

The Economics Nobel Prize
October 9, 2002

My second choice won the Nobel in economics and I am happy for him,
Since he was a long shot.

VERNON SMITH (Ph.D. in economics from Harvard) "for having established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms"

DANIEL KAHNEMAN (Ph.D. in Psychology from UC Berkeley) "for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty"

I will briefly speak about both.

VERNON SMITH

I first learned about Vernon Smith as an undergraduate at the University of California at Berkeley while writing a paper entitled "Oligopolistic Interaction under Market Uncertainty." Most of economics is concerned with either theory or empirical testing of theory on real data. Unlike physics or chemistry, it is very hard to do controlled experiments, because economics, by its nature involves the actions of human beings. Vernon Smith questioned that limitation and believed that given the right structure and setting, economic theories could be tested in controlled environments. In fact, I will quote from a paper I wrote in 1990:

"Vernon E. Smith attempts to defend his assertion that the decision behavior of suitably motivated individuals has important and significant application to the development and verification of theories of the economic system at large (Smith, 1976)."

Another experimental economist went on to say,

The advantage of experimental science has over other methods of economic testing is that "adequate control can be maintained and accurate measurement of relevant variables guaranteed." (Wilde, 1980).

Researchers have used experimental economics to test a variety of economic theories, including how price-setting duopolies behave, how auction systems work in practice, and even how traders behave as different information is made present.

It's a pleasure to see such a "non-mainstream" field of economics win the prize.

DANIEL KAHNEMAN

In my opinion, Dan is more of a psychologist, than an economist. However, they don't have a prize for that. I was trying to really think of why he got this prize and here is what I was able to come up with.

Daniel Kahenman and A. Tversky wrote one paper that had an impact on the field of Behavioral Economics. It's a theoretical paper published in Econometrica in 1979. It was entitled "Prospect Theory: An Analysis of Decision under Risk".

In standard expected utility (accepted economic paradigm prior to the paper), there were a number of experimental anomalies documented, including the famous "Allais Paradox". Thus, when people were faced with uncertain choices, they sometimes did not behave according to expected utility theory in laboratory experiments. These two men proposed a different utility function (loss aversion) that could better explain some of these "violations of expected utility theory". In this sense, they combined psychology and economics or "experimental evidence" and theory.

In essence, Dan won for one paper, and the Nobel committee left out Tversky, but that's because he died in 1996 (and you can't win if you're dead). And maybe the Nobel committee really wanted to get this obscure field out of the way by hitting two birds with one stone (although one bird was technically hit in 1996).

Either way, this year's prize went to some people that brought experimental evidence into the forefront of economics and allowed for the straightforward testing of various economic theories.

Sincerely
Ludwig