Risk, Uncertainty, and Nonprofit Entrepreneurship

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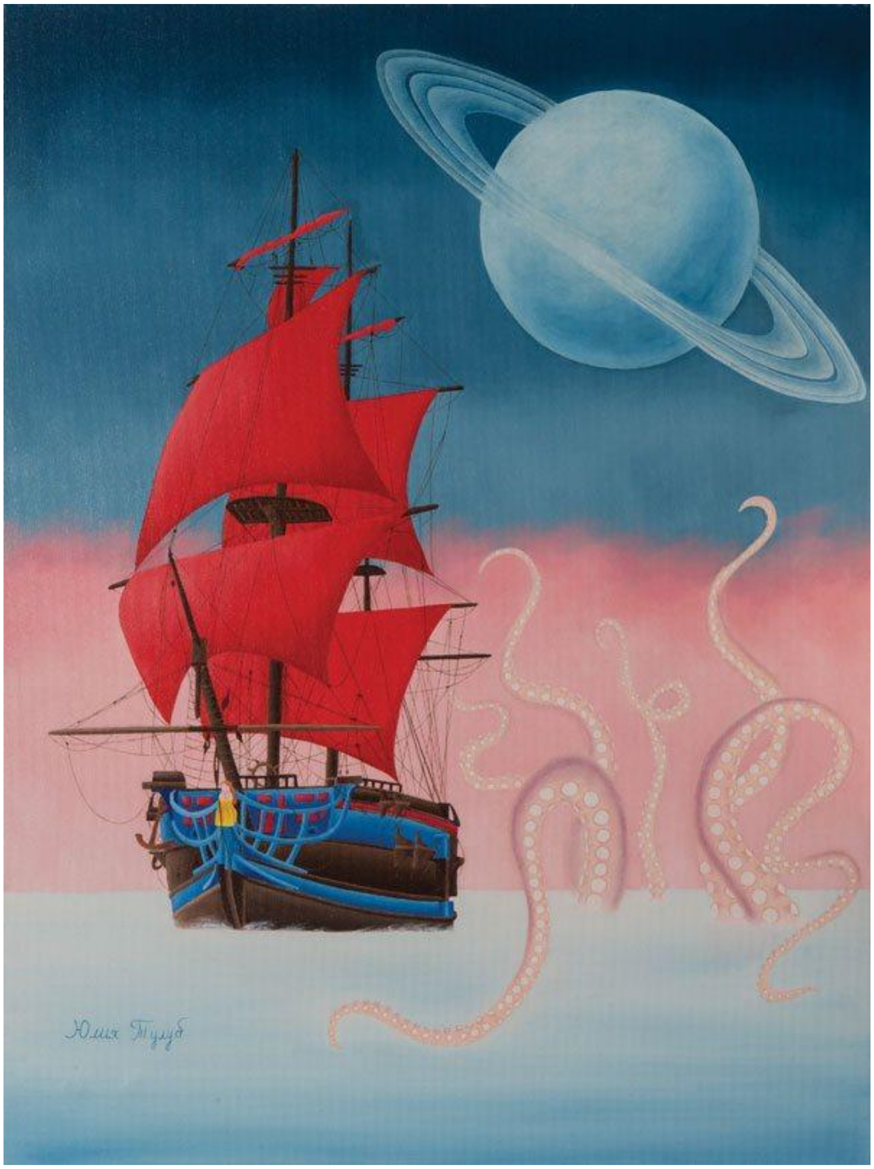

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[As] we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know.

—Donald Rumsfeld[1]

I'll admit, I don't normally look to former defense secretary Donald Rumsfeld for keen scholarly insight. However, Rumsfeld's now (in) famous passage eloquently illuminates what this article is all about: the importance of separating the risky from the uncertain. As Nicolai Foss and Peter Klein noted in *Organizing Entrepreneurial Judgment: A New Approach to the Firm*, the above quote also captures and helps explicate a principal function of entrepreneurship.[2] Drawing from the seminal work of Chicago economist Frank Hyneman Knight, the goal of this article is twofold: first, to discuss the difference between risk and uncertainty; and second, to deliberate on why the latter is essential for comprehending nonprofit sector entrepreneurship.[3]

The Difference Between Risk and Uncertainty

Frank Hyneman Knight (1885–1972) is perhaps not the most recognized economist of the twentieth century. Yet, as a scholar he provided early and important contributions to the study of financial markets and entrepreneurship. He also mentored several noteworthy students at the University of Chicago, including Nobel Prize recipients James M. Buchanan, George Stigler, and Milton Friedman. One key area of interest for Knight was economic dynamism, and in particular the link between economic change and knowledge. Rooted in his doctoral thesis, Knight's book, *Risk, Uncertainty, and Profit* (1921), argued for—and introduced—his now illustrious distinction between risk and uncertainty.

To elucidate the difference between the concepts, Knight focuses on three types of probability, in which circumstances involving two of the types can be said to capture risky situations, and circumstances involving the third type can be said to capture situations entailing uncertainty. *A priori probability* reflects situations where one can assess the probability of an event in a deductive manner. Imagine visiting a casino: When playing blackjack or standing at the roulette table, you not only know where these events will take place (i.e., you can define the state space—set of all possible configurations—of the game) but you can also come up with the probability of where the ball will land or the probability of pulling a certain card from the deck (which is the basis for the codified basic strategy in blackjack). Hence, roulette (for example) involves taking a risk knowing what you know with regard to the probability that the ball will land on red or black (and this number or that number).

The second type is *statistical probability*, which reflects situations in which the probability emerges as the result of experiences and events. In other words, by looking at and learning from empirical data, we can start to figure out and calculate the probability of certain situations. Consider, for example, how an insurance company operates. By studying and learning from data using numerous repeated events, such as car accidents, an insurance company can get a pretty good understanding of the probability of car accidents in different situations. Again, driving and owning a car involve risk, but by joining with others and pooling these risks, we are also able (or at least given the option) to insure against them.

The final type of probability is *estimated probability*, which Knight depicts in the following way:

The distinction here is that there is *no valid basis of any kind* for classifying instances. This form of probability is involved in the greatest logical difficulties of all, and no very satisfactory discussion of it can be given, but its distinction from the other types must be emphasized and some of its complicated relations indicated.[4]

Situations with estimated probability are not risky but, rather, uncertain, and shaped by "the fact of ignorance and necessity of acting upon opinion rather than knowledge."[5] What Knight here suggests is that true uncertainty can never be removed, addressed, or eradicated through the use of a priori or statistical probability; nor can it be insured against. Instead, when dealing with uncertainty, we must rely on judgment and put the resources we control in play in anticipation of future uncertain returns.

Uncertainty and Nonprofit Entrepreneurship

So what does this have to do with entrepreneurship? To answer this question, we need to start by saying something about the time when *Risk, Uncertainty, and Profit* was first published. During the early twentieth century, many economists had started to discuss how new economic value could be generated under conditions of perfect competition. Several economic models of the time postulated that competition on the free market would always reduce profits to zero—that is, reach an equilibrium with no profit. Hence, an obvious question arose: How does new profit come about? Knight offered the following answer:

Profit arises out of the inherent, absolute unpredictability of things, out of the sheer brute fact that the results of human activity cannot be anticipated and then only in so far as even a probability calculation in regard to them is impossible and meaningless.[6]

Knight is postulating that in order to unlock and potentially extract profits, one must engage in uncertain market activity. That is, decisions must be made and actions must be taken not knowing what the expected total returns will be, how much to produce, what quantity of product input to purchase, and so on. This is, in essence, the function of the Knightian entrepreneur: the undertaker under uncertainty. What distinguishes entrepreneurship from other economic phenomena is the activity of bearing uncertainty—or what economist Peter Klein identifies as "judgmental decision making under conditions of uncertainty."[7] Put somewhat differently, entrepreneurship clarifies how new value (in this case, taking the form of profit) is generated by directing our attention to the notion that entrepreneurs can be compensated with concomitant rewards and returns for having the prudence and willingness to take action, bestow resources up front, and put their reputation on the line in the face of uncertainty, where judgment represents their only available guide.

Today, Knight's work is considered one of the classical economic theories of entrepreneurship (alongside work of other scholars such as Joseph Schumpeter, Ludwig von Mises, and Israel Kirzner). Clearly, these theories focused on entrepreneurship from the perspective of firms operating in the private market, which raises the question of whether insights from these theoretical contributions have any utility in studying the various strands of social entrepreneurship, including those seeking to apply the entrepreneurship concept to the nonprofit sector. Several scholars maintain that the answer to this question is yes. Gordon Shockley and Peter Frank, for example, posit that "the tenets of the *[sic]* Schumpeter's and Kirzner's classical economic theories are perfectly suited to giving coherence to social entrepreneurship theory, indeed possibly for all forms of 'non-market' entrepreneurship."[8] Likewise, Wolfgang Bielefeld makes the observation that because social entrepreneurship stands on the shoulders of business entrepreneurship, "at the very least, all of the factors associated with entrepreneurship are potentially relevant to social entrepreneurship as well."[9]

Furthermore, there is an apparent need for more theory discussion, clarification, and development in the social sector entrepreneurship field. Certainly, over the past decade, progress has been made. Still, social entrepreneurship (in particular) is often used more as a slogan or inspirational catchphrase than a theoretical framework for testing and building a rigorous body of academic knowledge. Theory development is not an easy or rapid process, and whether it is possible to link social sector entrepreneurship to economic entrepreneurship theory remains to be seen.

However, this author believes the Knightian perspective has much to offer those interested in nonprofit entrepreneurship, because, just like for-profits, nonprofits seek and control resources and deploy those resources in anticipation of uncertain gains, trying to avoid losses.

Undoubtedly, as we overlay and apply the Knightian template to the study of nonprofits, there will be areas and features that do not align, fall outside its boundaries, generate tension, and so on—but herein also lie opportunities and challenges for nonprofit scholars to twist, turn, and debate. Thus, in the final section of this article, I will point out some of the key implications of the Knightian approach for studying nonprofit entrepreneurship.

Nonprofit Entrepreneurship: Being Different, Starting Organizations, Marshaling Resources, and Lighting Fires

Many discussions about nonprofit entrepreneurship center on the quality of newness, but I view nonprofit entrepreneurship to be much more about *difference*, and the question of how difference is generated. As economist Mark Casson notes: "The entrepreneur believes that he is right, while everyone else is wrong. Thus the essence of entrepreneurship is being different—being different because one has a different perception of the situation."[10] In *Organizing Entrepreneurial Judgment*, Foss and Klein discuss why shouldering uncertainty is key to understanding entrepreneurship. According to Foss and Klein, the most vital feature of Knight's distinction between risk and uncertainty is not whether probabilities can be calculated but rather how they are estimated and ultimately shared with others. "Knightian uncertainty is thus primarily about *the ability to articulate and communicate, or transfer, estimates about the future.*"[11]

So, even though the nonprofit entrepreneur may have a clear vision or image of what to do, he or she cannot fully portray, compress, and explicate the details of this vision using any of the tools and techniques associated with risk analysis. Put differently, the properties of uncertainty make it exceedingly difficult for any nonprofit entrepreneur to convey and communicate his or her entrepreneurial vision in such a way that other actors (e.g., funders) are able to assess its value and implications. As Wim Wiewel and Albert Hunter noted more than thirty years ago:

Just as it is hard for a new business to convince a bank that it will prove to be a good investment, new not-for-profit community organizations have a hard time convincing foundations, corporations, and city departments of their worthiness. The problem for a new organization is that it has nothing to offer but promises.[12]

The consequence of uncertainty is that “there is no market for the judgment that entrepreneurs rely on,” which is why entrepreneurs often find it necessary to start new organizations as the primary vehicle for taking on the unknown unknowns in the pursuit of making a difference.[13]

The Knightian approach does not only help to elucidate why new nonprofits emerge. The notion that entrepreneurial judgment is costly has further implications—namely, that in order to exercise judgment, one must obtain control over and marshal resources.[14] Hence, a key question nonprofit scholars must examine is, how do nonprofit entrepreneurial agents come to control such resources? Furthermore, how do nonprofit entrepreneurial agents organize and employ scarce resources? Because the Knightian perspective stresses deeds, merely possessing resources does not make one a nonprofit entrepreneur. Entrepreneurial judgment is ultimately residual, so the control of resources is imperative because it permits the nonprofit entrepreneur to control the decision making surrounding how, when, and where to deploy such resources.

What makes Knight’s perspective interesting and appealing from a nonprofit entrepreneurship perspective is that uncertainty in the nonprofit domain takes on a character that is an order of magnitude and complexity higher than in the private domain. For example, if one accepts the notion that the nonprofit sector exists due to market failure, then nonprofit entrepreneurs are indeed true bearers of uncertainty, given the complexity of the multiple “markets” they must operate in simultaneously.

Adding another layer of complexity is the fact that many of the resources used by nonprofits are jointly owned and controlled. In other words, a critical area for nonprofit scholars to investigate is how nonprofit entrepreneurial agents not just obtain but also maintain control over resources (tangible and intangible) to invest in their entrepreneurial efforts and in anticipation of uncertain future rewards.

Finally, nonprofit entrepreneurs and nonprofit organizations are deeply dependent on others—for example, their board, donors, volunteers, and community. The centrality of this interconnectedness brings to the forefront the relational and social aspects of nonprofit entrepreneurship. Consequently, a major task for nonprofit entrepreneurs willing to shoulder uncertainty is to connect with and influence others who share their mission and vision. The Swedish scholar Daniel Hjorth uses the metaphor of fire to describe this particular element of the entrepreneurial process—that is, the ability of the entrepreneur to ignite his or her entrepreneurial flame in others:

The breakout of the entrepreneurial event is described in terms of fire and as the release of creative social energy. It is the desire to achieve this event, to be part of creating it, and to become part of this fire (to be lit) that attracts people into the entrepreneurial process. Using fire to understand entrepreneurial processes further highlights the role of passion and politics in such processes. It also highlights the drama of the event of entrepreneurship.[15]

In recent years, I've sensed that the discussion about nonprofit entrepreneurship is becoming increasingly preoccupied with economy, calculation, and strategic decision making. Hjorth's depiction reminds us that we also need to focus on the narrative of the nonprofit entrepreneurial process, where passion, social interaction, wit, and reciprocity are equally essential elements in the process of negotiating uncertainty.

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In a popular article, Roger Martin and Sally Osberg make a simple yet critical observation: no matter what prefix we seek to attach to the entrepreneurship concept (social, nonprofit, institutional, etc.), we must first clarify and comprehend what we mean by entrepreneurship.[16] This article highlights uncertainty, as articulated by Knight, and the notion of judgment as intriguing and fruitful starting points for comprehending the notion of entrepreneurship and advancing nonprofit entrepreneurial thinking.

I want to end by pointing to two areas for continued discussion and future exploration. A central task for those seeking to advance the Knightian perspective is to explicate and conceptualize the specific mechanisms of judgment. Because we still know relatively little about the processes by which nonprofit entrepreneurs form their beliefs about future conditions, further research is needed to begin comprehending the cognitive as well as behavioral feats that establish and shape estimates of the future.[17] Also, it is important not to assume that entrepreneurs are wiser or endowed with better judgment abilities about uncertain futures. After all, many entrepreneurial undertakings fail, which implies the frequent occurrence of poor choice making and/or poor use of scarce resources. Instead, we need to acknowledge nonprofit entrepreneurship as an experimentally oriented process. Hence, nonprofit entrepreneurship signals action, in which the nonprofit entrepreneur continuously gathers, organizes, reorganizes, and puts resources into play, in pursuit of uncertain returns.

Though the notion of nonprofit entrepreneurship as a process may seem obvious, many scholars and practitioners still tend to ignore its implications. Processes take time—meaning we must have a theory that can capture and depict changes over time, and methods to study them that reflect this process. We cannot allow urgency and pursuit of short-term gain to crowd out what is important and takes time to develop.