No-Betting-Pareto Dominance*

Itzhak Gilboa†, Larry Samuelson‡, and David Schmeidler§

October 27, 2013

Abstract

We argue that the notion of Pareto dominance is not as compelling in the presence of uncertainty as it is under certainty. In particular, voluntary trade based on differences in tastes is commonly accepted as desirable, because tastes cannot be wrong. By contrast, voluntary trade based on incompatible beliefs may indicate that at least one agent entertains mistaken beliefs. We propose and characterize a weaker, *No-Betting*, notion of Pareto domination which requires, on top of unanimity of preference, the existence of shared beliefs that can rationalize such preference for each agent.

*We thank Markus Brunnermeier, José Heleno Faro, Johannes Hörner, Ben Polak, Andy Postlewaite, Anna Rubinchik, Alp Simsek, Glen Weyl, and Wei Xiong for discussions and comments. We thank the editor and three referees for helpful comments and suggestions. ISF Grant 396/10 (Gilboa and Schmeidler), ERC Grant 269754 (Gilboa), and NSF Grant SES-1153893 (Samuelson) are gratefully acknowledged.

†HEC, Paris and Tel-Aviv University. tzachigilboa@gmail.com

‡Department of Economics, Yale University. larry.samuelson@yale.edu

§The Interdisciplinary Center, Herzliya, Tel-Aviv University, and The Ohio State University. davidschmeidler@gmail.com

No-Betting-Pareto Dominance

Contents

1 Introduction **1**
- 1.1 Motivation . . . 1
- 1.2 No-Betting-Pareto . . . 2
- 1.3 Underlying Assumptions . . . 4
- 1.4 Alternative Definitions . . . 6
- 1.5 Related Literature . . . 8

2 The Model **10**
- 2.1 No-Betting-Pareto . . . 11
- 2.2 Illustration . . . 13

3 Characterizations **16**
- 3.1 Combining Agents . . . 16
- 3.2 Bets . . . 19
- 3.3 Characterization of Excluded Improvements . . . 20

4 Discussion **24**
- 4.1 Pareto Rankings . . . 24
- 4.2 A Comparison with Brunnermeier, Simsek, and Xiong . . . 25
- 4.3 The Range of Beliefs . . . 28
- 4.4 Implications . . . 30
- 4.5 Extensions . . . 33

5 Appendix: Proofs **33**
- 5.1 Proof of Theorem **1** . . . 33
- 5.2 Proof of Proposition 2 . . . 36
- 5.3 Proof of Theorem 2 . . . 37

6 References **43**

No-Betting-Pareto Dominance

1 Introduction

1.1 Motivation

Standard economic lore suggests that Pareto-improving trades are obviously a good thing—how can one argue with making everyone (at least weakly) better off? This paper argues that when outcomes are uncertain and agents have different beliefs, the Pareto-improving criterion is less compelling than when agents have common beliefs. Consider the following examples.

Example 1. Alice and Bob have one apple and one banana each. Their utility functions are linear. Alice is indifferent between 1 apple and 2 bananas, and Bob is indifferent between 2 apples and 1 banana. In the competitive equilibrium of this simple economy, Alice and Bob obtain a Pareto optimal allocation in which Alice consumes only apples and Bob consumes only bananas. Each prefers this outcome to the initial endowment. □

Example 2. Ann and Bill have one dollar each. There are two states of the world: in state 1 the price of oil a year from now is above $100 a barrel, and in state 2 it is no more than $100 a barrel. Ann and Bob are risk neutral. Ann thinks that state 1 has probability 2/3 and Bill thinks state 1 has probability 1/3. In the competitive equilibrium of this simple economy, Ann and Bill obtain a Pareto optimal allocation in which Ann has no money in state 2 and Bill has no money in state 1. Each prefers this outcome to the initial endowment, i.e., to consuming $1 whatever is the price of oil in a year. □

These examples map to the same Arrow-Debreu (1954) general equilibrium model: there are two goods $\{1, 2\}$, and two agents $\{A, B\}$. The utility functions are given by

$$\begin{aligned} u_A(x_1, x_2) &= \frac{2}{3}x_1 + \frac{1}{3}x_2 \\ u_B(x_1, x_2) &= \frac{1}{3}x_1 + \frac{2}{3}x_2 \end{aligned}$$

and the initial endowments are

$$e_A = e_B = (1, 1).$$

In equilibrium, goods one and two trade one-for-one, and person A consumes both units of good 1 while person B consumes both units of good 2. This equilibrium is Pareto optimal, and Pareto dominates the initial allocation.

It is not obvious that Pareto domination has the same meaning in both examples. In Example 1, there is no uncertainty and the two consumers differ only in tastes. If Alice prefers apples and Bob prefers bananas, they are better off when they trade one apple for one banana. By contrast, in Example 2 Ann and Bill are both better off after trade, but only because they have different beliefs about the future price of oil.

In example 2, Ann and Bill cannot both be right: if the probability of state 1 is 2/3, it cannot be 1/3 as well. It is not obvious how one interprets such a probability, and perhaps Ann and Bill should not have probabilistic beliefs over the future price of oil. But if they do, and if these beliefs have any concrete meaning, then these beliefs are incompatible, and yet the unanimous preference for trade follows directly from this difference in beliefs.

1.2 No-Betting-Pareto

This paper proposes a refined notion of Pareto domination for uncertain allocations. We do not take issue with Pareto domination under certainty, as in Example 1. We find Pareto domination compelling under uncertainty, *if* agents' preferences can be justified not only according to their actual, potentially different beliefs, but also according to hypothetical *shared* beliefs.

However, we argue that Pareto domination is less compelling when unanimous preference for one alternative over another can only be justified by differences in beliefs. As we show below, these situations are closely related to pure bets, as in Example 2.

We say that allocation f *No-Betting-Pareto dominates* allocation g if every agent (who isn't indifferent between the two at all states of the world) prefers f to g, *and* if there exists a single belief with the property that, if all agents held this belief, then they would still prefer f to g. The competitive allocation in Example 1 trivially No-Betting-Pareto dominates the initial endowment, since beliefs are degenerate in this case. More generally, when all the agents have the same beliefs, f No-Betting-Pareto dominates g if and only if f Pareto dominates g. However, the competitive allocation in Example 2 Pareto dominates the initial endowment but does not No-Betting-Pareto dominate it, because no belief can make both agents strictly prefer the former over the latter.

The distinction between Pareto domination and No-Betting-Pareto domination can be viewed as a manifestation of a more general principle, under which unanimity about a given claim—say, that trade is desirable—becomes more compelling when unanimity about the reasoning that leads to it is also possible. A unanimous conclusion loses much of its appeal if, by accepting it, one has to concede that at least some of the agents involved must be wrong in the reasoning process that led them to that conclusion.

Our definition is designed to rule out Pareto dominations that have a flavor of betting. However, trade under uncertainty need not be akin to betting; it is often justified by the need to share risks. The following example shows that risk sharing can qualify as No-Betting-Pareto domination.

Example 3. Agnes is a computer scientist with an idea for a start-up company. If successful, the company will net \$10 million. If unsuccessful she will lose her initial investment of \$1 million. Agnes assigns probability .9 to a success, but is not willing to take the risk and invest her own funds. She approaches Barry, who runs a venture capital fund, asking him to provide the initial $1 million in return for half of the resulting profit. Barry believes the probability of success to be only .3, but he is risk neutral and therefore willing to take the risk and make the investment. □

Once again, the agents have different beliefs. However, in this case there is a range of beliefs, including both Agnes's and Barry's belief, at which both agents would be willing to trade. In contrast to Example 2, where the difference in beliefs is crucial for trade to take place, the exchange in Example 3 can be justified as voluntary trade between agents who do not necessarily have mistaken beliefs. Their beliefs do differ, but this difference is not essential to the trade.

Observe that in this example one agent bears risk a priori: Agnes has an asset that will be worth a lot in one state and little in another, and trade allows her to share this risk with Barry. Example 3 thus indicates that the No-Betting-Pareto notion endorses productive trade in financial markets.

1.3 Underlying Assumptions

As we explain in Section 1.5, we examine agents who satisfy Savage's (1954) axioms and can therefore be viewed as maximizing expected utility with respect to a probability measure.[1] Thus, our agents satisfy the most demanding standard of rationality. We agree that Pareto comparisons may be problematic when agents are confused or inconsistent or otherwise irrational, but our focus here is on differences in beliefs.

Our definitions and interpretation implicitly assume that the utility functions of the agents have to do with desirability, so that higher utility values are (other things equal) a good thing. Similarly, we interpret the probability measures as related to the notion of beliefs. We thus view utilities and

[1] The formal model we use differs from Savage's in some technical details, such as allowing for finite state spaces and general sigma-algebras.

probabilities as meaningful and qualitatively different objects, in contrast to the view that expected utility maximization is merely a mathematical representation of choices and that the mathematical concepts of utility and probability have nothing to do with concepts such as desirability or belief.

We are interested in situations in which agents' beliefs differ. We take it to be self-evident that differences in beliefs abound. People express their views about market conditions, economic outlooks, inflation predictions, and a host of other events, often with wildly different but persistent beliefs. The large volume of trade in financial markets, despite agreeing to disagree results (Aumann, 1976) and no-trade findings (Milgrom and Stokey, 1982), testifies to the economic importance of different beliefs. We do not address the question of the origin of such differences. Our analysis is compatible with the assumption that agents start with different priors, or with the assumption that they have identical priors but obtain different information.[2]

We do not view probabilities as being purely objective. Otherwise, our prescription would be to simply find the true probability and use it to evaluate any allocation that comes along. Unfortunately, we do not know of an objective way to measure the probability that the price of oil is above $100 next year. At the same time, we do not view probabilities as being purely subjective, in the sense that it is meaningful for people to debate probabilities and attempt to convince one another about reasonable levels of such probabilities. In particular, we believe one should be troubled by a financial intermediary who could balance his books only by having the agents on the opposite ends of the trades he brokers hold different beliefs about the assets involved.

We have a special interest in concepts that do not rely on perfect observability of probabilities. That is, we assume that agents have beliefs that can be captured by probability measures, but these are not directly observable

[2]The latter position is tenable, despite the celebrated agreeing to disagree result (Aumann, 1976), if information partitions or some other aspects of people's models are not commonly known.

to other agents. By contrast, we believe that utility profiles will effectively be observable in many applications, in which case a willingness to trade will provide some information about an agent's belief, but will typically not pin down a single probability measure.

For concreteness, consider trade of financial assets by institutions that manage funds for clients, such as retirement funds or hedge funds. Suppose that these institutions have to make their holdings and their trades publicly available. Moreover, imagine that they must stand ready if challenged to justify their trading decisions by showing that these decisions maximized expected utility given a certain belief and a pre-determined utility function. Thus, utilities are effectively observable, and trade maximizes expected utility relative to some probability, but the latter is typically not directly observable.

1.4 Alternative Definitions

There are several reasonable alternatives for our definition of No-Betting-Pareto. For example, one may consider a variation on our criterion in which the single belief under which all agents prefer f to g must lie in the convex hull of the agents' beliefs. Brunnermeier, Simsek, and Xiong (2012), discussed in Subsection 4.2, impose such a convex-hull condition. Another alternative (suggested by Gayer, 2013) is to restrict Pareto domination to the cases in which an alternative guarantees a higher expected utility than another, for each agent, given *all* agents' beliefs. Blume, Cogley, Easley, Sargent, and Tsyrennikov (2013) ascribe sets of possible beliefs to a planner and to each agent, and then assess acts according to the minimum (over the planner's beliefs and the agent's beliefs) utility of the agent with the smallest expected utility.

Our No-Betting-Pareto criterion does not require the common belief under which all agents prefer f to g to be one of the agent's beliefs or to lie in the convex hull of the agents beliefs. Our criterion thus attaches less significance to the agents' actual beliefs than do the alternatives mentioned in the preceding paragraph. In particular, these alternatives respect unanimity among the agents: if all agents agree that the probability lies in a certain half-space, only probabilities in this half-space are considered for further discussion. While this property is appealing, it is also subject to question: once we admit that each agent may be wrong in her beliefs, it is difficult to dismiss the possibility that they are all wrong. In particular, if we were to view each agent's belief as a point estimate of a "true" probability, a confidence set for this belief would typically allow beliefs outside the convex hull of the point estimates.

Our criterion satisfies two additional desiderata. First, we prefer to take a cautious approach—our criterion imposes a relatively minimal restriction imposed on the standard notion of Pareto dominance, which we view as an obvious first step. Our criterion does not rank any pairs of alternatives that are not already ranked by the standard Pareto criterion, and rejects the standard ranking only when there exists *no* common belief that could rationalize the ranking, whether in the convex hull of the agents' beliefs or not. In this sense, our definition is conservative: it rules out relatively few Pareto-dominance instances. Given the general acceptance of the Pareto dominance criterion, it seems fruitful to start by a minimal modification, restricting attention to Pareto rankings and rejecting such rankings only when the argument against them is compelling.

Second, to verify whether our definition holds, one does not need to know the agents' beliefs. Given the agents' utility profiles before and after trade, one may check whether a single probability can justify this trade for all of them without wondering what the actual beliefs were.[3] This may prove to have practical advantages. Beliefs may not be directly observable, and definitions that use them may be more difficult to test, may raise manipulability problems, and so forth.[4]

[3]We mention in passing that this task is computationally easy.

[4]Utilities may also be difficult to observe. As we mentioned at the end of the preceding

1.5 Related Literature

It is well recognized that the concept of Pareto domination is troubling when beliefs differ. The difference between gains from trade based on tastes (as in Example 1) and differences in beliefs (as in Example 2) was discussed by Stiglitz (1989), in the context of an argument that inefficiencies arising from the taxation of financial trades might not be too troubling. Mongin (1997) referred to the type of Pareto domination appearing in Example 2 as *spurious unanimity*.

The growing sophistication of financial assets and the recent financial crisis have attracted increased attention to the question of the efficiency of financial markets. Weyl (2007) points out that arbitrage might be harmful when agents are "confused". Posner and Weyl (2012) call for a regulatory authority, akin to the FDA, that would need to approve trade in new financial assets, guaranteeing that it does not cause harm. Kreps (2012) and Brunnermeier, Simsek, and Xiong (2012) also discuss distorted beliefs.[5]

We agree that cognitive and affective phenomena such as confusion or over-confidence are important, and that they should be taken into consideration when discussing regulation of financial markets. But we do not think that the conceptual difficulty with Pareto domination is restricted to agents who are irrational in one way or another. To highlight this point, we discuss agents who are subjective expected utility maximizers, each satisfying all of Savage's axioms.[6] We believe that the conceptual underpinnings of voluntary trade among such agents needs to be examined even if the agents are not confused or over-optimistic.

subsection and discuss in Section 4.4, one application we envision is that in which the No-Betting-Pareto criterion is applied to pension funds or other investment funds, with utility functions drawn from a class set by regulators to identify appropriate risk levels.

[5] The latter paper is particularly relevant to ours, and the two are compared in Subsection 4.2.

[6] Again, we refer here to Savage's conceptual axioms P1-P5, rather than to P6 or to the structural assumption about the algebra of events consisting of all subsets of the state space.

Indications that it is more difficult to aggregate preferences under subjective uncertainty than under either certainty or risk have also appeared in the social choice literature. Harsanyi's (1955) celebrated result showed that, in the context of risk (that is, known, objective probabilities), if all individuals as well as society are von-Neumann-Morgenstern expected utility maximizers (von Neumann and Morgenstern, 1944), a mild Pareto condition implies that society's utility function is a linear combination of those of the individuals. However, Hylland and Zeckhauser (1979) and Mongin (1995) found that an extension of Harsanyi's theorem to the case of uncertainty cannot be obtained. An impossibility theorem shows that under a mild Pareto condition, one cannot simultaneously aggregate utilities and probabilities in such a way that society will satisfy the same decision theoretic axioms as the individuals.

Gilboa, Samet, and Schmeidler (GSS, 2004) introduce a restricted Pareto condition under which society finds f as desirable as g when all individuals do so, but only when these preferences concern alternatives over which there are no disagreements in beliefs. The result of their paper is that, when one restricts the Pareto condition in this way, preferences can be aggregated into a complete societal preference respecting the restricted Pareto criterion. By contrast, the present paper does not ascribe to society a complete preference over alternatives. It discusses a particular instance of unanimous preferences, $f \succsim_i g$ for all i (with strict preference for at least one), and asks whether society should agree with that particular ranking. Importantly, GSS apply the Pareto criterion only when agents have identical beliefs over the relevant alternatives, whereas we rank acts over whose distributions individuals may well disagree, as long as there is a shared *hypothetical* belief that would still rationalize trade for each of them.

The complete social preference relation in GSS (2004) and No-Betting-Pareto domination are quite different from a conceptual point of view. When a country has to choose an economic policy, decide whether to use nuclear power plants, or decide whether to wage a war, the decision cannot be decentralized; it has to be made for all individuals as a group. In this context, GSS show that the natural idea of simultaneous averaging of utilities and of probabilities is necessitated by a reasonable version of the unanimity (Pareto) axiom. However, these "averaged" preferences are not very relevant for decentralized decisions. Hence, economists would tend to eschew the task of defining a social welfare function or a complete preference order for society as a whole in deference to a weaker notion such as Pareto dominance. The current paper belongs in this tradition, while differing from the classical literature in its definition of "dominance".

2 The Model

There is a set of agents $N = \{1, ..., n\}$, a measurable state space (S, Σ), and a set of outcomes X. An outcome specifies all the aspects relevant to all agents. It is often convenient to assume that X consists of real-valued vectors, denoting each individual's consumption bundle, but at this point we do not impose any conditions on the structure of X.

The alternatives compared are *simple acts*: functions from states to outcomes whose images are finite and measurable with respect to the discrete topology on X. We denote

$$F = \left\{ f : S \to X \;\middle|\; \begin{array}{c} f \text{ is simple and} \\ \Sigma\text{-measurable} \end{array} \right\}.$$

The restriction to simple acts guarantees that acts will be bounded in utility for each agent, and for any utility function.

Each agent i has a preference order $\succsim_i$ over F. Agent i is characterized by a utility function $u_i : X \to \mathbb{R}$ and a probability measure[7] p_i on (S, Σ), and $\succsim_i$ is represented by the maximization of $\int_S u_i(f(s))dp_i$. We assume that the agents can be represented as expected utility maximizers to emphasize that

[7]For simplicity, we adopt the standard definition of a probability measure, which implies sigma-additivity. As we consider only simple acts, no modifications are needed to consider measures that are only finitely additive.

our arguments do not hinge on any type of so-called bounded rationality of the agents. We assume that the agents agree on the state space S, returning to the significance of this assumption in Section 4.3.

The standard notion of Pareto domination, denoted by $\succ_P$, is defined as follows:

Definition 1 *$f \succ_P g$ iff for all $i \in N$, $f \succsim_i g$, and for some $k \in N$, $f \succ_k g$.*

2.1 No-Betting-Pareto

Throughout the paper we consider pairs of acts, $(f, g) \in F^2$. A pair (f, g) is interpreted as a suggested swap in which the agents give up act g in return for f. Such a swap would involve some individuals but not others. Given a pair (f, g), agent $i \in N$ is said to be *involved* in (f, g) if there exists at least one state s at which the agent is not indifferent between $f(s)$ and $g(s)$. Let $N(f, g) \subset N$ denote the agents who are involved in the pair (f, g). Observe that, for given $f, g \in F$, the definition of $N(f, g)$ depends on the agents' utilities, $(u_i)_i$, but not on their beliefs, $(p_i)_i$.

Definition 2 *A pair (f, g) is an* improvement *if $N(f, g) \neq \varnothing$ and, for all $i \in N(f, g)$, $f \succ_i g$.*

We use the term *improvement* to emphasize the fact that the agents in the economy would swap g for f voluntarily. We will also use the terminology f *improves upon* g, denoted by $f \succ_* g$.

Our main interest lies in improvements for which $|N(f, g)| \geq 2$, though the cases in which $|N(f, g)| = 1$ are not ruled out.

Notice that we require *strict* preference for the agents involved in the improvement. The relation $f \succ_* g$ is thus more restrictive than standard Pareto domination, which allows some agents, for whom $u_i(f(s)) \neq u_i(g(s))$ for some s, to be indifferent between f and g. This definition eliminates some technical complications, but we also find it intuitive. Notice that we allow the existence of agents who are unaffected by the swap (f, g), and hence necessarily indifferent; our requirement is that those actually affected by the swap have a strict preference for it. In particular, we are reluctant to assume that indifferent agents are willing to actively participate in the trade. In addition, Section 3 imposes additional structure on the outcome space under which this requirement is innocuous, in the sense that for any (f, g) with $f \succsim_i g$ for all $i \in N(f, g)$, there exists f' arbitrarily close to f with $f' \succ_i g$ for all $i \in N(f, g)$.

Our weaker notion of domination is defined as follows:

Definition 3 *For two alternatives $f, g \in F$, we say that f* No-Betting Pareto dominates *g, denoted $f \succ_{NBP} g$, if:*

(i) f improves upon g;

(ii) There exists a probability measure p_0 such that, for all $i \in N(f, g)$,

$$\int_S u_i(f(s))dp_0 > \int_S u_i(g(s))dp_0.$$

Observe that our definition does not assume that the agents agree on the distributions of the alternatives f and g. The actual beliefs of the agents, determining their actual preferences, may be quite different. Condition (i) of the definition requires that the agents involved prefer f to g according to their actual beliefs. Condition (ii) requires that one be able to find a single probability measure, according to which all involved agents prefer swapping g for f. That is, one can find hypothetical beliefs, which, when ascribed to all relevant agents, can rationalize the preference for f over g. As in Example 3 above, two partners may invest in a business opportunity about which one is much more optimistic than the other. However, as long as there are some beliefs (say, of the more optimistic one) that justify the investment for both, the alternative of investment would No-Betting-Pareto dominate that of no-investment.

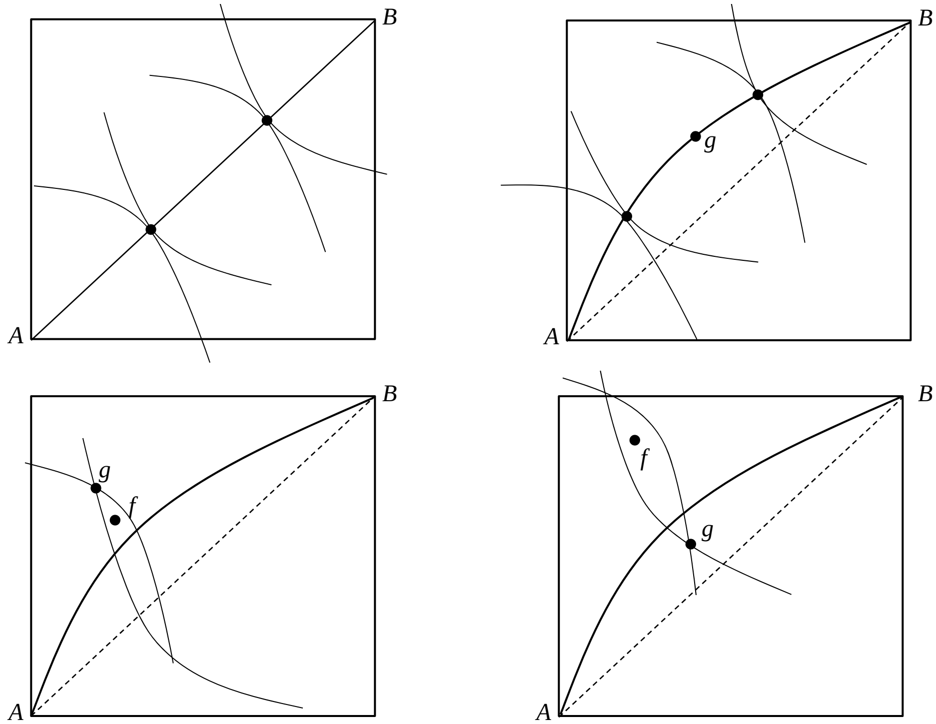

Figure 1: The horizontal axis in each panel identifies the allocation of money between agents A and B in state 1, with the vertical axis doing the same for state 2. The total endowment is constant across states. If the agents have identical beliefs, then the set of Pareto efficient allocations coincides with the set of full-insurance allocations, and hence is given by the diagonal, as in the top left panel. If the agents' beliefs differ, then the Pareto efficient allocations lie on a contract curve that differs from the diagonal, as in the top right and bottom two panels. These three panels have identical beliefs and contract curves. The two bottom panels show cases in which f Pareto dominates g.

Clearly, Condition (i) implies that f Pareto dominates g (recall that Condition (i) also implies that $N(f, g) \neq \varnothing$). Thus, if one uses our stronger notion of Pareto dominance, $\succ_{NBP}$, rather than the standard one, one gets a larger set of Pareto optimal outcomes. In particular, the first welfare theorem still holds, though the second does not.

2.2 Illustration

Much of our analysis can be illustrated by the following *Trade Example*. Suppose there two agents, A and B, and two states, 1 and 2. An alternative

f is defined by the amount of money that each agent has in each state. The aggregate endowment is the same in the two states, that is, there is no aggregate uncertainty. The agents have identical utility functions u defined on their own wealth, that are strictly monotone and strictly concave. We can then depict alternatives in an Edgeworth box, as shown in Figure 1. The diagonal in Figure 1 is the set of full-insurance allocations. Along this diagonal the slopes of the indifference curves of a given agent are identical, and are determined by the agent's probability for the two states.

Condition (i) in the definition of No-Betting-Pareto dominance is the standard Pareto efficiency condition. Pareto efficiency is described by a contract curve, along which the slopes of the two agents' indifference curves are identical. The contract curve coincides with the full-insurance diagonal if the agents' beliefs are identical, as in the top left panel of Figure 1. If the agents entertain different beliefs, then no interior point can be in the intersection of the contract curve and the diagonal, as in the top right panel.

In the top right panel in Figure 1, alternative g is on the contract curve and no f dominates it (in the standard Pareto sense, let alone in the No-Betting-Pareto refinement). The two bottom panels of Figure 1 show alternatives g that are dominated by other alternatives f. The distinction between these two panels is that in the bottom left f is closer to the diagonal than is g, whereas in the bottom right panel f is farther from the diagonal than is g. The standard notion of Pareto domination does not distinguish between the two, but we now explain how our refined notion does.

Consider alternative g in the interior of the box, strictly above the diagonal, as in Figure 2. Let $P(g)$ be the interior of the triangle that is to the right and below g but above the diagonal, and let $Q(g)$ be the interior of the rectangle that is to the left and above g. We note that:

Proposition 1 *Every f in $P(g)$ satisfies Condition (ii) of Definition 3, while every f in $Q(g)$ does not.*

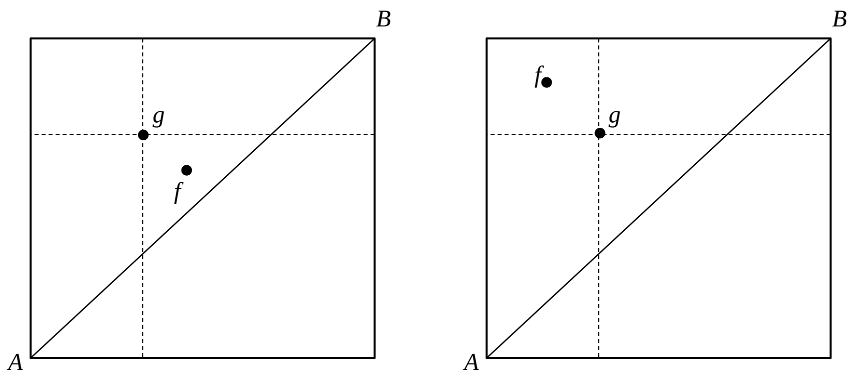

Figure 2: Illustration of Condition (ii) of the definition of No-Betting-Pareto dominance. Condition (ii) is satisfied in the left panel, but fails in the right panel.

Proof. Consider first $f \in P(g)$ as shown in the left panel. Choose p_0 to be the probability according to which f has the same expected value as does g for agent A, and hence also for agent B. Both agents would then be indifferent between f and g, were they risk neutral. Given that they are risk averse, and that g is a (p_0)-mean-preserving spread of f, both agents strictly prefer f to g under p_0 and hence Condition (ii) holds.

By contrast, consider $f \in Q(g)$ as shown in the right panel. Assume that Condition (ii) were to hold for the two agents with beliefs p_0. Given that these risk-averse agents strictly prefer f to g, despite the fact that f is a spread of g, such strict preferences would certainly hold were the agents expected value maximizers. However, for no p_0 can the difference $f - g$ simultaneously increase the p_0-expected value for both agents. ■

Condition (ii) of Definition 3 thus divides the feasible trades (on the same side of the diagonal) into those that are "closer" to the full-insurance diagonal than is g, versus those that are "farther away" from the diagonal. Confronted with agents who prefer f to g, and thus satisfy Condition (i) of Definition 3, we can conclude that f No-Betting-Pareto dominates g if and only if f

is closer to the full insurance diagonal than is g. Moreover, we can make this assessment without knowing the agents' beliefs or indifference curves. In the bottom two panels of Figure 1, allocations above the contract curve (see the left panel) are No-Betting-Pareto dominated (because allocations on the contract curve, for example, are preferred by both agents and satisfy condition (ii)). Allocations between the contract curve and the diagonal (right panel) are not No-Betting-Pareto dominated (because the allocations satisfying condition (ii) lie closer to the diagonal and are not preferred by both agents).

3 Characterizations

In this section we generalize the characterization of No-Betting-Pareto domination, developed for the Trade Example in Section 2.2, to arbitrary numbers of states and (heterogenous) agents. The appropriate generalization is not obvious, as there is no longer an obvious definition of a "move toward full insurance." We offer two characterizations. The first is general, while the second is specific to an environment that contains the Trade Example of Section 2.2 as a special case.

3.1 Combining Agents

We use the Trade Example of Section 2.2 to introduce our first characterization. Consider Figure 3. The left panel shows an allocation g and an allocation $f \in P(g)$, for which there exists a p_0 with $\int_S u_i(f(s))dp_0 > \int_S u_i(g(s))dp_0$. Continue the line segment gf until it intersects the diagonal, say at a point f^*.

For $\lambda \in [0,1]$, consider the "λ-averaged agent" whose utility in each state is the weighted average that places weight $\lambda \in [0,1]$ on the utility of agent A in that state and weight $1-\lambda$ on the utility of agent B in that state. Thus, if total endowment in each state is E and agent A has x in a particular state,

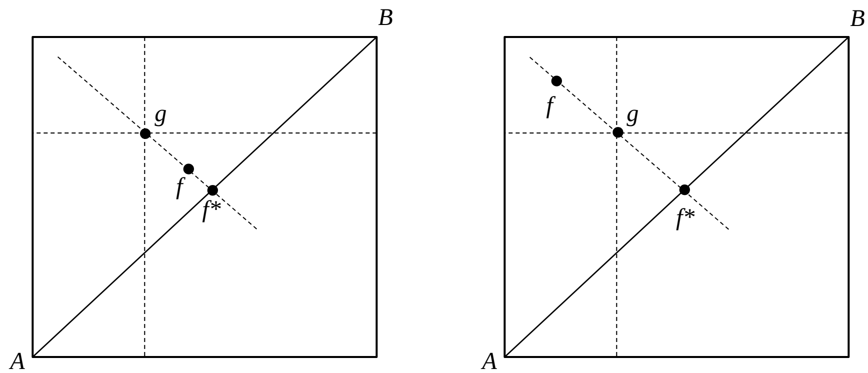

Figure 3: Illustration of Theorem 1, in the setting of the Trade Example of Section 2.2. In the left panel $f \succ_{NBP} g$, and the text explains how the key step in Theorem 1 is that there exists an alternative f^* and an average agent who is better off in both states under f^* compared to g. This is not possible in the right panel, where we do not have $f \succ_{NBP} g$.

the utility of the λ-averaged agent in that state is $\lambda u(x) + (1-\lambda)u(E-x)$ where u is the common utility function.

For every $x \in [0, E]$ there exists a λ such that x is the (unique) maximizer of $\lambda u(x) + (1-\lambda)u(E-x)$. (This λ is defined by $\lambda/(1-\lambda) = u'(E-x)/u'(x)$.) Let λ^* be the coefficient for which $f^*(1)$ (i.e., the amount consumed by A in state 1) in the left panel maximizes $\lambda u(x)+(1-\lambda)u(E-x)$. Observe that $f^*(2) = f^*(1)$ also maximizes this expression. It follows that, for this λ^*, the λ^*-averaged agent is better off at f^* than at g in both states $1, 2$.

Next we observe that for every other λ, the λ-averaged agent is better off at f^* than at g in at least one of the states $1, 2$. Indeed, if $\lambda > \lambda^*$, this obviously will be the case in state 1, and for $\lambda < \lambda^*$, this will be the case in state 2. Finally, it then follows from the convexity of preference, or the concavity of u, that for any λ, the λ-averaged agent is also better off at f

than at g in at least one state.

Consider now the right panel, where $f \in Q(f)$ and does not satisfy Condition (ii) of Definition 3. Continue the line segment fg until it hits the diagonal at a point f^*, and define λ^* as above. The λ^*-averaged agent is better off at f^* than at g in both states $1, 2$. Similarly, as $\lambda u(x) + (1 - \lambda) u(E - x)$ is single-peaked, this agent is also better off at g than at f in both states. Hence, for this $\lambda = \lambda^*$, there does not exist a state in which the averaged agent is better off at f than at g.

The upshot of this discussion is that, in the Trade Example, f satisfies Condition (ii) of Definition 3 (relative to g), if and only if for *every* λ there exists a state s in which the λ-averaged agent is better off at f than at g. This turns out to be a general result, independently of the number of states and of agents and independently of the specification of X.

Theorem 1 *Consider acts f and g with $N(f,g) \neq \varnothing$. There exists a probability vector p_0 such that, for all $i \in N(f,g)$,*

$$\int_S u_i(f(s))dp_0 > \int_S u_i(g(s))dp_0$$

if and only if, for every distribution over the set of agents involved, $\lambda \in \Delta(N(f,g))$, there exists a state $s \in S$, such that

$$\sum_{i \in N(f,g)} \lambda(i)\, u_i(f(s)) > \sum_{i \in N(f,g)} \lambda(i)\, u_i(g(s)).$$

To interpret this result, assume that a set of agents $N(f,g)$ wish to swap g for f. Presumably, each one of them has a higher expected utility under f than under g (according to the agent's subjective beliefs). In particular, it is necessary that each agent be able to point to a state s at which she is better off with f than with g. The proposition says that for f also to No-Betting-Pareto dominate g, this condition should be satisfied for all "convex combinations" of the agents involved, where a combination is defined by a distribution λ over the agents' utility functions.

A convex combination of agents, λ, can be interpreted in two famously related ways. First, we may take a utilitarian interpretation, according to which $\sum_{i\in N}\lambda(i)u_i(\cdot)$ is a social welfare function defined by some averaging of the agents' utilities (cf. Harsanyi 1955). Second, we may think of an individual behind the "veil of ignorance, believing that she may be agent i with probability $\lambda(i)$, and calculating her expected utility ex-ante (cf. Harsanyi, 1953). In both interpretations the condition states that not only the actual agents, but also all convex combinations thereof can justify the improvement by pointing to a state of the world that would make them at least as well off with the proposed improvement.

3.2 Bets

We would like to argue that agents cannot make themselves better off, under the No-Betting-Pareto criterion, by betting with one another. Intuitively, a bet is a transfer of resources between agents that is not driven by production, different tastes, or risk sharing. To capture the fact that a bet does not involve production, we need to endow the set of outcomes with additional structure. Assume then that $X = L^n$ (or is a convex subset thereof), where L is a partially ordered linear space, where $x = (x_1, ..., x_n) \in X$ specifies an allocation, x_i, of each agent i. In such a set-up, one can express the fact than an improvement (f, g) is a mere allocation of existing resources by requiring that

$$\sum_{i\in N(f,g)} f(s)_i \leq \sum_{i\in N(f,g)} g(s)_i \qquad \forall s \in S. \tag{1}$$

In this case, we say that the pair (f, g) is *feasible*.

For simplicity, we focus on the case $L = R \subset \mathbb{R}$, where R is a (possibly unbounded) interval, and $x_i \in R$ denotes agent i's wealth. Further, assume that each agent's utility function depends only on her own wealth. We abuse notation and denote this function by u_i as well, so that, for each $i \in N$ and $x \in X$, $u_i((x_1, ..., x_n)) = u_i(x_i)$. Finally, we assume that each u_i is differentiable, strictly monotone and (weakly) concave.

In this unidimensional set-up, trade cannot be driven by differences in tastes, as all agents are assumed to want more of the only good. It then remains only to exclude risk sharing, and hence we can define betting as follows.

Definition 4 *A feasible improvement (f, g) is a* bet *if $g(s)_i$ does not depend on s for $i \in N(f, g)$.*

The requirement that g be independent of s (for all i) precludes the risk-sharing motivation, thereby justifying the definition of (f, g) as a bet. In the Trade Example of Section 2.2, an improvement (f, g) is a bet if and only if g lies on the diagonal. We can now state:

Proposition 2 *If (f, g) is a bet, then it cannot be the case that $f \succ_{NBP} g$.*

Proposition 2 partly justifies the term "No-Betting-Pareto", as it shows that Condition (ii) of the definition of $\succ_{NBP}$ rules out Pareto improvements that are bets.

3.3 Characterization of Excluded Improvements

The No-Betting-Pareto criterion excludes many Pareto improvements that are not bets. What else does it exclude?

Consider again the Trade Example of Section 2.2, illustrated in Figure 4. Recall that the set of Pareto efficient alternatives under common beliefs is the full-insurance diagonal, and that under any beliefs, any move from the diagonal to a point off the diagonal is a bet.

Consider the left panel of Figure 4. Suppose that an outside observer were to observe the trade of f for g. In this case, the outside observer has no evidence that the agents' beliefs differ, and would not know how to construct

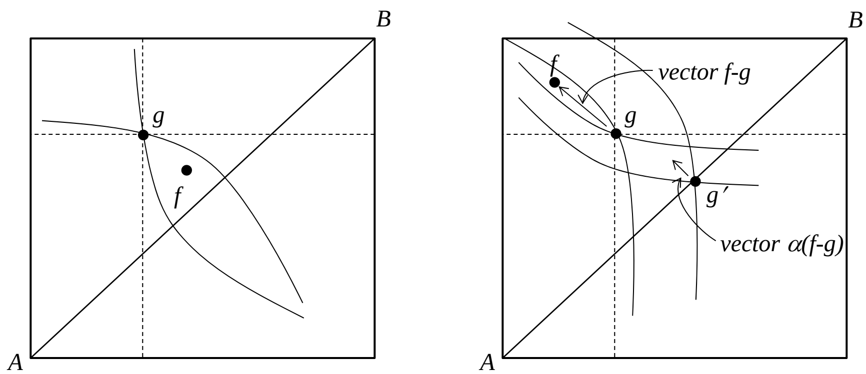

Figure 4: Motivation for Theorem 2, in the setting of the Trade Example of Figure 1. Movement from g to f pushes the agents toward full insurance in the left panel, but in the right panel exacerbates the bet that brings the agents from the full insurance allocation g' to g.

a book against them. Indeed, the left panel is compatible with the agents' beliefs being identical. But this is not the case in the right panel. In the right panel, f can be an improvement over g (with convex preferences) only if agent A's indifference curves along the diagonal are flatter than B's indifference curves (because A thinks state 2 is more likely than does B). Indeed, agent A's indifference curve must be flatter at any point on the diagonal than at g, and agent B's indifference curve must be steeper, and hence the trade $f - g$, acceptable by both agents at g, indicates a direction of change that would certainly be acceptable by both agents at any full insurance allocation g' along the diagonal. More precisely, at *any* point g' in the interior of the diagonal, the trade $\alpha(f - g)$ would be a strict improvement for both agents for some positive α. Thus, a distinguishing feature of the trade $f - g$ in the right panel is that, armed only with the information that the agents are willing to make the trade, one can construct a book against them, *starting at any at a full insurance allocation* g'.

This comparison reflects a key distinction between Pareto improvements that are NBP-improvements and Pareto improvements that are not: the former do not reveal differences in beliefs. In particular, if the agents trade, and keep trading until they are both fully insured, no information would have been revealed that an observer could use to offer the agents to bet against each other. By contrast, the Pareto improvements that do not satisfy our criterion are precisely those that do reveal such information. When the agents trade as in the right panel, even if by some process they manage to be fully insured, a bookie who observed the trade can then come up with a bet that they would both accept. Specifically, if the bookie offers financial assets corresponding to the functions $\left(f_i\left(s\right) - g_i\left(s\right)\right)_i$, there will be a positive amount that will be demanded by each agent respectively. Since their preferences are strict, this also means that the bookie can make a sure profit by offering the agents their part of the bet, deducting a fee for herself.

In the Trade Example, No-Betting-Pareto domination can be precisely characterized as prohibiting Pareto improvements that move the agents further away form full insurance. As we have noted, the concept of a movement way from full insurance does not readily generalize to settings with many agents, many states, and heterogeneous utility functions. However, we have just established that in the Trade Example, there is an equivalence between the existence of an improvement that moves the agents away from full insurance and the agents being willing to abandon any full insurance allocation in favor of a bet. The existence of a single bet acceptable to the agents at any full-insurance allocation is a well-defined condition in the general set-up. We now show that the Pareto improvements satisfying this condition are precisely those excluded by the No-Betting-Pareto criterion.

Theorem 2 *Let there be given utilities $\left(u_i\right)_i$ and two alternatives $f, g \in F$. The following are equivalent:*

(i) There does not *exist a probability vector p_0 such that, for all $i \in$*

$N(f, g)$,

$$\int_S u_i(f(s))dp_0 > \int_S u_i(g(s))dp_0$$

(ii) There exists an alternative $d \in F$ satisfying

$$\sum_{i \in N} d(s)_i = 0 \qquad \forall s \in S.$$

that also has the following property: for every $g' \in F$ such that $g'(s)_i$ is independent of s for each $i \in N(f, g)$ and lies in the interior of R, and for every beliefs $(p_i)_i$ such that $f \succ_* g$, there exists $\alpha > 0$ such that $(g' + \alpha d, g')$ is a bet (for the utilities $(u_i)_i$ and the beliefs $(p_i)_i$).

This theorem thus provides another characterization of the pairs (f, g) that satisfy Condition (ii) of Definition 3. This time we state the result in terms of the *failure* to satisfy Condition (ii): this condition does not hold (clause (i) of the theorem) if and only if the following is true: given the fact that the relevant agents prefer f to g, and given their utility functions, one may start at any state-independent allocation g', and construct $f' \equiv g' + \alpha d$ such that (f', g') is a bet. Note that in this case, since bets are defined by strict preferences, we have $|N(f', g')| \geq 1$, and the feasibility constraint and the assumption that all utilities are monotone then ensures that $|N(f', g')| \geq 2$. However, $N(f', g')$ may be a proper subset of $N(f, g)$.

The constructed bet d need not in general be a multiple of the trade $(f - g)$ that is preferred by both agents at g: with many states, it is possible that some agents prefer f to g despite the risk that the former entails, because this risk occurs at states where their wealth is high, but they may not be willing to take the same risk starting from another allocation g'.

At first glance, there is no surprise that, if we have $f \succ_* g$ but not $f \succ_{NBP} g$, one can construct a bet that fully-insured agents would take. Indeed, if we have $f \succ_* g$ but not $f \succ_{NBP} g$, we know that some agents have different beliefs, and it suffices to have two agents with different beliefs to be able to find a bet that they would be willing to take. However, finding such a bet would require one to know who are the two agents whose probabilities differ, and what these probabilities are, and the bet constructed would typically depend on these agents and on their beliefs. By contrast, Theorem 2 guarantees the existence of a bet independently of the identity of the agents and of their probabilities: a bookie may offer the agents to buy assets corresponding to their share in d, and these assets are independent of the beliefs (and of g'). Whatever are the probabilities p_i's, as long as they are known to lie in the respective half-spaces (so that p_i makes agent i prefer f to g), the agents would strictly prefer to bet by swapping g' for $f' = g' + \alpha d$ for some $\alpha > 0$. While the volume of trade α may depend on the beliefs, the financial assets d are uniformly constructed for all p_i's such that $f \succ_* g$.[8]

4 Discussion

4.1 Pareto Rankings

When uncertainty is considered, it is tempting to model the state of the world as one of the features of a good and analyze an economy with uncertainty as one analyzes an economy with more goods but no uncertainty (see Debreu 1959). This expands the scope of the welfare theorems to economies with uncertainty. One may then argue that under uncertainty as in the case of certainty, complete and competitive markets have the advantage of guaranteeing Pareto efficient allocations, whereas incomplete or regulated markets run the risk of resulting in Pareto inefficient equilibria.

However, we argue that trade in financial markets has a strong speculative component, fueled by differences in beliefs across agents, and that welfare analysis should be revisited in such contexts. For example, suppose

[8] The proof of Theorem 2 is constructive. One can therefore imagine a scenario in which automated bookies, observing swaps such as (f, g), are quick to offer bets such as (f', g'). This observation fortunately falls short of offering a practical method for making profit by exploiting differences in belief. Yet, it may help us see why some Pareto improvements are not as compellingly desirable as others.

that we are discussing the introduction of a new financial asset, currently not traded in the market. A standard argument would be that the introduction of such an asset cannot but help, since only under complete markets is Pareto efficiency guaranteed. However, once we question the notion of Pareto domination, it is no longer self-evident that a Pareto "inferior" allocation is a bad outcome. In particular, if the inferior allocation is only dominated by allocations that are generated by pure bets, one may well prefer the inferior allocation to the supposedly-dominating ones.

The growing complexity of financial assets makes the market completeness question quite relevant. Using complex financial derivatives, one may trade not only on the fundamentals of the economy, but also on other people's beliefs about these fundamental, as well as on higher-order beliefs. A given (finite) set of financial markets *must* be incomplete if one considers the entire hierarchy of beliefs, thereby suggesting that more sophisticated assets are needed to obtain Pareto optimality. However, if agents' assets are a priori independent of these higher-order beliefs, the resulting trade may be tantamount to pure betting, and it is not obvious that it should be supported.

Should financial markets be regulated, as suggested by Posner and Weyl (2012)? Without taking a stance on desired policy, our goal here is only to refine a theoretical argument. We claim that one standard argument for free markets, namely, that only complete and free markets are guaranteed to lead to Pareto efficient allocations, does not apply in this context without an appropriate qualification.

4.2 A Comparison with Brunnermeier, Simsek, and Xiong

Brunnermeier, Simsek, and Xiong (2012) (hereafter BSX) also develop a welfare criterion for markets in the presence of individuals who might entertain different beliefs.[9] This section offers a comparison between their model and ours.

BSX offer two criteria: one is utilitarian in spirit, and the other has the flavor of Pareto efficiency. The first, the *Expected Social Welfare* criterion, is based on the expected utility of an "average" agent, namely, a hypothetical agent whose utility function is $\sum_{i=1}^{n} \lambda_i u_i$ for a set of nonnegative weights $\lambda_1, \ldots, \lambda_n$. Given differences in beliefs, it is not obvious which probability measure should be used for the calculation of expected average utility. BSX's criterion solves this problem by a unanimity approach, requiring that one alternative be superior to another given the belief of each agent, or, equivalently, for each probability in the convex hull of the agents' beliefs. Thus, the expected social welfare criterion of BSX uses an aggregation over agent's utility functions, and a unanimity rule for the agents' beliefs.

When beliefs differ, the expected social welfare criterion is logically independent of No-Betting-Pareto domination. One direction of this comparison is familiar, and has nothing to do with beliefs, instead reflecting the basic difference between social welfare functions and Pareto comparisons. Once one has committed to welfare weights $\lambda_1, \ldots, \lambda_n$, presumably in order to obtain a complete ranking of alternatives, one may have attached a higher welfare to f than to g without there being Pareto domination, let alone No-Betting-Pareto domination between them. The other direction illustrates the differing role of beliefs. The statement that f No-Betting-Pareto dominates g requires that there is at least one belief at which all agents would prefer f to g, but this need not be true for all probabilities in the convex hull of the agents' beliefs. (In fact, it may not hold for any probability in this convex hull, as discussed in the following subsection.)

BSX offer another approach that is independent of a specification of the welfare weights and that is a more obvious comparison to our notion. They

[9] See also Simsek (2012), who discusses financial innovation where trade is motivated both by risk sharing and by speculation.

define f to be *belief-neutral inefficient* if for every belief p in the convex hull of the agent's beliefs, there is an alternative g with the property that every agent prefers g to f given belief p (with weak preference assumed for all agents and strict for at least one of them). Notice that the alternative g is allowed to depend on the belief p. An alternative f is *belief-neutral efficient* if there is no alternative g and belief p in the convex hull of the agents' beliefs with the property that every agent prefers g to f, given belief p. Clearly, if f is belief-neutral inefficient, it cannot be belief-neutral efficient. However, there may well be allocations f that are neither belief-neutral inefficient nor belief-neutral efficient.[10]

The notions of belief-neutral efficiency and inefficiency are closer in spirit to No-Betting-Pareto, as neither involves weighted averages of agents' utilities, but they are again logically independent, with their differences illustrated by the following possibilities:

- 1. An allocation g may be belief-neutral inefficient, but not NBP-inefficient as there may be no single f that Pareto-dominates g according to the agents' original beliefs.

  2. Turning this around, an allocation g may be NBP-dominated by an allocation f, but not belief-neutral inefficient as g may not be dominated by any f' according to some beliefs in the convex hull of the agents' beliefs.

  3. An allocation g may be belief-neutral efficient, but f may No-Betting-Pareto dominate g because there is a belief outside the convex hull of the agents' beliefs under which all prefer f to g. (We return to this point below.)

  4. An allocation g may be NBP-efficient, that is, undominated by any f, but not belief-neutral efficient, because g may be dominated by

[10] Brunnermeier, Simsek, and Xiong (2012, Proposition 1) make precise the sense in which their belief-neutral efficiency notion frees the expected social welfare criterion from dependence on a single set of welfare weights.

an allocation f for some (hypothetically shared) belief p, but that f does not Pareto dominate f according to the agents' original (and different) beliefs.

These possibilities reflect some conceptual differences. Belief-neutral inefficiency declares an alternative g to be inefficient if it is dominated according to *every* (rather than just one, as in NBP dominance) shared belief in a given set. However, belief neutral inefficiency allows different alternatives to dominate g for different beliefs, causing the belief neutral criterion to sort alternatives into three sets (efficient, inefficient, and unclassified). No-Betting-Pareto domination presumes standard Pareto domination, while the belief neutral comparisons do not. Finally, an alternative can be belief-neutral inefficient without being dominated by any alternative under the agents' actual beliefs.

4.3 The Range of Beliefs

Another difference between the belief-neutral and No-Betting-Pareto notions is the range of the beliefs involved. To argue that $f \succ_{NBP} g$, one may use any belief whatsoever when showing that there exists a belief under which all agents prefer f to g. In contrast, BSX restrict attention to beliefs in the convex hull of the agents' beliefs. Our motivation for considering all beliefs is that, once differences in beliefs have been detected, it is clear that some agents are wrong, and then we can't dismiss the possibility that they are all wrong. Consider the following example.

Example 4. Suppose that f and g are given by the following:

State	p_A	p_B	f		g	
			U_A	U_B	U_A	U_B
1	.4	.3	2	1	1	2
2	.3	.325	2	2	2	1
3	.3	.375	1	2	2	2

,

where p_A and p_B are the probabilities Amy and Bruce attach to the various states, and U_A and U_B are their payoffs in these states. Amy and Bruce both prefer f to g. Indeed, Amy prefers f to g iff $p_A(1) > p_A(3)$ and Bruce prefers f to g iff $p_B(2) > p_B(1)$. Clearly, there are beliefs that satisfy both inequalities, for example $(.325, .375, .3)$. However, no such belief is in the convex hull of Amy and Bruce's beliefs, as both p_A and p_B agree that state 3 is at least as likely as state 2. □

The possibility illustrated by Example 4 motivates our reluctance to restrict attention to some particular half-space of beliefs, simply because it includes all of the agents' beliefs. One agent has the belief $(.4, .3, .3)$ and – the belief $(.3, .325, .375)$. Does this mean that we can exclude the possibility that the appropriate belief is $(.325, .375, .3)$?

On the other hand, restricting attention to the convex hull of beliefs (as do BSX) makes the model more robust to irrelevant states of the world. The following example illustrates.

Example 5. Suppose there are three states. Abigail and Bart each have an endowment of two units of income in each state. Abigail and Bart are both expected income maximizers. They consider investing their endowment in a joint product giving net returns of $(3, 0)$ in state 1, $(0, 3)$ in state 2, and $(4, 4)$ in state 3. Abigail believes state 1 will surely occur, while Bart believes state 2 will surely occur, and hence each is willing to undertake the investment—the outcome of the investment Pareto dominates the endowment. It also No-Betting-Pareto dominates the endowment. There are many beliefs, one of which is that the three states are equally likely, under which both agents would be willing to undertake the investment. □

In Example 5, while there are many beliefs that would induce both agents to engage in the trade, none of them lies in the convex hull of the agents' beliefs. The Pareto criterion of BSX thus does not rank the two alternatives, while No-Betting-Pareto does. To defend the latter ranking, one may note that Abigail is absolutely sure that state 1 will occur, whereas Bart is willing to stake his life on state 2 being the case. An outside observer has to raise an eyebrow and say that at least one of them is wrong, and, to be on the safe side, it seems reasonable to doubt their beliefs—including what they happen to agree upon (namely, that state 3 is impossible). Hence, it seems cautious to allow NBP dominations even if they use probabilities that assign a positive weight to state 3.

However, this raises a potential modeling difficulty. Suppose that we consider a model in which f Pareto dominates g but not NBP-dominates it. Let us add to the model another state (such as state 3 in Example 5), according to which alternative f guarantees all agents eternal bliss. We can view the agents in the original model as assigning this state probability zero. The BSX notions, as well as Gayer's notion, which only consider the convex hull of the agents' beliefs, will be robust to the inclusion of this new states in the model, but NBP domination will not: given the new state, f now NBP dominates g, whereas it didn't before this state was introduced. It follows that our definition of NBP domination requires some care in defining the state space, and that we must take seriously the seemingly innocuous assumption that the agents agree on the state space.

4.4 Implications

The main goal of this paper is to make a theoretical contribution to the debate about free markets, and, in particular, to highlight a theoretical difference between two different interpretations of the same mathematical model. Our analysis relies on highly idealized assumptions about the agents' rationality, their common conception of a state space and so forth, and we therefore prefer to be cautious in suggesting policy recommendations.

The above notwithstanding, it may prove useful to ask if and how our analysis might affect policy decisions. Suppose, perhaps partly as a result of the financial crisis of 2007/8, lawmakers wish to change or tighten the regulation of financial markets. They need to deal with many issues that are not addressed by this paper, including incomplete information and incentive problems, complexity of financial assets, and so forth. However, they might also wonder whether, even in the simplest of cases, free trade in financial assets is necessarily to be endorsed. We suggest that they might reasonably consider limiting trade in financial assets if this trade comes too close to pure betting, and that the No-Betting-Pareto criterion is a reasonable starting point for identifying such trades.

How can this notion be applied? We can imagine a scenario in which proposed mergers, acquisitions, or financial swaps must either be approved before executed, or must be justified in response to audits. We can further imagine that in order to approve a proposal, the monitoring authority ascertains not only that each party views the proposal as beneficial, in the sense that they enter it willingly, but also that the parties can present (at least post-hoc) a model identifying the states of the world, their endowments, the net trade, and a single belief under which no party loses from the trade. In this exercise, one may assume that the utility functions, defined on monetary outcomes, are pre-determined to be in a given class, such as CARA or CRRA, with parameters calibrated to reflect the risk aversion appropriate for the relevant party.[11] We imagine the regulatory guidelines specifying the relevant functions and parameter ranges. The basic point here is that the parties to trade should be able to point to a shared probability according to which they all benefit from trade.

A scenario in which CFOs appear before a judge or regulator and compute integrals might seem a bit outlandish, but is not too far removed from the type of analysis performed when firms make cases for merger approval or respond to anti-trust allegations. When the deals proposed are large enough

[11] For example, a public employees pension fund may exhibit (or be required to exhibit) a greater degree of risk aversion than an investment bank, which may in turn exhibit greater risk aversion than a hedge fund.

to threaten the solvency of major financial institutions, such a scenario might be more realistic than it first appears.

To get an idea of how this might work, suppose that a pension fund and an investment bank currently have positions described by an alternative g, and consider a trade that would bring them to the allocation f. Both are willing to trade, signaling to a regulator that both prefer f to g, but the regulator will in general know nothing more about their preferences. The regulator can then ask whether, given the appropriate utility functions, there exists a shared belief under which both parties gain from the exchange. If the situation were as simple as the 2×2 case illustrated in Figure 2, this would be trivial, and would require confirming only whether f lies close to the diagonal than does g. In practice, we imagine the transactions will be quite complicated and the outcome will accordingly be less obvious. The regulator must then frame the assessment in terms of shared beliefs, with approval hinging upon whether the the No-Betting-Pareto criterion is satisfied, i.e., on whether there exists a shared belief under which all parties would be willing to trade.

We find the case for regulating trade, with restrictions on trade that is equivalent to betting, to be particularly compelling when it comes to institutions that manage other people's money. Retirement funds, for example, should be very careful in making financial decisions that may result in employees losing their lifetime's savings. We would find it troublesome if two such funds were to engage in trade that is not No-Betting-Pareto improving. While our paper is not intended to offer practical solutions to such problems, we do believe that the concept of No-Betting-Pareto may be a first step in thinking about how to make trade in financial markets more responsible than allowed by the standard general equilibrium model.

4.5 Extensions

Our definition of a bet (f, g) assumes that the given allocation, g, is constant across the state space. This is obviously restrictive. For example, assume that two agents are considering a bet on the outcome of a soccer match. It so happens that their current wealth does not depend on this match in any way. Yet, their current allocations are far from constant, as the two are exposed to various risks, ranging from their health to stock market crashes. Thus, Proposition 2 does not apply to such a swap (f, g). Yet, it would be nice to know that, for such swaps, f does not No-Betting-Pareto dominate g.

To capture this type of exchange in the definition of a bet, and correspondingly generalize Proposition 2, one has to allow the existing allocations g to depend on s, but to be independent of the exchange. That is, the variable $f - g$ should be stochastically independent of g according to all the probability measures considered. In other words, one may assume that the state space is a product of two spaces, $S = S_1 \times S_2$ such that g is measurable with respect to S_1, and consider only probabilities obtained as a product of a measure p_1 on S_1 and a measure p_2 on S_2. Relative to such a model, ours can be viewed as a reduced form model, where our entire discussion is conditioned on a state $s_1 \in S_1$.

5 Appendix: Proofs

5.1 Proof of Theorem 1

This is a standard application of a duality/separation argument. Let there be given two acts f, g. As each of them is simple and measurable, there is a finite measurable partition of S, $(A_j)_{j \leq J}$, such that both f and g are constant over each A_j. Thus, we use the notation $f(A_j), g(A_j)$ to denote the elements of X that f and g, respectively, assume over A_j, for each $j \leq J$.

The theorem characterizes condition (ii) of the definition of No-Betting-Pareto domination, namely that there be a probability vector p_0 such that, for all i,

$$\int_S u_i(f(s))dp_0 > \int_S u_i(g(s))dp_0. \tag{2}$$

We first note that (2) holds if and only if there exists a probability vector $(p_0(j))_{j\le J}$, such that, for all i,

$$\sum_{j\le J} p_0(j)\, u_i(g(A_j)) > \sum_{j\le J} p_0(j)\, u_i(g(A_j)). \tag{3}$$

In particular, if a measure p_0 that satisfies (2) exists, it induces a probability vector $(p_0(j))_{j\le J}$ (over $(A_j)_{j\le J}$) that satisfies (3). Conversely, if a vector $(p_0(j))_{j\le J}$ satisfying (3) exists, it can be extended to a measure p_0 on (S,Σ) such that (2) holds. (Since f and g are constant over each A_j, the choice of the extension does not matter.)

When is there a probability vector $(p_0(j))_{j\le J}$ satisfying (3)? Consider a two-person zero-sum game in which player I chooses an event in $(A_j)_{j\le J}$ and player II chooses an agent in $N(f,g)$. The payoff to player I, should she choose A_j and player II choose $i\in N(f,g)$, is $u_i(f(A_j)) - u_i(g(A_j))$. Then (3) is equivalent to the existence of a mixed strategy of player I, $p_0 \in \Delta\left((A_j)_{j\le J}\right)$ such that, for every pure strategy of player II, $i\in N$,

$$\sum_{j\le J} p_0(j)\left[u_i(f(A_j)) - u_i(g(A_j))\right] > 0$$

or: there exists $p_0 \in \Delta\left((A_j)_{j\le J}\right)$ such that for all mixed strategy of player II, $\lambda \in \Delta(N)$,

$$\sum_{j\le J} p_0(j) \sum_{i\in N} \lambda(i)\left[u_i(f(A_j)) - u_i(g(A_j))\right] > 0.$$

In other words, $\exists p_0 \in \Delta\left((A_j)_{j\le J}\right)$ such that $\forall \lambda \in \Delta(N)$

$$E_{p_0}E_\lambda\left[u_i(f(A)) - u_i(g(A))\right] > 0,$$

where A denotes a generic member of $(A_j)_{j\le J}$. The above is equivalent to

$$\max_{p\in\Delta\left((A_j)_{j\le J}\right)} \min_{\lambda\in\Delta(N)} E_pE_\lambda\left[u_i(f(A)) - u_i(g(A))\right] > 0,$$

which, by the minmax theorem for zero-sum games, is equivalent to

$$\min_{\lambda\in\Delta(N)} \max_{p\in\Delta\left((A_j)_{j\le J}\right)} E_p E_\lambda \left[u_i(f(A)) - u_i(g(A))\right] > 0,$$

that is, to the claim that $\forall\lambda \in \Delta(N)$ there exists $p \in \Delta\left((A_j)_{j\le J}\right)$ such that

$$E_\lambda E_p \left[u_i(f(A)) - u_i(g(A))\right] > 0.$$

It follows that (3) holds if and only if for every $\lambda \in \Delta(N)$ there exists $p \in \Delta\left((A_j)_{j\le J}\right)$ such that

$$\sum_{i\in N} \lambda(i) \sum_{j\le J} p(j) \left[u_i(f(A_j)) - u_i(g(A_j))\right] > 0.$$

However, for each $\lambda \in \Delta(N)$, such a $p \in \Delta\left((A_j)_{j\le J}\right)$ exists if and only if there exists such a p that is a unit vector, namely, if and only if there exists $j \le J$ such that

$$\sum_{i\in N} \lambda(i) \left[u_i(f(A_j)) - u_i(g(A_j))\right] > 0,$$

and this is the case if and only if there exists a state $s \in S$ such that

$$\sum_{i\in N} \lambda(i) \left[u_i(f(s)) - u_i(g(s))\right] > 0.$$

■

Observe that, should one use the weak inequality version of Condition (ii), a similar characterization holds: there exists a probability vector p_0 such that, for all i,

$$\int_S u_i(f(s))dp_0 \ge \int_S u_i(g(s))dp_0$$

if and only if for every $\lambda \in \Delta(N)$ there exists a state s such that

$$\sum_{i\in N} \lambda(i) \left[u_i(f(s)) - u_i(g(s))\right] \ge 0.$$

5.2 Proof of Proposition 2

We first show that $f \succ_{NBP} g$ cannot hold if (f, g) is a bet. Let there be given a bet (f, g). That is, $f \succ_i g$ for all $i \in N(f, g)$ and

(i) $g(s)_i$ is independent of s for each i;

(ii) $\sum_i f(s)_i \leq \sum_i g(s)_i$ for all s.

We provide two short proofs. First, observe that, if it were the case that $f \succ_{NBP} g$, there would be a belief p_0 such that

$$\int_S u_i(f(s)_i)dp_0 > \int_S u_i(g(s)_i)dp_0$$

for all $i \in N(f, g)$. For each $i \in N(f, g)$, let $\bar{g}_i = g(s)_i$ and $\bar{u}_i = u_i(g(s)_i)$ for all s. Then we have

$$E_{p_0}(u_i(f_i)) > E_{p_0}(u_i(g_i)) = \bar{u}_i$$

and, since u is concave,

$$u_i(E_{p_0}(f_i)) \geq E_{p_0}(u_i(f_i))$$

thus

$$u_i(E_{p_0}(f_i)) > \bar{u}_i$$

and, because u is strictly monotone,

$$E_{p_0}(f_i) > \bar{g}_i.$$

Summation over $i \in N(f, g)$ yields

$$\sum_i E_{p_0}(f_i) = E_{p_0}\left(\sum_i f_i\right) > \sum_i \bar{g}_i$$

which is a contradiction because $\left(\sum_i f_i\right)(s) \leq \sum_i \bar{g}_i$ for all s.

The second proof makes use of Theorem 1. To this end, consider the vector of weights $\lambda = (\lambda_i)_i$ defined by

$$\lambda_i = \begin{cases} \frac{1}{|N(f,g)|} & i \in N(f, g) \\ 0 & \text{otherwise} \end{cases}.$$

Because $\sum_i f(s)_i \leq \sum_i g(s)_i$ for all s, we also have $\sum_{i\in N(f,g)} f(s)_i \leq \sum_{i\in N(f,g)} g(s)_i$ and it follows that the λ-weighted utility under f cannot exceed that corresponding to g. Thus, the λ-weighted "average" agent cannot point to a state where she is strictly better off under f than under g. ■

5.3 Proof of Theorem 2

Let utilities $(u_i)_i$ and alternatives f, g be given. We first observe that (ii) implies (i). Indeed, if (i) does not hold, then there exists p_0 such that

$$\int_S u_i(f(s))dp_0 > \int_S u_i(g(s))dp_0$$

for all $i \in N(f,g)$. Setting $p_i = p_0$, we obtain beliefs for which $f \succ_* g$. However, for any $g' \in F$ such that $g'(s)_i$ is independent of s (for each $i \in N(f,g)$), and any d with $\sum_{i\in N} d(s)_i = 0$ (for all s), defining $f' = g' + d$, it cannot be the case that all agents in $N(f', g')$ strictly prefer f' to g' because the agents are (weakly) risk averse. Thus, there is no bet (f', g') that can be constructed for the beliefs $(p_i)_i$, contrary to (ii).

We now turn to the main part of the theorem, namely, that (i) implies (ii). Assume, then, that (i) holds, that is, that there does not exist a probability p_0 such that

$$\int_S u_i(f(s))dp_0 > \int_S u_i(g(s))dp_0$$

for all $i \in N(f,g)$. We need to construct an alternative d such that $\sum_{i\in N} d(s)_i = 0$ (for all s) and, whenever the beliefs $(p_i)_i$ imply $f \succ_* g$, then, for every g' (in the interior of the diagonal) there exists $\alpha > 0$ such that $f' \succ_* g'$ where $f' = g' + \alpha d$.

Suppose that $(A_j)_{j=1}^J$ is a finite, measurable partition of S, which is a refinement of the two partitions of S defined by f^{-1} and g^{-1}. In other words, f and g are constant on each A_j. Let $f(A_j)$, $g(A_j) \in X$ denote their values, correspondingly, on the elements of the partition, for $j \leq J$. Consider a probability over (S, Σ), restricted to the elements of the partition (and their unions). With a minor abuse of notation this probability is still denoted by p, and we write $p(j)$ instead of $p(A_j)$. Let Δ^{J-1} denote the simplex of all such probabilities.

Each $i \in N(f,g)$ would strictly prefer f to g whenever her belief p is in

$$C_i = \left\{ p \in \Delta^{J-1} \left| \sum_{j \leq J} p(j) \left(u_i \left(f \left(A_j \right) \right) - u_i \left(g \left(A_j \right) \right) \right) > 0 \right. \right\}.$$

Observe that, since $f \succ_* g$ (i.e., $f \succ_i g$ $\forall i \in N(f,g)$), it has to be the case that $p_i \in C_i$ $\forall i \in N(f,g)$. Clearly, for such f, g, $f \succ_{NBP} g$ does not hold if and only if $\cap_{i \in N(f,g)} C_i = \varnothing$.

For simplicity of notation, assume $N = N(f,g)$. Without loss of generality, assume that the state space is $\{1, ..., J\}$, that is, that $A_j = \{j\}$. Also without loss of generality, assume that $g'(j)_i = 0$ for all $i \in N$, $j \leq J$.

We mention:

Claim 0: For each $i \in N$, C_i has a non-empty interior relative to the simplex Δ^{J-1}.

Proof: Since $f \succ_i g$, we know that C_i is non-empty, as agent i's actual beliefs p_i lie in C_i. Then C_i has a non-empty interior relative to the simplex, as it is the non-empty intersection of an open half-space and the simplex. □

We need to construct an act d such that (f', g') is a bet for $f' = g' + \alpha d$, that is, such that $f' \succ_i g'$ for all $i \in N(f', g')$ and all $p_i \in C_i$, and $\sum_i f'(j)_i = 0$ for all j. To this end, we start by constructing an act f'' such that $\sum_i f''(j)_i = 0$, and, for every $i \in N(f'', g')$, $\sum_i p_i(j) f''(j)_i > 0$. (The last step of the proof would consist of defining f' as a multiple of f'' by a small positive constant.)

Step 1: First, we fix beliefs $p_i \in C_i$ and construct a bet (f'', g') for these beliefs. This would also prove a weaker version of the theorem, in which a bookie can find a bet, if the bookie knows the actual beliefs (p_i) (and not only that they lie in the respective C_i).

Define, for $k \geq 1$ and $i \in N$,

$$C_i^k = \left\{ p \in \Delta^{J-1} \;\middle|\; \sum_{j \leq J} p(j) \left(u_i \left(f \left(A_j \right) \right) - u_i \left(g \left(A_j \right) \right) \right) \geq \frac{1}{k} \right\}$$

so that, for all k, $C_i^k \subset C_i^{k+1} \subset C_i$ and $C_i = \cap_k C_i^k$. Since we have $\cap_{i \in N} C_i = \varnothing$, it is certainly true that $\cap_{i \in N} C_i^k = \varnothing$ for all k. However, C_i^k is a non-empty, convex, and (as opposed to C_i) also compact subset of Δ^{J-1}. When such compact and convex sets of priors have an empty intersection, it is known that one can find a bet that they would all accept, as long as their beliefs are in the specified sets of priors. Specifically, Theorem 2 in Billot et al. (2000, p. 688) states that there are linear functionals h_i, such that h_i is strictly positive on C_i^k, and $\sum h_i = 0$.[12] Thus, for each k there exists a $n \times J$ matrix, $\left(h_{i,j}^k \right)_{i,j}$ of real numbers, such that

$$\sum_i h_{i,j}^k = 0 \qquad \forall j$$

and

$$\sum_j p(j) h_{i,j}^k > 0 \qquad \forall i, \quad \forall p \in C_i^k.$$

Since, for each i, $p_i \in C_i$, for each i there exists $K = K(i)$ such that $p_i \in C_i^k$ for $k \geq K$. Let $K_0 = \max_i K(i)$, and note that $f''(j)_i = h_{i,j}^{K_0}$ satisfies $\sum_i p_i(j) f''(j)_i > 0$ and $\sum_i f''(j)_i = 0$ as required.

Step 2: We now wish to show that the construction of f'' above can be done in a uniform way: there exists an f'' such that $\sum_i f''(j)_i = 0$ and $\sum_i p_i(j) f''(j)_i > 0$ for all $p_i \in C_i$ and all $i \in N(f'', g')$. (Observe, however, that while in Step 1 we obtained a bet that involved all agents, here we may find that $N(f'', g') \subsetneq N$.)

[12] Similar theorems have been proved by Bewley (1989) and Samet (1998). Billot et al. provide a stronger result, also saying that the hyperplanes corresponding to the functionals h_i can be chosen so that they intersect at a point in the convex hull of the sets of priors, but this geometric fact is not used here.

Since we intend to consider a converging sub-sequence of matrices $\left(h^k_{i,j}\right)_{i,j}$, it will be convenient to consider matrices that satisfy weak inequalities. However, to veer away from the origin, we will restrict attention to matrices of norm 1. Let H denote the set of all such matrices h that satisfy

$$\sum_i h_{i,j} = 0 \qquad \forall j \tag{4}$$

$$\sum_{i,j} \left(h_{i,j}\right)^2 = 1 \tag{5}$$

and,

$$\sum_j p(j) h_{i,j} \geq 0 \qquad \forall i, \quad \forall p \in C_i. \tag{6}$$

Claim 2.1: $H \neq \varnothing$.

Proof: Defining C^k_i and $\left(h^k_{i,j}\right)_{i,j}$ as above, one may assume without loss of generality that $\left(h^k_{i,j}\right)_{i,j}$ is on the unit disc, that is, that

$$\sum_{i,j} \left(h^k_{i,j}\right)^2 = 1$$

so that $h^k = \left(h^k_{i,j}\right)_{i,j} \in H$.

Because the unit disc is compact, there exists a subsequence of $\left(h^k\right)_k$ that converges to a matrix h^*. This point satisfies conditions (4, 5) because it is the limit of points that satisfy these conditions. The matrix h^* also satisfies (6) because it is the limit of matrices that satisfy this inequality (strictly) on a subset that converges to C_i. Explicitly, for any $p \in C_i$ there exists K such that for $k \geq K$, $p \in C^k_i$ and $\sum_j p(j) h^k_{i,j} > 0$, which implies $\sum_j p(j) h^*_{i,j} \geq 0$. It follows that $h^* \in H$ and $H \neq \varnothing$. □

For $h \in H$ let the set of agents who would be involved in h, were it offered as a bet, be denoted by

$$D(h) = \{\, i \in N \mid \exists j, \quad h_{i,j} \neq 0 \,\}.$$

Clearly, $D(h) \neq \varnothing$ for $h \in H$, as h is on the unit disc and therefore cannot be 0. Also, $D(h)$ cannot be a singleton because of (4).

Claim 2.2: For $h \in H$ there is no $i \in D(h)$ such that $h_{i,j} \leq 0 \; \forall j$.

Proof: Suppose, to the contrary, that h and i satisfy $h_{i,j} \leq 0$. As $i \in D(h)$, $h_{i\cdot}$ isn't identically zero. Hence there is a j such that $h_{i,j} < 0$. In view of Claim 0, there is a $p \in C_i$ that is strictly positive. For such a p, $\sum_j p(j) h_{i,j} < 0$, contradicting (6). □

Claim 2.3: Let $h \in H$ be such that $D(h)$ is minimal (with respect to set inclusion). Then there is no $i \in D(h)$ such that $h_{i,j} \geq 0 \; \forall j$.

Proof: Assume, to the contrary, that h and i satisfy $h_{i,j} \geq 0$. As $i \in D(h)$, $h_{i\cdot}$ isn't identically zero. Hence there are j's such that $h_{i,j} > 0$. We wish to construct another matrix $h' \in H$ such that $D(h') = D(h) \setminus \{i\}$, contradicting the minimality of $D(h)$.

By (4) we know that there exists $k \in D(h) \setminus \{i\}$. Define

$$h''_{r,j} = \begin{cases} 0 & r = i \\ h_{k,j} + h_{i,j} & r = k \\ h_{r,j} & \text{otherwise} \end{cases} .$$

It is easy to verify that h'' satisfies (4). To see that (6) also holds, observe that, for i (6) is satisfied as an equality, for k the left side of (6) could have only increased, as compared to the left side of h, while it is unchanged for $r \notin \{i, k\}$.

Next we wish to show that h'' is not identically zero. If it were, we would have $h_{k,j} = -h_{i,j}$ for all j. But, since $h_{i,j} \geq 0$ (for all j), this would imply $h_{k,j} \leq 0$ (for all j), in contradiction to Claim 2.2.

It follows that h'' can be re-normalized to guarantee (5) without violating (4,6), obtaining $h' \in H$ with $D(h') \subsetneq D(h)$. □

Claim 2.4: Let $h \in H$ have a minimal $D(h)$ (with respect to set inclusion) over H. Let $i \in D(h)$. Then $(h_{i,j})$ contains both positive and negative entries.

Proof: Combine Claims 2.2 and 2.3. $\square$

Claim 2.5: Let $h \in H$ have a minimal $D(h)$ (with respect to set inclusion) over H. Let $i \in D(h)$ and $p \in C_i$. Then $\sum_j p(j)h_{i,j} > 0$.

Proof: Because $h \in H$, we know that $\sum_j p(j)h_{i,j} \geq 0$ holds for all $p \in C_i$. Assume that it were satisfied as an equality. Distinguish between two cases (in fact, the argument for Case 2 applies also in Case 1, but the argument for the latter is simple enough to be worth mentioning):

Case 1: p is in the relative interior of Δ^{J-1} (hence also in the interior of C_i relative to Δ^{J-1}). In this case, by Claim 2.4, there exist j, j' such that $h_{i,j} < 0 < h_{i,j'}$. One can find a small enough $\varepsilon > 0$ such that $p_\varepsilon = p + \varepsilon e_j - \varepsilon e_{j'} \in C_i$ where e_j is the j-unit vector. For such a p_ε, $\sum_j p_\varepsilon(j)h_{i,j} < 0$, a contradiction to (6).

Case 2: p is on the boundary of Δ^{J-1}. Consider the problem

$$\begin{aligned} & Min_p \sum_j p(j)h_{i,j} \\ & \quad s.t. \\ & \qquad \sum_{j \leq J} p(j)\left(u_i\left(f\left(A_j\right)\right) - u_i\left(g\left(A_j\right)\right)\right) \;\geq\; 0 \qquad (1) \\ & \qquad p \;\in\; \Delta^{J-1}. \end{aligned}$$

Since $h \in H$, the optimal value of this problem is non-negative. Since $\sum_j p(j)h_{i,j} = 0$, p is a solution to the problem. However, because $p \in C_i$, constraint (1) is inactive at p. Given that this is a linear programming problem, removing an inactive constraint cannot render p sub-optimal. Hence p is also an optimal solution to $Min_p \sum_j p(j)h_{i,j}$ subject to $p \in \Delta^{J-1}$. But this implies that $\sum_j p(j)h_{i,j} \geq 0$ for all $p \in \Delta^{J-1}$. This, in turn, implies that $h_{i,j} \geq 0$ for all j, contradicting Claim 2.3. $\square$

To complete the proof of Step 2, all we need to do is define $d = h$ for some $h \in H$ for which $D(h)$ is minimal with respect to set inclusion, and observe that $N(f'', g') = D(h)$. □

Step 3: Finally, consider an act $f'_\alpha = \alpha d$ for $\alpha > 0$. Clearly, $\sum_i f'_\alpha(j)_i = 0$ for all j and all α. As u_i are differentiable, for a small enough α the conclusion $\sum_i p_i(j) u_i(f'_\alpha(j)_i) > 0$ follows. ■

6 References

Arrow, K. J. and G. Debreu (1954), "Existence of an Equilibrium for a Competitive Economy", *Econometrica*, **22**: 265-290.

Aumann, R. J. (1976), "Agreeing to Disagree", *The Annals of Statistics*, **4**: 1236-1239.

Bewley, T. (1989), "Market Innovation and Entrepreneurship: A Knightian View", Discussion Paper 905, Cowles Foundation for Economic Research.

Billot, A., A. Chateauneuf, I. Gilboa, and J.-M. Tallon (2000), "Sharing Beliefs: Between Agreeing and Disagreeing", *Econometrica*, **68**: 685-694.

Blume, L. E., T. Cogley, D. A. Easley, T. J. Sargent, and V. Tsyrennikov (2013), "Welfare, Paternalism, and Market Incompleteness", working paper.

Brunnermeier, M. K., A. Simsek, and W. Xiong (2012), "A Welfare Criterion for Models with Distorted Beliefs", working paper.

Debreu, G. (1959), *Theory of Value.* New Haven: Yale University Press.

de Finetti, B. (1931), "Sul Significato Soggettivo della Probabilità", *Fundamenta Mathematicae*, 17: 298-329.

——— (1937), "La Prevision: ses Lois Logiques, ses Sources Subjectives", *Annales de l'Institut Henri Poincare*, 7: 1-68 (translated in *Studies in Subjective Probability*, edited by H.E. Kyburg and H.E. Smokler, Wiley, 1963).

Gayer, G. (2013), personal communication.

Gilboa, I., O. Lieberman, and D. Schmeidler (2009), "On the Definition of Objective Probabilities by Empirical Similarity", *Synthese,* **172**: 79-95.

Gilboa, I., A. Postlewaite, and D. Schmeidler (2008), "Probabilities in Economic Modeling", *Journal of Economic Perspectives*, **22**: 173-188.

——— (2009), "Is it Always Rational to Satisfy Savage's Axioms?", *Economics and Philosophy*, **25**: 285-296.

——— (2012), "Rationality of Belief", *Synthese*, **187**: 11-31.

Gilboa, I., D. Samet, and D. Schmeidler (2004), "Utilitarian Aggregation of Beliefs and Tastes", *Journal of Political Economy*, **112**, 932-938.

Harsanyi, J. C. (1953), "Cardinal Welfare in Welfare Economics and in the Theory of Risk Taking,", *Journal of Political Economy*, **61**, 434-435.

——— (1955), "Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparison of Utility", *Journal of Political Economy*, **63**, 309-321.

——— (1967-68), "Games of Incomplete Information Played by Bayesian Players", *Management Science*, **14**: 159-182, 320-334, 486-502.

Hylland A. and R. Zeckhauser (1979), "The Impossibility of Bayesian Group Decision Making with Separate Aggregation of Beliefs and Values", *Econometrica*, **47**, 1321-1336.

Kreps, D. M. (2012), *Microeconomic Foundations I: Choice and Competitive Markets*. Princeton: Princeton University Press.

Milgrom, P. and N. Stokey (1982), "Information, Trade, and Common Knowledge", *Journal of Economic Theory*, **26**: 17-27.

Mongin, P. (1995), "Consistent Bayesian Aggregation", *Journal of Economic Theory*, **66**, 313-351.

——— (1997), "Spurious Unanimity and the Pareto Principle", working paper, Cergy-Pontoise, France: Universite Cergy-Pontoise, Theorie Economique, Modelisation et Applications and Centre National de Recherche Scientifique, presented at the Conference on Utilitarianism, New Orleans.

Posner, E. A. and G. Weyl (2012), "An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st-Century Financial Markets", working paper.

Ramsey, F. P. (1926), "Truth and Probability", in R. Braithwaite (ed.), (1931), *The Foundation of Mathematics and Other Logical Essays*. London: Routledge and Kegan.

Samet, D. (1998), "Common Priors and Separation of Convex Sets", *Games and Economic Behavior*, **24**, 172-174.

Savage, L. J. (1954), *The Foundations of Statistics*. New York: John Wiley and Sons. (Second addition in 1972, Dover)

Simsek, A. (2012), "Speculation and Risk Sharing with New Financial Assets", working paper.

Stiglitz, J. (1989), "Using Tax Policy to Curb Speculative Trading," *Journal of Financial Services Research*, **3**: 101-115.

von Neumann, J. and O. Morgenstern (1944), *Theory of Games and Economic Behavior*. Princeton, N.J.: Princeton University Press.

Weyl, G. (2007), "Is Arbitrage Socially Beneficial?", working paper.