Abstract:
Classically, risk aversion is equated with concavity of the utility function. We explore the conceptual foundations of this definition. In accordance with neo-classical economics, we seek an ordinal definition of the notion (of risk aversion), based on the decisions maker's preference order alone, independent of numerical values. We explore two such definitions. We then show that when cast in quantitative form these ordinal definitions coincide with the classical Arrow-Pratt definition, once the latter is defined with respect to the appropriate scale (which, in general is not money), thus providing a conceptual foundation for the classical definition. The implications of the theory are discussed, including, in particular, to defining risk aversion for non-monetary goods, and to disentangling risk aversion from diminishing marginal utility. The entire study is within the expected utility framework.