COURSE ECO3054 INSTRUCTOR Luke Boosey Page 1 of 4 Pages

TODAY'S SUBJECT Rabin's Critique DATE 3/28/17

* Read Rabin's Critique Paper
• Rabin's Critique

→ In the expected utility model, we equate risk aversion with diminishing marginal utility of wealth (concavity of the utility function)

→ Explains much of our aversion to large-scale financial risk

→ However, when it comes to small or even moderate stakes, diminishing marginal utility is a poor representation of risk aversion

→ In order to explain risk aversion ~~of~~ over these smaller stakes, the utility function must exhibit preposterously severe risk aversion over large stakes

→ To be more reasonable in regards to large-scale gambles (where expected utility seems more appropriate) the theory should imply that people are virtually risk neutral over small and moderate stakes gambles

Ex) Suppose Johnny is a risk-averse EU maximizer and that he will always reject the 50-50 gamble of losing \$10 or winning \$11. If there is a 50-50 chance of losing \$100 and winning some amount \$Y, then Johnny will reject the bet no matter what value Y takes.

* The concavity implies diminishing marginal utility.

→ For large stakes, Rabin argues that expected utility theory remains a useful and adequate model of risk aversion