No. 1 (Spring 1973): 202

¹⁴Schumpeter, Capitalism, Socialism, and Democracy, p. 261

work, Schumpeter emphasizes the relevance of dynamics to real economic processes. Clearly, it is a process conception of socioeconomic rationality.

The classical definition of democracy to Schumpeter is "an institutional arrangement for arriving at political decisions which realizes the common good by making the people decide issues through the election of individuals. . . ." ¹⁵ But, he contends, the classical state cannot exist. First, rational arguments cannot induce agreement upon a common good for all people. This is due to the fact that society's view of what life should be is beyond mere logic. Compromises are possible in some areas and impossible in others. Thus, it is impossible to discern a unique common good. Further, the idea of a "volonte generale" or common will of the people is easily dismissed, when one realizes all individual wills do not naturally gravitate toward a natural equilibrium even with rational discussion. In fact, the will of the people is the product of the political process. This manufactured will is the product of politicians or advocates of an economic interest who are able to fashion the will of the people.

Schumpeter is exceedingly skeptical about human nature in politics. He doubts the common man's powers of observation and interpretation of facts as well as his ability to make rational inferences. He elaborates considerable evidence against the assumption of rationality inherent in the classical definition of democracy. Specifically, he points out that economists are learning that the consumers portrayed in textbooks do not have wants nearly as definite as assumed and do not act upon those wants in such a rational and prompt way. He suspects ordinary man is so susceptible to the influence of advertising that producers dictate to consumers rather than being directed by them. Schumpeter infers

¹⁵Schumpeter, Capitalism, Socialism and Democracy, p. 250

from this state of affairs that extreme public gullibility exists in the realm of political action.

When typical citizens enter the political field, Schumpeter suggests, they drop to a lower level of mental performance. In fact, the common man argues and analyzes in a manner which he would readily recognize as infantile within the sphere of his real, i.e., personal interests. In summary, the weakness of the rational process applied to politics, the absence of logical control over the arrived at results, and the relaxation of moral standards in political affairs render the ordinary citizen "more unintelligent and irresponsible than he usually is."¹⁶ Thus, Schumpeter concludes that "the people" do not hold definite and rational opinions about every individual question and it is unlikely that they can elect representatives to carry out their opinions.¹⁷

KNIGHT ON RATIONALITY IN ECONOMICS AND POLITICS

Individual Economic Rationality

Frank Knight worked toward and hoped for a society based upon common-sense rationality. Such a hope probably sprang from his mid-American roots.¹⁸ He acknowledged that the economic man exists, to some degree, in every person, but in the institutionalist tradition recognized that the romantic, the social animal, the prejudiced ignoramus exists alongside the calculating, self-interested individual. He rejected intellectual elitism and took it upon himself to expose

¹⁶Ibid., p. 262

¹⁷David McCord Wright, "Schumpeter's Political Philosophy," Schumpeter, Social Scientist (Freeport, New York: Libraries Press, 1969): 130-135

¹⁸In a recent paper Donald Dewey presents, with a refreshing combination of genealogical and philosophical perspectives, a detailed and entertaining account of Knight's early years. Donald Dewey, "Frank Knight Before Cornell: Some Light on the Dark Years," paper presented at the 55th annual meeting of the Southern Economic Association, Dallas, November 25, 1985.

the fallacies, nonsense and absurdities in what is passed off as sophisticated-scientific discourse. Ultimately, he urged society to nurture the will to develop a more critical attitude.

Knight sardonically notes: "That 'man is a rational animal' is one of those interesting statements which do not have to be proved, since the subject admits it."¹⁹ Even though man may hold such a view of himself, Knight considers the description to be too one-dimensional as well as generally false. To describe human beings as rational ignores the fundamental romantic element of human behavior. Further, Knight argues that the classical meaning of rationality is efficiency: the premeditated maximization of limited resources to achieve an envisioned end. In Knight's pursuit to emphasize man's romantic nature and to debunk social and economic dogma, he points out that humans seldom seek the "naked" and "cold" results of efficiency. Thus, man's view of himself as a rational creature is most likely a conviction based upon premises inferred from conclusions. (Man is rational because he is the highest order of reasoning animal.) Thus, Knight holds: "Man is certainly not the rational animal that he pretends to be He is very superior to other animals in reasoning power, but reason is not distinctive of man and is hardly his predominant trait; it is often used for irrational ends."²⁰

¹⁹Frank H. Knight, "The Planful Act: The Possibilities and Limitations of Collective Rationality," Freedom and Reform (Indianapolis: Liberty Press, 1982), p. 405

²⁰Frank H. Knight, "The Free Society: Historical Background," Intelligence and Democratic Action (Cambridge, Mass.: Harvard University Press, 1960), p. 52

The clarification of the nature and significance of the economic man is perhaps Knight's major contribution to economic methodology.²¹ He recognized that in order to build a rigorous and useful model of economic maximization man must be described as purposely and consciously utilizing means to attain predefined ends--the rational economic man. However, he also contends "there is no such man" because human beings do not know what they want--not to mention what is "good" for them--and do not act very intelligently to get the things which they have decided to acquire. Besides, to act completely rationally would require totally impersonal and non-romantic behavior which is not only "irrational" but impossible. Hence, he believed a science of conduct is an impossibility because the data of conduct are provisional, shifting, and specific to individual situations to such a high degree that generalization is relatively fruitless.²² Consequently, Knight always cautions against the overzealous application of economic theory to sociological phenomenon and argues that economic theory is not an explanatory science of all reality. Perhaps, ironically, Knight's neoclassical link to modern positivist economics is the reinstatement of Knight's economic man.

In order to understand the essence of Knight's institutional view of individual rationality and its place in economics, it is necessary to know the definition and description of rationality which was being promulgated by neo-classical economists in Knight's day. For, as he himself acknowledged, Frank Knight was essentially a critic and much of his work is a search for logical contradictions in economic

²¹William Breitt, "Frank H. Knight - Philosopher of the Counter-Revolution in Economics," The Academic Scriblers (New York, N.Y.: Holt, Rinehart and Winston, 1971), p. 200

²²Frank H. Knight, "Ethics and the Economic Interpretation," Ethics of Competition (Freeport, New York: Libraries Press, 1969), p. 35

theory. He saw his main task, and the task of general education, to be to "unteach" the acceptance of dogma and to develop the will to be intelligent, i.e., objective and critical.

It appears that Frank Knight was not pleased with the course modern economics was taking. He particularly disapproved of the "economic" explanation of human behavior as well as attempts at predicting real world results from idealized theoretical economic models. Thus, he found Marshallian definitions of economics, viz., "the ordinary business of life" or "the science of rational activity," useless and misleading.²³ To Knight, such definitions suggested that economics is the science of everything that generally concerns mankind. On the one hand, economizing behavior does not encompass all human activity, and on the other, life must be much more than rational conduct or the intelligent use of resources to achieve pre-determined results.

In the opening pages of The Economic Organization, he points out that common definitions of Economics are too broad, and the rational economic conception of life is too narrow. He draws out the implications of the statement by noting: "Living intelligently includes more than the intelligent use of means in realizing ends; it is fully as important to select the ends intelligently," and "Living is an art; and art is more than a matter of scientific technique, and the richness and value of life are largely bound up in the 'more.'"²⁴ In this he concurs with John M. Clark that an irrational passion for dispassionate rationality would take all of the joy out of life. Although Knight was not a utopian, he expresses hope for a society where the everyday struggle to maximize

²³Frank H. Knight, The Economic Organization (New York, N.Y.: Harper & Row Publishers, 1933, 1951), p. 4

²⁴Ibid., pp. 3-4

the production of material necessities will give way to a culture devoted to problems of truth, improved human relations, and beauty.

Collective Rationality and Democracy

In his essay, "Can the Mind Solve the Problems Raised by Its Liberation," Knight recognizes the tendencies released by liberal culture toward "acute discontent, criticism, and fault-finding."²⁵ He infers, much like Schumpeter, that favorable capitalist conditions have caused a critical attitude to develop with astonishing speed as a culture trait. He concedes that the propensity to dissent against economic and political conditions has existed all along but speculates it was held in check by the harsh discipline of precapitalist-preliberal culture.

Knight is probably as skeptical as Schumpeter about the possibility of society making rational political selections in a democracy. In dealing with the existence of collective rationality in a democracy, Knight, as always, is attempting to show something of the complexity and difficulty of accepting traditional truths. He recognizes that collective rationality in a democracy involves rationally delegating power. This implies: the will and intellect exist to choose a representative; the mechanics to rationally select an agent are operational; once selected, the agent is given instructions concerning the process to use in order to achieve a rational end; and a means must exist for holding the agent responsible for carrying out the instructions. Using an analogy whereby a patient must choose a physician, Knight expresses his reservations concerning the public's ability to rationally choose political leadership.

²⁵Frank H. Knight, "Can the Mind Solve the Problems Raised by Its Liberation," Intelligence and Democratic Action (see No. 14), p. 144

First, it is impossible for a leader to be selected intelligently, in the scientific sense. In order to select his doctor scientifically, the patient would have to know all the medical science known by all the candidates under consideration, and in addition know how much of this knowledge was possessed by each separate candidate. Secondly, the relation between leader and follower must be a moral relation, one of confidence and trust on the part of the client and of moral integrity and of candor tempered by judgment on the part of the counsellor. Thirdly, where the leader is chosen by the follower or client on the basis of active competition for the position, the follower becomes the real leader; for the methods of competition by those seeking appointment will run largely to competition in promising to do what the client wants done, and by debating technical details will make him the judge of these, and to promising results of whose probability of realization the counsel-seeker must judge. And all this is the more certainly true where the follower is a group, amenable to manipulation through crowd psychology. Fourthly, active competition for positions of leadership, especially leadership of groups of considerable size, means the progressive degradation of the entire system through the use of salesmanship or "influence,"--flattery, cajolery, outright deception, and sheer pressure of suggestion and assertion. This means appeal from intelligence to the most irrational emotions. The methods of competition adopted by aspirants to positions of leadership must be those which "work"; candidates in any way restrained by "principles" will simply be eliminated. And it goes without saying that competence to persuade is only accidentally and improbably associated with competence to counsel and to lead.²⁶

Clearly, Knight thought that due to human nature and the complexity of modern decisions there are very narrow limits to the achievement of collective rationality. He argued that in the political field the possibility of knowledge adequate for rational group action is extremely limited.

Even though Knight is skeptical about the possibility of collective rationality, he holds that intelligent social action is distinctly possible. In fact, Knight contends that in a truly democratic system men must use freedom intelligently and intelligent is preferable to rational.

²⁶Knight, "Economic Theory and Nationalism," Ethics of Competition, pp. 304-305

The first step in Knight's system for intelligent social action is to compare the alternatives, beginning with understanding what they are. This procedure must logically be conducted prior to action. After knowledge of alternatives and conditions is assimilated, it is possible to proceed to the second stage of the analytical process of social reform: the formulation of an ideal or a rationally desired end. To Knight, it is imperative that reformers have a detailed view of the consequences of change before action is undertaken. The final task in Knight's model for undertaking intelligent social action is to decide the appropriate means for social change. Knight is quick to point out that inaction and the "natural" course of events may be the best alternative. His basic axiom is that it is better not to act unless it can be done intelligently because the chances are good that harmful results will follow from acting randomly--or unintelligently.

In summary, Knight concurred with Lord Bryce that democracy should ideally be "government by discussion." Thus, in a Jeffersonian sense, Knight held that the cost of freedom is intellectual initiative and the will to use intelligence intelligently.

Summary and Methodological Implications

The following matrix summarizes the views of rationality held by Schumpeter and Knight.

	Joseph A. Schumpeter	Frank H. Knight
Individual Economic Rationality in Capitalism	Psychological Superstructure of Capitalist Economic System	Too Limiting Definition of Human Beings
	Common Logic in Economic Relations	Necessary for Economic Models, But Unrealistic
	Self-defeating Principle	Produces Critical Mind-Set
Collective Political Rationality in Democracy	Uncommon Among "Typical" Citizens	Impossible Without Agreement on Common End
	Impossible Without Common Will	Insufficient Public Knowledge for Rational Actions
	Promotes Socialist Development	Preferred Critical Intelligence

Schumpeter contends that the "matrix of logic" in economic life is rationality; the socio-psychological superstructure of capitalism is founded upon rational cost-profit calculations; and, rationalism inspires an almost universal hostility to capitalism which will promote the demise of the capitalist system. As an evolutionist, Schumpeter believes rationality develops as institutions of the capitalist economic system take shape. Money facilitates the cost-profit calculus, and social legislation fosters both the economic status and the cognitive ability to act rationally. Also, the Schumpeterian concept of rationality includes the importance of social-cultural interactions as class affects "rational" economic decisions.

The view of rationality held by Knight is more sanguine than Schumpeter's. Knight argues that life is more than economics and rational conduct, and that living intelligently requires more than acting rationally toward unexplained ends. Further, in Knight's view most economic activity is rivalrous and contentious, and, thus, irrational. He thoroughly proves the irrationality of complete rationality with his description of the "economic man." He also contends that liberal culture's "liberation of the mind" releases a tendency to be critical of capitalist relations. Ultimately, Knight replaces economic calculation with critical intelligence as the imperative mental process for democratic economic and political action.

The popularization of rational-expectations macroeconomics (REM) has rekindled interest in defining rational individual economic actions. In fact, the economic policy debate between rational-expectations theorists and Keynesians is founded on the controversy over efficient formulation of rational expectations. REM theorists contend that existing Keynesian macroeconomic models cannot provide reliable guidance in the formulation of monetary or fiscal policy. The fundamental assumption of REM is that people make rational choices based upon the latest available data and the best available economic theory. The striking macroeconomic policy implications of such a postulate is that government cannot "fool" the people and, hence, countercyclical policies will not affect macroeconomic performance.

The theoretical synthesis presented in this study of Schumpeter and Knight's views on individual and collective rationality suggests that the average citizen/-consumer is less than an unbiased and efficient information processor; there is no rational economic man. The macroeconomic policy implication of these findings is that predictable government policies can affect employment and output.

Further, the unlikelihood of rational utility maximization noted by Schumpeter and Knight undermines the microeconomic assumption of rationality and warrants further methodological consideration. Perhaps Samuelson's consumer theory whereby individuals are consistent in their tastes and actions is the appropriate assumption for modeling behavior and should be further developed. To conclude, if policy recommendations are to be based upon economic theory, then assumptions about rationality must be realistic. Likewise, if microeconomic models of utility maximization are to be useful, a thorough understanding of consumer rationality is imperative. An awareness of the concepts of Schumpeter and Knight on individual and collective rationality should contribute to such a realistic understanding of rationality for the science of economics.