

# Neuroeconomics: An Introduction

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## Outline

- Colin F. Camerer (2007), "Neuroeconomics: Using Neuroscience to Make Economic Predictions," *Economic Journal*, 117, C26-C42.
- Introduction
- Neuroscientific Facts and Tools
- Neuro evidence about economic behavior:
  - Evidence for rational choice principles
  - Evidence for behavioral economics principles
  - Evidence for new psychological variables
- Conclusion



## Introduction

- What is **Neuroeconomics**? It...
- Seeks to ground microeconomic theory in details about how the brain work
  - Subfield of behavioral economics and experimental economics
- Supplies theories and experimental designs for neuroscience (to study "higher-order cognition")
- Essentially, it **uses Neuroscience methods to investigate Economic (Cognitive) questions**
  - Economics + Neuroscience + Psychology



## Introduction

- Is this a sharp turn in economic thought?
- Back in 1900, maybe yes...
- Pareto (1897)
  - "It is an empirical fact that the natural sciences have progressed only when they have taken secondary principles as their point of departure, instead of trying to discover the essence of things. ...**Pure political economy has therefore a great interest in relying as little as possible on the domain of psychology.**"



## Introduction

- Jevons (1871), *Theory of Political Economy*
  - I **hesitate to say that men will ever have the means of measuring directly the feelings of the human heart.** It is from the quantitative effects of the feelings that we must estimate their comparative amounts.
- This pessimism led to the "as if" approach...



## Introduction

- Milton Friedman (1953): Positive Economics
- If **Assumption A** makes formal **predictions P**:
  1. **Assumption A** should be judged by the accuracy of the **predictions P** they imply.
  2. A (empirically) false **assumption A** should be tolerated if they make accurate **predictions P**
- Do you agree with this?
  - Why or why not?



## Introduction



- Principle (1) is fine, but principle (2) is not
- If (2) holds, that means there is a hidden **repair condition R** so that
  - (not-A and R)  $\rightarrow$  P
- Hence, we should go find **condition R**
  - Why stick with A  $\rightarrow$  P ???

## Introduction



- Behavioral (**R**) vs. rational choice (**A**) models:
  - Loss-aversion
  - Learning and limited strategic thinking
  - Preference for immediate rewards
  - Preferences over social allocations (fairness, etc.)
- Technology allows us to observe the brain
- Why not look for **more accurate assumptions**
- to make “**even better**” predictions?

## Introduction



- Theory of the firm
  - Before 1970: reduced-form production function
  - After 1970: contract theory model firm “structure”
- “The **new** theory of the **firm** replaces the (perennially useful) fiction of a **profit-maximizing firm** which has a single goal, with a more detailed account of...”
- how **components** of the **firm** – **individuals**, **hierarchies**, and **networks** – interact and communicate to determine **firm** behavior.”

## Introduction



- Theory of the brain
  - Before 2002: reduced-form utility maximizer
  - After 2002: neuroeconomics models brain “structure”
- “The **neuroeconomic** theory of the **individual** replaces the (perennially useful) fiction of a **utility-maximizing individual** which has a single goal, with a more detailed account of...”
- how **components** of the **individual** – **brain regions**, **coognitive control**, and **neural circuits** – interact & communicate to determine **individual** behavior.”

## Introduction



- Example:
  - Fudenberg and Levine (2006), “A Dual-Self Model of Impulse Control,” *American Economic Review*, 96(5), 1449-1476 – LR vs. SR player
  - Shefrin and Thaler (1988) – planner-doer
  - Benhabib & Bisin (2005) – executive vs. automatic
  - Brocas & Carillo (2005) – cortical control vs. emotional process, etc.
- Outlook: Can we explain Macro phenomena?

## Neuroscientific Facts



1. The brain is weakly modular,
2. The brain is also “plastic” (responsive to environment as “software” are “installed”)
3. Attention and consciousness are scarce
  - How should the brain use them economically?
  - This is holy grail of “Neuroeconomics I” in Montague (2007)
4. Human brain = extra neocortex + primate brain
5. Primate brain = some neocortex + mammalian brain
  - (this is why studying animals is interesting...)

## Neuroscientific Tools

1. fMRI (Good spatial resolution)
2. PET (Radioactive glucose, more direct than blood flow)
3. Lesion patients (Causal, but limited in number)
4. TMS (Causal, but can't do it everywhere)
5. Single neuron recording (only in primates)
6. EEG, MEG (Good temporal resolution)
7. Psychophysical recording (GSR, PDR, heart rate...)
8. Eyetracking (Information search + PDR)

## Neuroscientific Tools

- Tools are complements because each tool can compensate for the weakness of others
- Graduate students should master one tool that can help answer the questions at hand
- Neuro evidence about economic behavior:
  - Evidence for rational choice principles
  - Evidence for behavioral economics principles
  - Evidence for new psychological variables

## Evidence for Rational Choice Principles

- Monkey's lateral intraparietal cortex (LIP) neurons fire at rates correlated to expected value of juice rewards (triggered by saccades)
  - Platt and Glimcher (Nature 1999)
- Monkey's trade off juice & exposure to images
  - Deaner et al. (Current Bio. 2005)
- Monkey's learn to play approximate MSE
  - Glimcher et al. (GEB 2005)

## Evidence for Rational Choice Principles

- OFC neurons express values of choice
  - Padoa-Schioppa and Assad (Nature 2006)
- "Neural currency" creates tradeoffs
  - Conover and Shizgal (GEB 2005)
- Capuchin monkeys respond to price change, obey GARP when exchanging tokens for food rewards
  - Chen et al. (JPE 2006)
- Bayesian Model of Human Visual Speed Perception
  - Stocker and Simoncelli (Nature Neuro. 2006)
- vs. Violations of Bayes' Rule (Kahneman, AER 2003)
  - The citation here is about humans, not monkeys...
  - Can you think of experiments to test when Bayes' rule fails?

## Evidence for Behavioral Economics Principles

- **Time Discounting:** Quasi-hyperbolic utility
 
$$U(c_0, \dots, c_t, \dots) = u(c_0) + \beta \sum_{t=1}^{\infty} \delta^t u(c_t)$$
- $\beta$  areas: emotional limbic system (MFC, cingulate, ventral striatum)
- $\delta$  areas: lateral OFC, dorsolateral cortex
  - McClure et al. (Science 2004)

## Evidence for Behavioral Economics Principles

- **Ambiguity-aversion:** Ellsberg Paradox
  - 20 "red or blue" balls in urn; one ball is drawn...
- 1. Are you willing to bet the ball drawn is red?
- 2. Are you willing to bet the ball drawn is blue?
- Ambiguity-averse if say no to both bets
  - Home bias, robust control in macroeconomics,...
  - Scottish law: guilty, not guilty, and "unproven"

## Evidence for Behavioral Economics Principles

- Ambiguity vs. risk conditions activate DLPFC, OFC, amygdala (vigilance area)
- Higher ambiguity-aversion parameter ~ Higher OFC activation
  - Hsu et al. (Science 2005)
  - (More later...)

## Evidence for Behavioral Economics Principles

- Limited Strategic Thinking: Cognitive hierarchy
  - Camerer et al. (QJE 2004)
- Heterogeneous levels of thinking
  - Step-0: randomize
  - Step-1: BR to randomization
  - Step-2: BR to mixture of step-0 and step-1, etc.
- Low types have non-equilibrium beliefs

## Evidence for Behavioral Economics Principles

- Bhatt and Camerer (GEB 2005) ask subjects
  - their choices (what will you do?),
  - 1<sup>st</sup> order beliefs (what you think she will do?), and
  - 2<sup>nd</sup> order beliefs (what you think he think you'll do?)
- Equilibrium subjects' choice & belief have same brain activity; non-equilibrium ones don't
- Equilibrium = State of the Mind

## Evidence for Behavioral Economics Principles

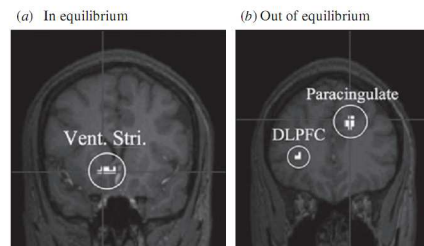


Fig. 1. Differences in Brain Activity During Choosing a Strategy and Expressing a Belief About Another Player's Strategy (Bhatt and Camerer, 2005). Equilibrium Trials (a) Show only a Difference in Ventral Striatum (a Reward Anticipation Area). Out-of-equilibrium Trials (b) Show Stronger Activity in Choosing than in Belief Expression (Highlighting Paracingulate and Dorsolateral Prefrontal (DLPFC) areas), which Suggests Subjects are not Reasoning Strategically About Other Players.

## Evidence for New Psychological Variables

- Neuroeconomics not only provides data for existing theory, but also point to new variables that influence behavior
- Can preference be "innovated" just like R&D "innovates" production functions?
- Only few examples up to now...
  - Can you come up with a new one?

## Evidence for New Psychological Variables

- OFC activation produces ambiguity-aversion
  - Hsu et al. (Science 2005)
  - OFC lesion patients show no ambiguity aversion
- $\gamma = 0.82$  for right OFC lesion patients (fMRI results predict  $\gamma = 0.85$ )

## Evidence for New Psychological Variables

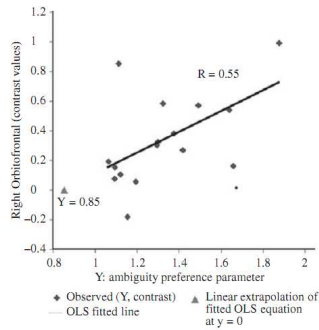


Fig. 2. Correlation Between Individual-specific Ambiguity-aversion Parameters  $\gamma$  Estimated from Choices (x-axis, Higher  $\gamma$  is more Ambiguity-aversion) and Differential Activity in Right Orbitofrontal cortex in Ambiguous vs. Risky Gamble Evaluation Scenarios.

## Evidence for New Psychological Variables

- PDR predicts lying in cheap talk games
  - Wang, Spezio and Camerer (2006)
- Disrupting DLPFC with TMS makes you accept unfair offers in the ultimatum game
  - Wout et al. (Neuroreport 2005) and Knoch et al (Science 2006); based on Sanfey et al. (Science 03)
- Oxytocin doses increase trust in trust game
  - Kosfeld et al. (Nature 2005)

## Conclusion

- Future research
- Multiple-process theories of the brain
  - What is the best “dual-self” (or triple-self) model?
  - Can we find these selves in the brain?
- Neural evidence of behavioral distinctions
  - Loss aversion? Emotion for self-image? Framing?
- Can state-dependent preference explain this?
  - Are you aware of these influences on your “state”?

## Conclusion

- The “Mindless Critique”: Economics is (historically) only about making choices
- But, can’t we consider intermediate products?
- “Neuroeconomics I”: How come we “chose” to develop our brains into its current form?
- History of Economic Thought Response
  - If Edgeworth were alive today, would he just be making boxes, or also recording the brain?

## Neuroeconomics: A View from Neuroscience

- Montague, Read (2007) Neuroeconomics: A View from Neuroscience. *Functional Neurology*, 22(4): 219-234.
- **Holy Grail 1** (from Neuroscience side)
- How does neural tissue sustain itself and process information **efficiently**?
  - Unlike computers who don’t worry about heat
- **This is “Neuroeconomics I”**
  - How economics can help neuroscience...
  - Just like game theory helping theoretical biology...

## Neuroeconomics: A View from Neuroscience

- **Holy Grail 2** (from Economics side)
- Can we find a “Theory of the Brain” that explains more human behavior?
  - Like “Theory of the Firm” in IO
  - For example: Fudenberg and Levine (2006)
- Some already covered above
- See Montague (Func. Neuro. 2007) for a “consumer’s” account for this...

## Neuroeconomics: Where We Stand?



- Bits and pieces are coming together
- fMRI (most advance tool) has great spatial resolution (areas of the brain), but
  - Temporal resolution is still 2 second per scan
  - “Activation” is indirect, not causal (only trace hemodynamic blood flow into brain regions)
- However, combining several tools gives a much clearer picture

## Neuroeconomics: Where We Stand?



- Economics can guide experimental design
  - And can benefit from opening the black box
- SPM2 – Matlab Toolbox for fMRI data (GLM!)
- Can you think of a study to do yourself?
- Remember, since Imaging data are noisy:
  - Need 90+ trials per subject (to aggregate)
  - Need very clean design (treatment vs. control)
  - Interaction is difficult (typically only 1 scanner)