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Comments on "The Allocation of Social Risk"

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"By "uncertain" knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory Bond being drawn. Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth-owners in the social system in 1970. About these matters there is no scientific basis on which to form any capable probability whatever. We simply do not know. Nevertheless, the necessity for action and for decision compels us as practical men to do our best to overlook this awkward fact and to behave exactly as we should if we had behind us a good Benthamite calculation of a series of prospective advantages and disadvantages, each multiplied by its appropriate probability, waiting to be summed." 1/

The above is how Keynes in his rebuttal to Viner's review characterized the uncertainty relevant to the behavior of a capitalist economy. It followed from this view that wealth was "---a peculiarly unsuitable subject for the methods of the classical economic theory."

The papers under consideration take the Arrow-Debreau state preference approach to uncertainty seriously and generally speaking apply the model to determine whether insurance contracts can be designed so as to realize classical optimal situations. I will examine whether the Arrow-Debreau model can throw light on how uncertainty enters into macro economic theory and analysis, in particular the generation of social risk.

1/ Keynes, J. M. "The General Theory of Employment" Quarterly Journal of Economics, February, 1937.

Even though this session is on social risk,only Brainard-Dolbear define and discuss the concept. They define social risk as "uncertainty in the aggregate consumption opportunities of society." As Kihlstrom-Pauly point out, in the standard Arrow-Debreau scheme there is " --- an objective probability distribution Pr ( ) over the set {1 --- T} of states and that this is known to all consumers," thus the Brainard-Dolbear definition merely extends the set of states of nature and associated probabilities to include variable aggregate consumption levels.

An alternative view of social risk follows from the Keynes citation. Even though at each instance decisions are made as if Benthamite calculations are appropriate, in truth each actor knows that for many problems his views are based on a limited capacity to scan alternatives and vague conjectures as to the likelihood of the various alternatives taking place. Thus, a degree of confidence is associated with the assigned probabilities and actors recognize that other states of nature, pay-offs and probability distributions are possible. Events will modify views as to possible alternatives and relevant probabilities, and these events need not be markedly different from events which would not have had this effect. Thus the behavioral relations that depend upon these changeable subjective conjectures are unstable

This need to make decisions in the face of known instabilities leads to social risk. Brainard-Dolbear recognize this in their asides on cyclical phenomena. The other authors are not directly concerned with these issues, although the costs of information considered by Kihlstrom-Pauly suggests why subjective evaluations cannot be avoided.

This is 1970. The financial happenings of 1966 and 1970 have instructed us in how events induce changes in the contemplated states of nature and the probability associated with each state. However, these events did not happen in a vacuum. The ground was set by strong expansions that were largely financial by portfolio adjustments. In both instances the Federal Reserve induced rundowns in particular bank liabilities and forced banks and non-banks into novel financial instruments for position making. Increasingly, liability structures were generated whose viability depended upon the proper functioning of special financial markets. In both years, fears arose that market failure was not only possible, but imminent. Even though such failure was aborted by prompt Federal Reserve action, a revision of the states contemplated and their associated probabilities occurred.

Both years were preceded by periods of rapidly increasing investment demand. Liability experimentation more than offset the modest attempts by the authorities to restrict credit. Given the economy's history of business cycles, the initial set of likely states of nature and probability distribution induced conservative portfolio choices. The run of success modified both the alternatives considered and the associated probability distribution. Prolonged success of the economy erodes the felt uncertainty and thus induces both an investment boom and by shifting liquidity preference helps to generate the needed financing. Central bank action is ineffective in constraining such expansions unless it can increase felt uncertainty. In such circumstances, policy needs to bring the economy to the brink of failure of some financial markets.

Once successful brinkmanship increases the felt uncertainty, it is unlikely that an easing of financial dangers will lead to a quick resumption of strongly expanding investment demand.

The papers show that Arrow-Debreau format can yield insights into the design of insurance schemes and it helps make precise the obstacles to the achievement of optimality by way of insurance. However, for many phenomena the ingredients to a state-preference view are both subjective and unstable. Nevertheless, the Arrow-Debreau schema is valuable, for it allows us to inquire into how the subjective states of nature and their probabilities are determined. In particular, it enables us to state the Keynesian ideas about uncertainty more precisely. The Arrow-Debreau formalization can be used to argue that the scale of investment can " ---fluctuate for reasons quite distinct --- from those physical conditions of technical capacity to aid production which have usually been supposed hitherto to be the chief influence governing the marginal efficiency of capital." (Keynes op cit) and thus it is a valuable ingredient to business cycle theory.