
Catastrophic risks

Graciela Chichilnisky

Columbia University,
335 Riverside Drive, New York, NY 10025, USA
E-mail: chichilnisky1@gmail.com

Abstract: Catastrophic risks are rare events with major consequences and of great interest to green economics. The article investigates the way economics deals with catastrophic risks. Classic expected utility theory is insensitive to rare events no matter how important these may be, based on the axioms of Von Neumann (1944), Arrow (1971) and DeGroot (1970/2004) that define proximity of observations in terms of ‘averages’ obliterating outliers. A new axiomatic extension to the theory of choice introduced new axioms that are sensitive to rare events, and characterised the criteria that these imply (Chichilnisky, 1996, 2000, 2002, 2010; Lawuers, 1993). These are expected utility combined with a new term that focuses on extremal events, explaining ‘fat tails’ and ‘outliers’. Continuity based on ‘the topology of fear’ provides the required sensitivity to rare events (Chichilnisky, 2009c). Experimental evidence for the new axiomatic treatment is in Chanel and Chichilnisky (2009). The results relate to Debreu’s (1954) work on Adam Smith’s Invisible Hand and Le Doux’s (1996) work on the neurological responses to fear.

Keywords: catastrophic risks; risk and uncertainty; outliers; rare events; axioms of choice; topology; fear.

Reference to this paper should be made as follows: Chichilnisky, G. (2009) ‘Catastrophic risks’, *Int. J. Green Economics*, Vol. 3, No. 2, pp.130–141.

Biographical notes: Graciela Chichilnisky has worked extensively in the Kyoto Protocol process, creating, designing and writing the carbon market that became international law in 2005. She also acted as a lead author of the Intergovernmental Panel on Climate Change, which received the 2007 Nobel Prize. A frequent keynote speaker, special adviser to several UN organisations and heads of state, her pioneering work uses innovative market mechanisms to reduce carbon emissions, conserve biodiversity and ecosystem services and improve the lot of the poor. She is a Professor of Economics and Mathematical Statistics at Columbia University and the Sir Louis Matheson Distinguished Professor at Monash University.

1 Introduction

This article¹ is an investigation on the way that mathematical economics deals with the sort of catastrophic risks that are of great interest to green economics, such as climate change and the extinction of a species. Catastrophic risks are rare events with major consequences. They include the 2008–2009 global financial crisis that is a one-in-a-hundred-years event with momentous consequences for global markets, and more generally any rare event that threatens human survival – such as a large asteroid impact

(Posner, 2004; United Nations, 2000). The article addresses the *IJGE* reader who is quite sceptical of over reliance on mathematical methods (Vol. 1, Nos. 3/4 of *IJGE* deals with this issue).² While not denying that over reliance on mathematical methods can obscure economic insight, the article shows how through the prism of advanced and perhaps more imaginative mathematics one can develop a more comprehensive and sensitive treatment for rare events. These events can transform our social universe – and are of great interest in green economics such as the momentous change caused by the 1997 creation of the Kyoto Protocol carbon market that changed energy markets globally. Also changes in the market participation of women, and of developing nations in global markets leading to widespread outsourcing. The article shows how to rewrite the foundations of statistics – the way we observe the universe around us – so as to systematically incorporate ‘outliers’ and ‘fat tails’ in our formal discourse, and how to develop a decision theory that agrees with the recent neurological experiments on how the human brain reacts to fear – both of which are denied in conventional Von Neumann Morgenstern theory of decision under uncertainty.

This article summarises how the classic Von Neumann theory of choice under uncertainty evaluates catastrophic risks, and traces how and why it is insensitive to rare events. The classic theory was developed axiomatically by Morgenstern, Hershkowitz and Milnor, Villegas, Arrow, De Groot and others.³ The point of the article is to show how the classic axioms evaluate catastrophic risks – to explain their insensitivity to rare events no matter how catastrophic they may be (Posner, 2004; Tversky and Wakker, 1995; Chichilnisky, 2000, 2009c), leading therefore to a ‘disconnect’ between decisions involving classic economic theory, and the way green economics and many human societies react to potential catastrophes such as global warming and widespread biodiversity extinction. Without throwing the baby out with the bathtub water, the article explains a recent sharp generalisation of the classic theory of decision making under uncertainty that requires equal treatment of frequent and rare events and is sensitive to catastrophic events, explicitly incorporating outliers and explaining the common observation of ‘heavy tails’ as part of the standard statistical treatment (Cass et al., 1996; Chichilnisky, 1977, 1996, 2000, 2002, 2006, 2009b, 2009c; Chichilnisky and Wu, 2006; Chanel and Chichilnisky, 2009). The recent treatment of catastrophic risks presented here is linked to the early work of Gerard Debreu (1954) on Adam Smith’s invisible hand, the two welfare theorems of economics, and to the work of Kurt Godel (1940) on the axiom of choice and the ‘incompleteness’ of mathematics. We illustrate the connection between rare events and the foundation of statistic analysis in econometrics (Chichilnisky, 2009b), and recent neuro-economic evidence of how humans choose when they face catastrophes and under conditions of fear (Le Doux, 1996; Chichilnisky, 1977; Chanel and Chichilnisky, 2009).

2 Classic axioms of choice under uncertainty

Over half a century ago, Von Neumann and Morgenstern (1944), Hershkowitz and Milnor (1953) and Arrow (1963) introduced axioms to explain how we choose under conditions of uncertainty, see also Villegas (1964), Arrow (1963) and De Groot (1970/2004). The main consequence is to predict that we rank our choices under uncertainty (also called

‘lotteries’) according to their ‘expected utility’, namely by optimising a function defined on lotteries $c(t)$ of the form

$$\int_R u(c(t))d\mu(t),$$

more on this below. The practical importance of the classic theory is underscored by the fact that US Congress requires its use in cost benefit analysis of any major budgetary decision. Decisions based on ‘expected utility’ have been elevated to the status of ‘rational decisions’, and rational behaviour under uncertainty has become identified with optimising expected utility. Indeed, in many cases ‘rationality’ has come to mean ‘optimising expected utility’.

Yet for almost as many years as the classic theory exists, experimental and empirical evidence has questioned the validity of the expected utility model. Well known examples of diverging experimental evidence include the Allais paradox (Allais, 1988), and practical ‘puzzles’ in finance such as the ‘equity premium puzzle’ and the ‘risk free premium puzzle’ (Mehra, 2003; Mehra and Prescott, 1985; Reitz, 1988; Weil, 1989), showing that the returns from equity and bonds are orders of magnitude different in practice from what expected utility analysis would predict. Early theoretical developments of this critical line of thought include Tversky and Wakker (1995), Machina (1982, 1989) and Kahneman and Tversky (1979) leading more recently a new field of decision analysis, *behavioural economics*, which questions rational behaviour interpreted as expected utility optimisation.

This article focuses on one aspect of the classic theory: how it deals with *catastrophic risks* and the issues that arise as well as the links that these issues, with the classic work on Adam Smith’s invisible hand, with the foundation of non-parametric estimation, with Godel’s fundamental theorems on the incompleteness of mathematics, with the foundations of statistics and how it treats ‘outliers’ and ‘heavy tails’, as well as with the experimental evidence of how we choose when we face rare events that inspire fear.

In the following we summarise the motivation and provide the mathematical context. We then provide new axioms for decision under uncertainty that update the classic axioms in a way that coincides with Von Neumann’s axioms in the absence of catastrophic events – so it represents a true extension of the existing theory – while improving their sensitivity to rare events. A representation theorem identifies new types of probability distributions that rank lotteries in situations involving catastrophic events, combining expected utility (which averages risk) with extremal reactions to risk: these are convex combinations of ‘countably additive’ and ‘finitely additive’ measures. An intuitive example of the new type of rankings is *to optimise expected returns while minimising losses in a catastrophe*. This is a natural criterion of choice under uncertainty that seeks to limit the downside damages of a catastrophe – but it is inconsistent with expected utility.

3 The topology of fear

‘Expected utility’ analysis anticipates average responses to average risks, which seems fair enough. But it also anticipates average responses to extreme risks. The latter is more questionable. Through magnetic resonance imaging (MRI) Le Doux (1996) has shown that humans often use a different part of the brain to deal with fear: we use the *amygdala*

rather than the *frontal cortex* to make decisions on events that elicit fear. The amygdala is a primitive part of the brain that handles extreme emotions, and as such provides very simplified responses to risk. It causes *extremal responses to extreme risks*. When we feel fear, rather than averaging the evidence using probabilities, as we do with expected utility, we have extreme and simplified responses, for example a zero/one response such as ‘flight or fight’. This finding is the key to understanding how Von Neuman’s (VN) theory under represents catastrophic risks, and to update the theory to represent more accurately how we behave when we face fear. The key can be found in the topology we use to evaluate ‘nearby events’, the foundation of statistical measurements. The reason is simple. Topology is by definition the way we formalise the concept of ‘nearby’. Mathematically, the VN axioms postulate nearby responses to nearby events, a form of continuity that is necessary for empirical validation and robustness of the theory. But the specific topology used in the definition of continuity by Arrow (1963), Heston and Milnor (1953) and De Groot (1970/2004) means that they anticipate that nearby is measured by averaging distances. Under conditions of fear, however, we measure distances differently, by extremals. Mathematically the difference is as follows: average distance is defined by averaging coordinate by coordinate as in Euclidean space;⁴ in continuous function spaces on the real line (such as $L_p(p < \infty)$, and Sobolev spaces) the average distance is defined as

$$\|f - g\|_p = \left(\int |f - g|^p dt \right)^{1/p}$$

Extremal distances are measured instead by the supremum of the difference, namely by focusing on extremes,⁵ for example, using the *sup norm* of L_∞ :

$$\|f - g\|_\infty = \text{ess sup}_R |f - g|$$

Changing the topology, namely the way we measure distances, changes our approach to risk: it leads to new ways to evaluate catastrophes. If we use a topology that takes extremals into consideration, our actions become more sensitive to extremal events no matter how rare they may be. We call this the ‘topology of fear’ (Chichilnisky, 2009c) because it focuses sharply if not uniquely on the worst that can happen in the case of catastrophes. This is the approach followed in Chichilnisky (1996, 2000, 2009c, 2002, 2009b, 1977). The new axioms for choice under uncertainty introduced in this work agree with the classic theory when catastrophic events are absent, but otherwise they lead to a different type of statistics and econometrics that is based on regular measures combined with singular measures (Chichilnisky, 2000), more on this below.

4 Mathematics of risk

A few definitions are needed. A system is in one of several possible states which can be described by real numbers, the integers or a bounded segment of real numbers. Here we choose the real line for simplicity. To each state $s \in R$ there is an associated outcome, so that one has $f(s) \in R^N$, $N \geq 1$. A description of probabilities across all states is called a *lottery* $x(s): R \rightarrow R^N$. The space of all lotteries L is therefore a *function space* L . Under uncertainty one ranks lotteries in L . Von Neumann-Morgenstern’s (NM) axioms provided

a mathematical formalisation of how to rank lotteries. Optimisation according to such a ranking is called ‘expected utility maximisation’ and defines decision making under uncertainty. To choose among risky outcomes, we rank lotteries. A lottery x is ranked above another y if and only if there is a real valued continuous function on lotteries, W , that assigns to x a larger real number than y :

$$x \succ y \Leftrightarrow W(x) > W(y)$$

5 Expected utility

The main result from the VN axioms is a *representation theorem* that explains in practice how to choose under uncertainty.

Theorem: (VN, Arrow, Hershstein and Milnor) A ranking over lotteries which satisfies the VN axioms admits a representation by an *integral operator* $W : L \rightarrow R$, which has as a ‘kernel’ a countably additive measure over the set of states, with an integrable density. This is called *expected utility*.

The VNM representation theorem proves that the ranking of lotteries is given by a function $W : L \rightarrow R$,

$$W(x) = \int_{s \in R} u(x(s)) d\mu(s)$$

where the real line R is the state space, $x : R \rightarrow R^N$ is a ‘lottery’, $u : R^N \rightarrow R^+$ is a (bounded) ‘utility function’ describing the utility provided by the (certain) outcome of the lottery in each state s , $u(x)$, and where $d\mu(s)$ is a standard countably additive measure over states s in R . The optimisation of an expected utility W is a widely used procedure for evaluating choices under uncertainty. Euler equations are used to characterise optimal solutions.

6 What are catastrophic risks?

A catastrophic risk is a small probability – or rare – event which can lead to major and widespread losses. Classic methods do not work: it has been shown empirically and theoretically (Posner, 2004; Chichilnisky, 1996, 2000, 2009c) that using VNM expected utility criteria undervalues catastrophic risks and conflicts with the observed evidence of how humans evaluate such risks. Mathematically the problem is that the measure μ which emerges from the VNM representation theorem presented above, is *countably additive* implying that any two lotteries $x, y \in L$ are ranked by W quite independently of the utility of the outcome in states whose probabilities are lower than some threshold level $\varepsilon > 0$ depending on x and y . This means that expected utility maximisation is insensitive to small probability events, no matter how catastrophic these may be. As shown in Chichilnisky (2000) the properties of the measure arise from continuity under an L_1 norm and when one changes this to continuity under a L_∞ norm, the sup norm, one obtains in general different types of measure. Formally the problem with VN axioms is the following.

7 Expected utility is insensitive to rare events

A ranking W is called *insensitive to rare events* when it ranks two choices focusing on their outcomes in frequent events, and neglects their outcomes are rare events. Formally,

Definition 1: A ranking W is *insensitive to rare events* when

$$W(x) > W(y) \Leftrightarrow \exists \varepsilon > 0, \quad \varepsilon = \varepsilon(x, y): \\ W(x') > W(y')$$

For all x', y' such that

$$x' = x \text{ and } y' = y \text{ a.e. except on } A \subset R: \mu(A) < \varepsilon.$$

In words, W ranks x above y if and only if it ranks x' above y' for any pair of lotteries x' and y' which are obtained by modifying arbitrarily x and y in sets of states A with probability lower than ε . The interpretation of this property is that the ranking defined by W is *insensitive* to the outcomes of the lottery in rare events. Similarly,

Definition 2: A ranking W is called *insensitive to frequent events* when it ranks choices focusing exclusively on rare events, and neglects frequent events:

$$W(x) > W(y) \Leftrightarrow \exists M > 0, \quad M = M(x, y): \\ W(x') > W(y')$$

for all x', y' such that

$$x' = x \text{ and } y' = y \text{ a.e. on } A \subset R: \mu(A) < M.$$

Proposition 1 Expected utility is insensitive to rare events.

Proof: In Chichilnisky (2000, 2009c)

As defined by VN, the expected utility criterion W is therefore less well suited for evaluating catastrophic risks.

8 Updating Von Neumann Morgenstern axioms

A well-defined set of axioms introduced in Chichilnisky (1996, 2000) update and extend Von Neumann Morgenstern axioms by treating symmetrically rare and frequent risks. These axioms lead to a new representation theorem and define new types of criteria or functions that are maximised under uncertainty. These functions are commonly used in practice but were not used in economics, mathematics or statistics before. The result is quite different from expected utility maximisation or any other optimisation criterion used so far. The space of lotteries is L_∞ with the sup norm.

9 New axioms for choices that involve catastrophes

Here are the new axioms:

Axiom 1 The ranking $W : L_\infty \rightarrow R$ is sensitive to rare events.

Axiom 2 The ranking W is sensitive to frequent events.

Axiom 3 The ranking W is continuous and linear.

Axioms 2 and 3 are standard, they are satisfied for example by expected utility, and agree with VN axioms. But Axiom 1 negates Arrow's 'axiom of monotone continuity', which leads to expected utility. Indeed:

Theorem 1: The monotone continuity axiom (Arrow, 1963; Hershstein and Milnor, 1953) is equivalent to 'insensitivity to rare events'. It is the logical negation of our Axiom 1.

Proof: In Theorem 2, 'the topology of fear' (Chichilnisky, 1977)

Example: The monotone continuity axioms of Arrow and Milnor provides a statistical value of life (Chichilnisky, 1977). This defies the experimental evidence on how people value life (Chanel and Chichilnisky, 2007).

10 A representation theorem

As in the case of the prior VN axioms, the new axioms lead to a (new) representation theorem.

Theorem 2 (Chichilnisky, 1996, 2000, 2002): There exist criteria or functionals $\psi : L_\infty \rightarrow R$ which satisfy all three new axioms. All such functionals are defined by a convex combination of purely and countably additive measures, with both parts present.

Formally, there exists v , $0 < v < 1$, a utility function $u(x) : R \rightarrow R$ and a countably additive regular measure μ on R , represented by an L_1 density Γ , such that the ranking of lotteries $\psi : L_\infty \rightarrow R$ is of the form

$$\psi(x) = v \int u(x(s))\Gamma(s)d\mu(s) + (1-v)\Phi(u(x(s))). \quad (1)$$

where Φ denotes a purely finite measure on R .

The interpretation of (1) is straightforward. The first part of ψ is an integral operator with a countably additive kernel such as $\lambda^{-2s} \in L_1$ emphasising the weight of frequent events in the ranking of a lottery $x \in L_\infty$. This satisfies the second axiom Axiom 2, but not the first. The second purely finitely additive part assigns positive weight to rare events which have 'small probability' according to μ , it satisfies Axiom 1 but not the second axiom. An example of a function of this nature is long run averages when the catastrophic event is in the long run future. When both parts are present, ψ is sensitive to both rare and frequent events, it satisfies Axioms 1 and 2, both axioms are satisfied. Catastrophic risks are therefore ranked more realistically by such functionals.

When there are no catastrophic events, the second axiom is void. Therefore the second component of ψ ‘collapses’ to its first component, and we have

Theorem 3: In the absence of catastrophic events, the choice function ψ agrees with the expected utility criterion for evaluating lotteries. Therefore, absent catastrophes, the new theory coincides with the old.

Proof: In Chichilnisky (2009c)

11 Gerard Debreu and Adam Smith’s invisible hand

Decisions involving catastrophic events, and the topology of fear that they induce, have deep mathematical roots. We show below that the decision rule involves a new type of statistics, based on a combination of regular measures (countably additive) as well as singular measures (finitely additive). In the most general cases, the construction of a singular measure is equivalent to the construction of Hahn Banach’s separating hyperplanes and depends on the axiom of choice (Godel, 1940; Chichilnisky, 2009c). Thus extreme responses to risk conjure up the ‘axiom of choice’ an axiom that K. Godel (1940) has proved is independent from the rest of mathematics. This finding is the so called ‘Godel’s incompleteness theorem’, and demonstrates a profound ambiguity that is part and parcel of logics and mathematics, no matter how rigorous they may be. This is a critical finding in the philosophy of science and has many important practical implications.

There are also interesting implications for the foundations of statistics, or how we measure reality. The new types of probability distributions that emerge with catastrophic events are both regular and singular, exhibiting ‘heavy tails’, and were never used before. However the ‘sup norm’ topology of fear that is required to introduce sensitivity to rare events, is not new in economics. This topology was already used in 1953 by Gerard Debreu to prove Adam Smith’s invisible hand theorem (Debreu, 1954). He used the function space L_∞ with the sup norm – namely what the author has called ‘the topology of fear’ (Chichilnisky, 2009c) – to describe commodities, and to prove Adam Smith’s invisible hand theorem. This is the famous second welfare theorem of economics, which establishes that any optimal social distribution can emerge from a market equilibrium. The market reaches any optimal social solution, including the optimal allocation of risk bearing. Using Hahn Banach’s theorem, Debreu found a separating hyperplane that represents the market prices and transforms any Pareto efficient allocation into a competitive equilibrium. This is what we now call Adam Smith’s invisible hand.

The critical point in all this is that Debreu’s theorem is correct as stated – but is not constructible since, as Godel has shown, the construction of the market prices depends on Hahn Banach’s theorem and this in turn requires the axiom of choice that is independent from the rest of mathematics (Chichilnisky, 1977, 2009a). The logical and mathematical tools are rigorous and deep, but the full scope and practical implications for decision theory of Debreu’s 1953 results have not been understood before. His 1953 welfare theorems are correct – markets can support any socially optimal solutions – but the market prices at stake may not be constructible. It may not be possible to design an algorithm to compute market prices that correspond to Adam Smith’s invisible hand.

Similarly, we can decide on catastrophic events with criteria that treat rare and frequent events symmetrically, as in the new axioms required here. But the criteria may not always be constructible: in some cases the decisions may be ambiguous and we cannot ‘construct’ an algorithm that decides on the solution. The constructability of the second (finitely additive) term ψ is equivalent to the constructability of Hahn-Banach theorem, as used by G. Debreu in proving the second welfare theorem. An interesting historical observation is that Gerard Debreu published his original 1953 (Debreu, 1954) results in the *Proceedings of the US National Academy of Sciences* – and his result contains the seed for expanding Von Neumann’s theory of choice under uncertainty in a completely different direction that was meant by Von Neumann, as we saw above. In an interesting historical twist, Debreu’s NAS publication shows in its header that the article was introduced to the National Academy by John Von Neumann himself.

12 Arrow’s monotone continuity and the value of life

The axiom that leads to the second term ψ – namely the author’s Axiom 1 of sensitivity to rare events – is equivalent to the axiom of choice in mathematics and to the existence of Ultrafilters – and is therefore independent of the rest of the axioms in mathematics, see Chichilnisky (2009c). An example that comes to mind is in computing the ‘value of life’ – and recent experimental results by Chanel and Chichilnisky (2007) show the deep ambiguity involving choice when death is a possible outcome. This point comes out clearly in the ‘monotone continuity axiom’ in Arrow (1963), who makes this point by means of the following sharp example and comments (see Arrow, 1963): ‘If one prefers 10 cents to 1 cent, and 1 cent to death, then one should prefer 10 cents and a small probability of death, to 1 cent’. This example comes directly from the definition of monotone continuity definition in Arrow (1963), who calls it, ‘at first sight, outrageous’. Arrow also points out that the choice may be different if instead of 10 cents one would consider a large sum of money such as US\$1 billion. This can be seen as an ambiguity in the choice that was denied in the classical theory but appears in the new axiomatic approach to choice under uncertainty presented above. We must learn to live with ambiguity.

13 The limits of econometrics: non-parametric estimation in Hilbert spaces

At the frontiers of econometrics we find non-parametric estimation – namely econometric estimation in which we make no assumptions about functional forms. Therefore we work within a general function space – in this case a Hilbert space, which is the closest there is to Euclidean space in continuous time and was first introduced in economics in 1977 (Chichilnisky, 1977). The limit of this *NP* estimation technology is reached when one tries to remove not just the constraint on functional form but also any a-priori determination of a bound for the sample data, using as sample space the entire real line R . In such cases, a new result identifies necessary and sufficient conditions for *NP* estimation, and curiously enough this relates to the same issues that underlie choices that are sensitive to rare events.

Theorem: (Chichilnisky, 2009c) Axiom 1 requiring sensitivity to rare events is the logical negation of Assumption SP_4 in De Groot (1970/2004), which compares the relative likelihood of bounded and unbounded events. Furthermore, Assumption SP_4 is both necessary and sufficient for NP estimation in Hilbert spaces on an unbounded sample space R (Chichilnisky, 2009b).

14 Examples of the new criteria of choice

Example 1. Financial choices. In finance a typical example involves maximising expected returns while minimising the drop in a portfolio's value in case of a severe market downturn.

Example 2. Network choices. In terms of network optimisation a well-known criterion is to maximise expected electricity throughput in the grid, while minimising the probability of a 'black out'.

Both examples seem reasonable, and they agree with our three new axioms for choice under uncertainty. However they contradict expected utility, the monotone continuity axiom of Arrow (1963), the corresponding continuity axiom in Hershman and Milnor (1953) and axiom SP_4 introduced in De Groot (1970/2004).

15 Conclusions

This article summarises the classic theory of choice under uncertainty introduced by Von Neumann and its insensitivity to rare events, even to those with major consequences such as environmental catastrophes. The cause is a continuity axiom that is essential in this theory, which averages risks and defines rationality in terms of *averaging responses* even when one is confronted with extreme risks. Through this bias against rare events our classic tools of analysis underestimate the importance of environmental catastrophes, an issue of concern for green economics. This helps explain the gap between standard economic thinking and green economics. New tools are required to properly account for environmental issues and more generally for situations involving rare events with major consequences.

The article presented such new tools new axioms of choice under uncertainty introduced in Chichilnisky (1996, 2000, 2002) that are consistent with Von Neumann's expected utility in the absence of rare events – but require equal treatment for frequent and rare events and as such are quite different from expected utility. The new axioms lead to criteria of choice that seem quite natural, yet inconsistent with expected utility analysis when rare events are at stake. For example, when choosing according to the new criteria of choice one optimises expected utility moderated by a constraint on the worst outcomes in case of a catastrophe. The article showed how the new axioms rely on statistical foundations based on a notion of continuity that the author has called elsewhere 'the topology of fear' (Chichilnisky, 2009c) as it reproduces a type of behaviour (extremal responses to extremal events) that neuro-economics has observed in situations involving fear (Le Doux, 1996). The approach leads to new types of statistical distributions that are consistent with the persistent observation of 'heavy tails' and 'jump diffusion' processes, both of which are inconsistent with normal distributions, and offers a systematic

approach to including ‘outliers’ into the formal discourse. Finally we showed the connection between the new criteria of choice, the frontiers of econometrics in non-parametric estimation in Hilbert spaces, Godel’s work on the incompleteness of mathematics and the classic axioms of choice.

References

- Allais, M. (1988) ‘The general theory of random choices in relation to the invariant cardinal utility function and the specific probability function’, in Munier, B.R. (Ed.): *Risk Decision and Rationality*, pp.233–289, Reidel Dordrecht, The Netherlands.
- Arrow, K. (1963) ‘Essays in the theory of risk bearing’, *Yrjo Jahansson Lectures*, Yrjo Jahonssonin Saatio, Helsinki, and North Holland, Amsterdam.
- Arrow, K. (1971) *Essays in the Theory of Risk Bearing*, North Holland, Amsterdam.
- Cass, D., Chichilnisky, G. and Wu, H. (1996) ‘Individual risks and mutual insurance’, *Econometrica*, Vol. 64, No. 2, pp.333–341.
- Chanel, O. and Chichilnisky, G. (2007) ‘Experimental validation of axioms of choice under uncertainty involving fear’, Working paper, GREQAM, Universite de Marseille.
- Chanel, O. and Chichilnisky, G. (2009) ‘The influence of fear in decisions: experimental evidence’, *Journal of Risk and Uncertainty*, Vol. 39, No. 3, December.
- Chichilnisky, G. (1977) ‘Nonlinear functional analysis and optimal economic growth’, *Journal of Mathematical Analysis and Applications*, Vol. 61, No. 2, 15 November, pp.504–520.
- Chichilnisky, G. (1996) ‘Updating Von Neumann Morgenstern axioms for choice under uncertainty’, *Proceedings of a Conference on Catastrophic Risks*, The Fields Institute for Mathematical Sciences, Toronto Canada.
- Chichilnisky, G. (2000) ‘An axiomatic approach to choice under uncertainty with catastrophic risks’, *Resource and Energy Economics*, Vol. 22, No. 3, July, pp.221–231.
- Chichilnisky, G. (2002) ‘Catastrophic risk’, El-Shaarawi, A.H. and Piegorsch, W.W. (Eds.): *Encyclopedia of Environmetrics*, Vol. 1, pp.274–279, John Wiley & Sons, Ltd., Chichester, UK.
- Chichilnisky, G. (2006) ‘Catastrophic risks: the need for new tools, financial instruments and institutions’, *Symposium on the Privatization of Risk – Social Science Research Council*, New York, June.
- Chichilnisky, G. (2009a) ‘La paradox des marches vertes’, *Les Echos*, January 26, p.15.
- Chichilnisky, G. (2009b) ‘The limits of econometrics: nonparametric estimation in Hilbert spaces’, presented at University of Essex Conference in Honour of Rex Bergstrom, June 2006, *Econometric Theory*, Vol. 25, pp.1070–1086.
- Chichilnisky, G. (2009c) ‘The topology of fear’, *J. Math. Econ.*, Special Issue NBER General Equilibrium Conference University of Kansas in Honor of Gerard Debreu, Vol. 45, Nos. 11–12, December 2009.
- Chichilnisky, G. (2010) ‘Choice under uncertainty: the work and legacy of Kenneth Arrow’, to appear in the *Encyclopedia of Quantitative Finance*, due to publish March 2010, John Wiley & Sons Ltd.
- Chichilnisky, G. and Wu, H.M. (2006) ‘General equilibrium with endogenous uncertainty and default’, *J. Mathematical Economics*, Vol. 42, pp.499–524.
- De Groot, M.H. (1970/2004) *Optimal Statistical Decisions*, John Wiley and Sons, Hoboken, New Jersey.
- Debreu, G. (1954) ‘Valuation equilibrium and pareto optimum’, *Proceedings of the National Academy of Sciences*, Vol. 40, July, pp.588–592.
- Godel, K. (1940) ‘The consistency of axiom of choice and the continuum hypothesis’, *Annals of Mathematical Studies*, Vol. 3, Princeton University Press, Princeton New Jersey, USA.

- Hernstein, N. and Milnor, J. (1953) 'An axiomatic approach to measurable utility', *Econometrica*, Vol. 21, pp.291–297.
- Kahneman, M. and Tversky, A. (1979) 'Prospect theory: an analysis of decisions under risk', *Econometrica*, Vol. 47, No. 2, pp.263–291.
- Lawuets, L. (1993) 'Infinite Chichilnisky rules', *Economic Letters*, April, No. 4, pp.349–352.
- Le Doux, J. (1996) *The Emotional Brain*, Simon and Schuster.
- Machina, M. (1982) 'Expected utility analysis without the independent axiom', *Econometrica*, Vol. 50, pp.277–323.
- Machina, M. (1989) 'Dynamic consistency and non-expected utility models of choice under uncertainty', *Journal of Economic Literature*, December, pp.1622–1688.
- Mehra, R. (2003) 'The equity premium: why is it a puzzle?', *Financial Analysts Journal*, January/February, pp.54–69.
- Mehra, R. and Prescott, E.C. (1985) 'The equity premium: a puzzle', *Journal of Monetary Economics*, Vol. 15, No. 2, March, pp.145–161.
- Posner, R. (2004) *Catastrophes, Risk and Resolution*, Oxford University Press.
- Rietz, T.A. (1988) 'The equity risk premium: a solution', *Journal of Monetary Economics*, Vol. 22, No. 1, July, pp.117–131.
- Tversky, A. and Wakker, P. (1995) 'Risk attitudes and decision weights', *Econometrica*, Vol. 63, November, pp.1225–1280.
- United Nations (2000) *Millennium Report*.
- Villegas, C. (1964) 'On quantitative probability σ – algebras', *Annals of Mathematical Statistics*, Vol. 35, pp.1789–1800.
- Von Neumann, J. and Morgenstern, O. (1944) *Theory of Games and Economic Behavior*.
- Weil, P. (1989) 'The equity premium puzzle and the risk-free rate puzzle', *Journal of Monetary Economics*, Vol. 24, No. 3, November, pp.401–421.

Notes

- 1 The results of this article were presented at Greqam Universite de Marseille, 18 December 2008, at LAMETA Universite de Montpellier, 19 and 20 December 2008, at the *NBER-NSF General Equilibrium Conference in Honor of Gerard Debreu*, 6 October 2006, at the Statistics Department of Columbia University 11 October 2006, at the *Fields Institute for Mathematical Research Conference on Catastrophic Risks*, 1996, Toronto Canada, and at a *Staff Seminar of NHH*, University of Oslo, Norway, 21 March 2007.
- 2 In particular the article by Lawson in *IJGE*, Vol. 1, Nos. 3/4.
- 3 The classic theory of choice under uncertainty that parallels the treatment of uncertainty in physics, was created over half a century by Von Neumann and Morgentern (1944), see also Hernstein and Milnor (1953), Arrow (1963), and is based on the statistical foundations of Villegas (1964) and De Groot (1970/2004).
- 4 $d(x, y) = (\sum_i x_i - y_i)^{1/2}$.
- 5 The two topologies are the same in finite dimensional space – whether using extremals or averages – but they are radically different in continuous time models or with infinite horizons, which are needed to explain 'rare events'.