## Contents

Preface ........................................... xiii

Chapter Seventeen. Introduction to Volume II:  
Not a Symphony, but Œtudes .................. 1

Chapter Eighteen. Cournot and Bertrand .... 9
  18.1. Basic Cournot .......................... 9
  18.2. Cournot “In General” .................. 14
  18.3. Basic Bertrand ......................... 19
  18.4. Differentiated Goods ................. 25
Bibliographic Notes ............................ 29
Problems ....................................... 30

Chapter Nineteen. Moral Hazard and Incentives 35
  19.1. A Very Simple Model .................. 38
  19.2. A Somewhat General Model .......... 48
  19.3. Back to Effort Incentives ............ 61
  19.4. A Continuum of Actions and the First-order Approach 68
  19.5. Linear Incentive Schemes ............ 73
  19.7. Is Risk Aversion the Key to Agency Issues? 94
Bibliographic Notes ............................ 97
Problems ....................................... 98

Chapter Twenty. Private Information Part I:  
One-shot Interactions ......................... 105
  20.1. Adverse Selection: Akerlof’s Market for Lemons 105
  20.2. Akerlof Meets Game Theory: One Seller .... 109
  20.3. Adverse Selection in Other Contexts .... 119
  20.4. A Toy Model of Adverse Selection in Insurance 122
  20.5. Screening as an Economic Concept .... 126
  20.6. Single Crossing ......................... 130
  20.7. Insurance with Two Types .......... 135
  20.8. Signaling: Spence’s Job Market .... 148
  20.9. Cheap Talk ............................ 167
Bibliographic Notes ............................ 173
Problems ....................................... 173

For general queries contact webmaster@press.princeton.edu.
### Chapter Twenty-One. Private Information Part II: An Introduction to Dynamics 181

- 21.2. When Does the Coase Conjecture Hold? 193
- 21.3. (How) Can the Monopolist Escape the Coase-Conjecture Trap? 201
- 21.4. Other Contexts 203

### Bibliographic Notes 206

### Problems 207

### Chapter Twenty-Two. Credibility: Reciprocity and Reputation 211

- 22.1. Oligopoly and Implicit Collusion 213
- 22.2. Entry Deterrence and Predation: The Chain-Store Paradox 231
- 22.3. Relational Contracting 242

### Bibliographic Notes 256

### Problems 257

### Chapter Twenty-Three. Bilateral Bargaining 268

- 23.1. One-Sided Bargaining 270
- 23.2. The Two-Sided Demand Game 273
- 23.3. Rubinstein’s Alternating-Offer Game 275
- 23.4. Alice and Bob Negotiate Where to Eat Dinner 286
- 23.5. Abreu and Gul (2000); A War of Attrition with Incomplete Information 292
- 23.6. The “Most Natural” Context with Private Information and Simultaneous Bid and Ask 300
- 23.7. The Most Natural Context and Dynamic Bargaining 308
- 23.8. Axiomatic Approaches: The Nash Bargaining Solution 313

### Bibliographic Notes 321

### Problems 322

### Chapter Twenty-Four. Auctions 327

- 24.2. Private Values 331
- 24.3. Common-Value Contexts: Preliminaries 352
- 24.4. Symmetric Equilibria in the Wallet-Game Context 356
- 24.5. The Drainage-Tract Context (a.k.a. Maxco–Gambit) 361
- 24.6. Conditionally Independent Signals 363
- 24.7. Multi-Item Auctions 371
- 24.8. Why Do We (Think We) Know More about Auctions Than about Bilateral Bargaining? 373

### Bibliographic Notes 374

### Problems 375
Chapter Seventeen

Introduction to Volume II: Not a Symphony, but Ètudes

Readers of Volume I, *Choice and Competitive Markets*, may expect that this second volume will be similar in form and content. If you have such expectations, set them aside: This volume is utterly different from Volume I, and my first task is to explain why and what you should expect instead.

Volume I concerned (1) the basic models of choice by individual economic agents (consumers and firms), (2) more specifically, the utility-maximizing and profit-maximizing choices of those agents in *competitive* market environments, environments in which they have no influence over prices, and (3) how those choices are reconciled in a *general equilibrium*.

Three characteristics of the models of Volume I are noteworthy:

- To the extent that more than one economic agent is explicitly involved, agents collectively affect the opportunities of other agents only through market prices, and all agents act as if prices are unresponsive to what they themselves do. Therefore, given prices, no agent is (directly) concerned with the actions of any other agent.\(^1\) Economic opportunities for each agent are limited to price-mediated, competitive markets.

- No agent has information about states of nature that another agent lacks. Agents are well informed.

- Each agent is fully capable of making optimal choices, given her objectives and the opportunities that circumstances present to her. Agents are cognizant of all relevant uncertainty, even if they lack information that others possess, and they anticipate accurately what will transpire in every possible future contingency. In a word, agents are *hyper-rational*.

Roughly speaking, in this volume, subtitled *Imperfect Competition, Information, and Strategic Interaction*, we study economic choices and interactions where the first two of these characteristics fail to hold. But in the models discussed in this volume, the third characteristic is maintained.

Volume I concludes with General Equilibrium Theory, in which (virtually) everything that came before comes together in one grand framework. In a sense, Volume I is like a symphony in which early movements provide themes, all of

\(^1\) There are a few minor exceptions, particularly in the discussion of externalities and Lindahl equilibria in Chapter 15.
which are blended together in a grand final movement.²

No such grand synthesis is presented in this volume. Economic theorists have created more or less “general equilibrium models” in which many of the issues studied in this volume are unified. However, in my opinion, none of those unified theories captures everything of importance. Instead, I contend that economic models with imperfect competition, private information, and strategic interaction are best employed to model and analyze specific economic contexts and, in so doing, to gain insight into real-world contexts. The terms partial equilibrium or small-world model are appropriate: A particular relatively isolated piece of the economic environment is identified, modeled, and analyzed, so that (one hopes) insight is gained into that piece of the environment.

Franklin Fisher (1989), in his cri de coeur “Games Economists Play: A Noncooperative View,” distinguishes between generalizing theory and exemplifying theory. Quoting him (p.117), “Generalizing theory proceeds from wide assumptions to inevitable consequences. It speaks in terms of what must happen, given the background circumstances.” Fisher’s first example of generalizing theory is General Equilibrium and the First and Second Theorems of Welfare Economics. In contrast (and again quoting from p.117), “Exemplifying theory does not tell us what must happen. Rather it tells us what can happen. In a good exemplifying-theory paper, the model is stripped bare, with specializing assumptions made so that one can concentrate on the phenomena at issue.”

I prefer the term exemplifying modeling to Fisher’s exemplifying theory. And I think that Fisher credits the generality of General Equilibrium too much: How “general,” in the sense of being general conditions of real-life economic systems, are the assumptions that all markets are perfectly competitive, or all actors have access to the same information, or (in the sense of Chapter 16 in Volume I) all actors have perfect contingent foresight concerning future equilibrium prices? But setting those quibbles aside, I agree wholeheartedly with Fisher on this distinction. Theories in microeconomics that involve imperfect competition, private information, and strategic interaction are exemplifying: They employ models simple enough to provide insight into what might take place in a specific context.

This leads to Fisher’s complaint about exemplifying theory: Such models settle nothing, because their conclusions derive from their assumptions and, just as much, from what the model builder leaves out of the model. Models can be shaped and tweaked to get virtually any conclusion the model builder desires; skeptics use the term reverse engineering to describe the practice of beginning with a desired conclusion and then creating a model from which that conclusion emerges.

So, how are the fruits of exemplifying modeling to be judged? Two types of tests can be employed. The first involves the intuitive appeal of the model: Do the assumptions on which the model was built make sense? Does the logic that leads from assumptions to conclusions seem sensible? What does the model ignore? And there is the possibility of empirical testing: Which predictions can be made, and are

² Experts in classical music will observe that I am stretching things in this analogy, for which I apologize.
What’s in this volume? Tools of this trade

As a practicing economist and, in particular, as a practicing microeconomist, the odds are good that you will engage in exemplifying modeling. To help understand a particular economic phenomenon of interest, you may create and analyze a structured model of it. And even if you aren’t directly in the model–creation business, you will need to understand such models. Because interesting economic phenomena often involve imperfect competition, private information, and (dynamic) strategic interactions, the models with which you must deal will probably possess some of these features. To define these terms:

- Agents do not necessarily take prices (when there are prices) as given. Agents may set prices, either unilaterally or as the result of a process of interaction with others. As far as price-and-market-mediated interactions go, this is imperfect competition.

- Agents may possess information that others lack. This can be information about the underlying state of nature, and it can be information about actions taken by themselves or others.

- When a specific agent’s actions affect directly the choices and/or outcomes available to other agents—so that agents are concerned with what other specific agents do—we have a situation with strategic interaction. And when we add the modifier dynamic, we add the idea that agents may act and react to the actions taken by other agents. Indeed, in some cases, the economic essence is that agents interact repeatedly, with opportunities to react to the earlier actions of others.

Over the years, economists have developed paradigmatic models of these features, such as Akerlof’s (1970) market for lemons, Spence’s (1974) model of job-market signaling, and Green and Porter’s (1984) model of collusion with imperfect price information. It is unlikely that one of these paradigmatic models will fit perfectly the context you are trying to understand, but these paradigms provide the techniques and basic ideas you will use in building your own model (or that are used to build a model that you wish to understand).

This describes the basic nature of Volume II: It is a book of études, models on which you learn and practice the techniques that go into the construction of models fitted to the specific contexts and phenomena in which you will be interested.

The organization of these études creates a dilemma. On one hand, the different models can be organized contextually: We might have, say, a chapter on oligopoly, which would include models from the classic work of Cournot and Bertrand, through to Green and Porter’s model of collusion in repeated interactions with noisy prices. A separate chapter on auctions would deal with private-values and then common-value auctions.

Alternatively, we could organize the models based on the underlying mode
of analysis. Start with models of static, one-shot interactions, with no private information, including the classic models of oligopoly. Move on to, say, models in which one party acts and a second (or several) others respond, such as von Stackelberg competition or the classic principal–agent model. At some point, models of dynamic interactions with an infinite horizon are considered, and simple models of oligopolistic collusion are provided. At another point, private information is explored, and (say) models of entry deterrence are discussed.

The problem with the first method is that virtually any contextual topic, covered completely, requires the full gamut of techniques, from basic static interactions to complex, multi-period interactions with private information that is strategically revealed and/or hidden. The problem with the second method is that the discussion will jump from contextual topic to contextual topic. Neither option is attractive.

In this volume, I present things in a hybrid fashion. The first five chapters gradually introduce the tools of modeling and analysis: Chapter 18 looks at situations that can be modeled with straightforward strategic-form games, in which the participants are assumed to act once, simultaneously and independently. Chapter 19 concerns situations modeled by simple action–reaction games: One party “sets the rules,” and the other parties respond. Chapter 20 introduces incomplete information and beliefs-based equilibria. And Chapters 21 and 22 introduce the complexities of dynamics.

However, these chapters are written contextually. Chapter 18 concerns the classic models of oligopolistic competition—those of Cournot and Bertrand. Chapter 19 concerns moral hazard and the basic principal–agent model. Chapter 20 is about adverse selection, screening, and signaling. Chapter 21 introduces dynamics in the context of the Coase Conjecture; and Chapter 22 concerns repeated play, reciprocity, and reputation. The final four chapters are then contextual: Bilateral bargaining in Chapter 23, auctions in Chapter 24, matching markets in Chapter 25, and mechanism design in Chapter 26.

By organizing things in this fashion, I have tried to make this a book about economics, where game theory is the main tool of analysis, and more complex tools are introduced one by one. It is a text on economics using game theory, not game theory illustrated by economics.

“Foundations” has a double meaning

The title of these volumes begins with Microeconomic Foundations. One meaning of “foundations” is that the topics covered are the building blocks out of which economists study microeconomic phenomena (and also some macroeconomic phenomena, when the macroeconomics has “microfoundations”). But, there is a second meaning: In selecting models and contexts to discuss, I favor the “classics,” papers and books such as Akerlof’s (1970) “The Market for ‘Lemons,’” Spence’s (1974) “Market Signaling,” Green and Porter’s (1984) “Noncooperative Collusion under Imperfect Price Information,” and Rubinstein’s (1982) “Perfect Equilibrium in a Bargaining Model.” As warranted by expositional ease, I simplify in places, and I modify details. But I strongly believe that your education as an economist should include knowledge of the seminal work on each subject.
Noncooperative game theory

There has been and continues to be a deluge of extensions, amendments, qualifications, and improvements to the classics, and in places, I provide some “next steps.” My selection is based on my perception of whether the methods employed serve a pedagogical function and on personal familiarity. Personal familiarity introduces a “home bias” in what is selected, for which I apologize.

However, this volume is not intended to be up to date or to cover all important work on any topic. Any specific topic covered in this volume can be—and often is—the basis of a full course that covers subsequent work. If you plan to work on any of these topics, you have a lot of reading to do to get up to date. What this volume tries to do—all I think a first textbook can do—is to provide you with a foundation (third meaning?) for your subsequent reading. So, in terms of up to date: Only a handful of papers that I cover are relatively recent, where my definition of “relatively recent” stretches to include any paper published in the current century.

This volume is limited in another way. Entire contextual topics are omitted; examples are networks, search, asset pricing with private information, and corporate finance. The études presented in this volume are intended to strengthen your skills while covering some, but not all, important contextual areas. With your skills strengthened, you should (I hope) be able to absorb and then contribute to the literatures in contextual areas that are not covered here.

The bottom line is that this is a textbook of études, not a reference book on the topics covered. It is, perhaps, a bit more than “Introductory (Finger) Exercises for the Economist,” but it should be approached in the spirit of such books.

Assertions and proofs

In Volume I, I aimed to prove rigorously nearly every assertion. There were a few notable exceptions, and in places I only sketched the proof (often asking you to supply the missing steps as a problem, with the solution available online). That is no longer my objective in Volume II. Instead, my objective is to expose you to a variety of different models of economic phenomena and, to achieve the desired breadth, in places I tell you what is proved in the original source and send you to that source to see how the proof goes.

This approach comes with a warning: Journal articles are often not self-contained; they rely on previous work. Notation is not always consistent from article to article (or from this volume to the article I discuss). A skill you must develop is “reading backward”; I will cite a result from Article X and send you there to see the proof. Article X will use different notation from mine, and the proof there will rely on a result from Article Y, with still different notation. Volume I aimed to be self-contained, to spare you from having to make your way through this sort of maze. In this volume, to get the full picture, reading backward is sometimes required.

Noncooperative game theory

With few exceptions, the language of modeling and analysis in this volume is noncooperative game theory. This language isn’t necessary, but it is reasonably well suited to formulating and then analyzing models of some economic phenomena.
that are of interest. And this way of doing business has become standard in the literature.

That said, this is not a textbook on noncooperative game theory, any more than Volume I was a textbook on real and convex analysis. To make your way through Volume I requires at least a good working knowledge of real and convex analysis; in precisely similar fashion, to make your way through this volume requires a good working knowledge of noncooperative game theory. In Volume I, the bare mathematical necessities were provided in a series of appendices; in similar fashion, appendices in this volume provide a review (blended with some strong opinions) of what you need to know about noncooperative game theory.

Game theory is not economics. It is a useful mathematical (abstract) language for building and studying models in economic contexts, as well as for building and studying models in at least some parts of political science, sociology, and social psychology. (I am told that it also can be fruitfully employed in various branches of the biological sciences and computer science, although I know little about this.) Game theory is useful because it has considerable virtues in deductive rigor, in understanding which assumptions lead to which conclusions, and in communicating ideas. But it has some very significant weaknesses. Perhaps its two greatest weaknesses are:

1. It relies on hyperrationality of economic agents. This is not new; in Chapter 16 (in Volume I), when we considered adaptations of general equilibrium to economies with time and uncertainty, the relevant equilibrium concept was an Equilibrium of Plans, Prices, and Price Expectations (EPPPE). In an EPPPE, consumers not only are assumed to know and react to prices of goods and securities being sold today; they are assumed to make their immediate consumption and security-purchase decisions based on accurate expectations about future equilibrium prices (contingent on states of nature). This, we observed, is asking a lot of the agents in the model. And, in some of the models discussed in this volume, we ask even more.

2. Game theory, as applied in the models encountered in this volume, begins with the specification of a game: a set of players; rules for how they can interact; and payoffs they receive, depending on how they interact. It is assumed that the game is common knowledge among the players: They know the rules; they believe that their rivals know the rules; they believe that their rivals believe that they know the rules; and so forth. The introduction of so-called games of incomplete information loosens this modeling straitjacket to some extent. But, to keep the models tractable (amenable to analysis), this loosening barely begins to reflect the confusion and ambiguity of real-life interactions.

In 1990, when the methods of noncooperative game theory were at the height of economic fashion, I gave a series of lectures on what I saw as the strengths and weaknesses of this mode of modeling and analysis as a tool of economics (Kreps 1990b). I’d say things a bit differently today: Given what has happened in the intervening years, I’m more skeptical about how these methods have been used.
Concerning the appendices

One thing is worth saying right away: One cannot run an empirical test of “game theory.” Game theory cannot be falsified empirically, any more than convex analysis can be. What can and should be tested to the extent possible—and what are certainly amenable to falsification—are the predictions that are derived from the contextual models discussed in this volume, models built with the language of noncooperative theory.

And, since empirical tests of applications of game theory are not always available or easy, practitioners—that means you—must employ common sense. Go back to the first paragraph in this section, and the italicized some in the penultimate sentence. Not every economic phenomenon of interest is amenable to game-theoretic analysis, and not every game-theoretic model of some phenomenon passes the test of being sensible or capturing the most important aspects at work in the real world. As game theory is enlisted in this volume to model specific phenomena, it is essential that you ask and answer the subjective question: Does this model and analysis provide valuable insight into the phenomena? (In some cases, with models that are justifiably regarded as landmarks in the literature, I provide my own, negative opinion.) When and if you enlist these methods in your own research, answering this question—and being able to explain to others what those insights are—is even more important.

Concerning the appendices

In Volume I, the appendices succinctly outline the basic results in real and convex analysis that the text requires. A similar plan for this volume would mean appendices that outline basic concepts from and results in noncooperative game theory. Such appendices are provided, but they are longer and far more conversational than the appendices in Volume I. Controversies about the meaning of Berge’s Theorem or the Separating Hyperplane Theorems may exist, but if they do, they surely aren’t important to economists. But how one thinks about the application of game theory in economic modeling—when and why is it appropriate and/or useful in generating economic insight—is controversial; in the text but also in the appendices, I often wax philosophical on such issues. And, to be clear, the commentary that I provide is, in places, controversial among economists. Since I had personal involvement in the development of some of these concepts, I am certainly biased. You should seek out other perspectives to correct for my biases and to make up your own mind on these questions.

In particular, I present game theory as a tool for modeling and analyzing economic interactions. In so doing, I interpret game-theoretic concepts and constructs from what might be called an “intuitionist” perspective. Those parts of the game-theory literature that pursue foundational issues about game-theoretic concepts and constructs—in particular, what is known as epistemic game theory—might in contrast be said to take a “formalist” perspective. I do not mean to denigrate work that takes a more formalist perspective and, indeed, I suggest in the appendices sources that pursue these perspectives. But, for a textbook intended for first-year graduate students in economics, or even economics students who are taking a deeper look at the applications of game theory to economic issues, I believe the
“intuitionist” perspective is appropriate. To put it plainly: Game theory, to be a fruitful tool of economic analysis, must support and not replace economic intuition. If you stipulate this view of the role game theory should play in economic analysis, I contend that the “intuitionist” perspective is the appropriate perspective to take.

Because the appendices are more than a collection of definitions and propositions in noncooperative game theory, readers who have not taken a course in game theory may conclude that the appendices can substitute for a full course on the subject. Instructors may conclude that they can use the appendices to “review” game theory as part of a course they teach, where “review” is very broadly interpreted. If one wants a nodding acquaintance with game-theoretic techniques, this may be so. However, the appendices are insufficient for anything approaching mastery of the material they cover. Game theory is a mathematical discipline, and to understand deeply any branch of mathematics, one needs to do the math, not just read about it. This requires problem sets, which the appendices do not contain. There are many excellent textbooks in game theory, and you will get more out of the economics in this volume if you consume one of them, preferably in a structured course or organized reading group on the subject, complete with working on the problems provided.

The craft of model building and analysis

A book of études for, say, the piano, is intended primarily to promote the technique of performing or playing the piano, not to instruct the user in music composition. In this sense, the analogy between a book of piano études and this volume breaks down. It is true (and I’ve emphasized here) that the point of this volume is for you to learn and practice the techniques of analysis that are nowadays applied in microeconomics. But as a practicing economist, you must both compose—build the model—and then perform, that is, provide a reasoned analysis of your model. I hope this volume helps you both to build and then analyze models. In this respect, what you read here provides examples of how this has been done by others. But reading about models and their analysis is insufficient; both are crafts that you learn best by doing. At the end of each chapter (after this one) are problems. Many have you complete proofs or arguments that are left undone in the text. Others—fewer perhaps—require you to construct variations on models in the text. In an ideal world, you would do them all. In the real world, you will get much more out of this volume if you do your fair share of these problems.

And, as you do the problems, please note: Solutions for all the problems in this volume are available in the Online Supplement, available online at the URL press.princeton.edu/online-supplement/microfoundations-II.
### Index

<table>
<thead>
<tr>
<th>Name</th>
<th>Page(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abreu, Dilip</td>
<td>224, 231, 292, 298, 300, 312, 322, 681, 684, 703, 728</td>
</tr>
<tr>
<td>Abreu–Gul model of bargaining</td>
<td>293–300</td>
</tr>
<tr>
<td>Adachi, Hiroyuki</td>
<td>397, 428</td>
</tr>
<tr>
<td>Admati, Anat</td>
<td>309, 311, 322</td>
</tr>
<tr>
<td>adverse selection</td>
<td>4, 106, 124–35</td>
</tr>
<tr>
<td>financial models and</td>
<td>120</td>
</tr>
<tr>
<td>insurance and</td>
<td>121–22, 181, 203</td>
</tr>
<tr>
<td>used-car markets</td>
<td>106–9. See also</td>
</tr>
<tr>
<td>Akerlof’s market for lemons</td>
<td></td>
</tr>
<tr>
<td>voluntary retirement and, 119–20</td>
<td></td>
</tr>
<tr>
<td>affiliated random variables</td>
<td>365</td>
</tr>
<tr>
<td>monotone-likelihood condition and, 365–67</td>
<td></td>
</tr>
<tr>
<td>agency theory. See principal-agent model</td>
<td></td>
</tr>
<tr>
<td>agreeing to disagree</td>
<td>608–9</td>
</tr>
<tr>
<td>Akerlof, George</td>
<td>3, 4, 106–9, 173, 618</td>
</tr>
<tr>
<td>Akerlof’s market for lemons</td>
<td>3, 4, 105–19, 173–75, 181, 203</td>
</tr>
<tr>
<td>game-theoretic models of</td>
<td>109–18</td>
</tr>
<tr>
<td>Allis–Chalmers</td>
<td>220, 224, 256</td>
</tr>
<tr>
<td>all-pay auctions</td>
<td>330, 340, 375</td>
</tr>
<tr>
<td>Alphabet Corporation</td>
<td>234</td>
</tr>
<tr>
<td>Amazon</td>
<td>234</td>
</tr>
<tr>
<td>anticipatory equilibrium</td>
<td>143</td>
</tr>
<tr>
<td>Arrow, Kenneth</td>
<td>9, 436</td>
</tr>
<tr>
<td>Arrow’s (Im)Possibility Theorem</td>
<td>436</td>
</tr>
<tr>
<td>Ashlagi, Itai</td>
<td>428</td>
</tr>
<tr>
<td>Auctions</td>
<td>327–79. See also private-values auctions; common-value auctions; first-price auctions; second-price (Vickrey) auctions</td>
</tr>
<tr>
<td>all-pay auctions</td>
<td>330, 340, 375</td>
</tr>
<tr>
<td>button</td>
<td>330</td>
</tr>
<tr>
<td>collusion and</td>
<td>351–52</td>
</tr>
<tr>
<td>common-value contexts</td>
<td>352–55</td>
</tr>
<tr>
<td>Dutch</td>
<td>329</td>
</tr>
<tr>
<td>English, or ascending bid</td>
<td>329</td>
</tr>
<tr>
<td>envelope theory and</td>
<td>342</td>
</tr>
<tr>
<td>first-price (sealed-tender)</td>
<td>328</td>
</tr>
<tr>
<td>mechanism design and</td>
<td>327</td>
</tr>
<tr>
<td>multi-item</td>
<td>330, 371–73</td>
</tr>
<tr>
<td>optimal</td>
<td>461–73</td>
</tr>
<tr>
<td>pay-per-bid</td>
<td>330</td>
</tr>
<tr>
<td>protocols for</td>
<td>328</td>
</tr>
<tr>
<td>reserve prices and</td>
<td>344–50</td>
</tr>
<tr>
<td>revelation principle and</td>
<td>341</td>
</tr>
<tr>
<td>revenue equivalence theorem for</td>
<td>337–44</td>
</tr>
<tr>
<td>royalty based</td>
<td>329, 377</td>
</tr>
<tr>
<td>second-price (sealed tender)</td>
<td>329</td>
</tr>
<tr>
<td>Vickrey (second-price) auctions</td>
<td>329, 454</td>
</tr>
<tr>
<td>Vickrey–Clarke–Grove mechanism and</td>
<td>373</td>
</tr>
<tr>
<td>winner’s curse and</td>
<td>355–56</td>
</tr>
<tr>
<td>Aumann, Robert</td>
<td>519, 520, 545, 546, 609–10, 624n, 630, 679, 728, 729</td>
</tr>
<tr>
<td>backward induction</td>
<td>553</td>
</tr>
<tr>
<td>Bacon, Nathaniel</td>
<td>29</td>
</tr>
<tr>
<td>Baiman, Stanley</td>
<td>97</td>
</tr>
<tr>
<td>Banks, Jeffrey</td>
<td>173, 654</td>
</tr>
<tr>
<td>bargaining. See bilateral bargaining</td>
<td></td>
</tr>
<tr>
<td>Battigalli, Pierpalo</td>
<td>603</td>
</tr>
<tr>
<td>battle-of-the-sexes game</td>
<td>501</td>
</tr>
<tr>
<td>beer–quiche game</td>
<td>634n</td>
</tr>
<tr>
<td>behaviorally mixed strategies in extensive-form games</td>
<td>536-40</td>
</tr>
<tr>
<td>beliefs at information sets. See also intuitive criterion; perfect Bayesian equilibrium; sequential equilibrium; sequential rationality</td>
<td></td>
</tr>
<tr>
<td>consistency of off-path beliefs</td>
<td>579–89</td>
</tr>
<tr>
<td>full consistency (in sequential equilibrium)</td>
<td>586–88</td>
</tr>
<tr>
<td>on-path and extended on-path consistency of</td>
<td>568–79</td>
</tr>
<tr>
<td>proper-subgame consistency of</td>
<td>580–81</td>
</tr>
<tr>
<td>sequential equilibrium and</td>
<td>588–89</td>
</tr>
<tr>
<td>bench marking</td>
<td>87–89</td>
</tr>
<tr>
<td>Benoit, Jean-Pierre</td>
<td>678, 728</td>
</tr>
</tbody>
</table>

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Berger, Dirk, 482
Bergen, Douglas, 520
Berger's theorem, 7, 57–58, 99–100
Bernheim, Douglas, 520
Bernstein, Joseph, 3, 4, 9, 29, 520
Bertrand model (price competition), 4, 19–25
capacity constraints, 22–25
derdifferentiated goods, 26–29
travel costs and, 32–35
bid rigging, 220
bilateral bargaining, 4, 268–326
Abreu–Gul model, 292–300
axiomatic approach, 313–12
contexts for, 269–70
inefficiency of, 307–8, 474–79
“most natural” context, 300–312, 474
Myerson–Satterthwaite theorem for, 474–79
Nash bargaining solution, 313–21
one-sided bargaining protocol, 270–73
protocols for, 269
Rubinstein’s alternating-offers model, 275–86, 317–21
simultaneous bid and ask, 273–75, 300–308
strategic delay in making offers, 309–12
two-sided demand game, 273–75
war of attrition, 286–300
Binmore, Kenneth, 322
Blume, Lawrence, 600, 603
Bowen, T. Renee, 254n
building a reputation, 726–27
Bulow, Jeremy, 206, 471, 473, 482
cadaver kidney allocation, 383
career concerns, 204–5
Carroll, Gabriel, 89
cartels. See collusion in auctions (bid-rigging); collusion in oligopolies
Cassady, Ralth, 374
centipede game, 544
chain-store parable, 234–37, 264–66
instrumental reputation for, 237–37
threat game and, 235
chain-store paradox, 237–42, 628
incomplete-information resolution of, 237–40
one chain store versus one entrant, 240–41
Chatterjee, Kaylon, 303, 306, 322
cheap talk, 105, 167–73
Chiappori, Pierre-Andr´e, 419
Cho, In-koo, 158, 654
Clarke, Edward, 481
closed-loop strategies, 293–94
Coase, Ronald, 182, 202n, 206
Coase conjecture, 4, 181–203
commitment possible and, 185–87
double limits and, 194
finitely many repricing periods, 190–93
how to avoid, 201–3
infinitely many repricing periods, 198–201
naive consumers and, 184–85
single consumer variation, 183–84
two repricing periods, 187–90
collusion in auctions (bid-rigging), 220
collusion in multi-agent models, 86–87
collusion in oligopolies, 3, 4, 212, 213–31
folk theorem, versus 217, 218, 221–22
Green–Porter model of, 222–25
multiplicity of equilibria, 218–21
noisy prices and 222–25
noisy quantity outcomes and, 225–31
non-Nash punishments for, 221–22
promise and threat strategies, 221
common knowledge, 604–8
robustness to lack of, 623–30
common-value auctions. See also affiliated random variables
conditionally independent signals, 353–54, 363–71

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Index

drainage-tract model (Maxco–Gambit), 354–55, 361–63
English (button) auction equilibrium 359–61, 369
first-price auction equilibrium, 358–59, 362–63, 369–71
multi-item, 371–73
second-price auction equilibrium, 357–58, 361–62, 367–68
wallet game, 352–53, 356–61
winner’s curse in, 353–56
comparative performance evaluation, 37, 97, 102–4
complete and perfect information
definition of, 552
ties encountered with, 555–56
Zermelo’s theorem for, 554
conditionally independent signals in auctions. See also common-value auctions
affiliation of signals and value, 363–67
English (button) auction equilibrium, 369
first-price auction equilibrium, 369–71
revenue equivalence (does not hold), 371
second-price auction equilibrium, 367–68
conjunctural variations, 144, 176
consistency of beliefs. See beliefs at information sets
contractible contingency (definition), 36
convexity-of-the-distribution property, 65, 69
correlated equilibrium, 518–20
Cournot, Antoine-Augustin, 3, 4, 9, 29, 520
Cournot model (quantity competition), 4, 9–19
differentiated goods, 25–29
multiple equilibria, 16–17
simple linear parameterization, 11–14
travel costs, with, 32–34
uniqueness of equilibrium, 18–19
Cramton, Peter, 311, 312, 322
credibility, 206, 548–49, 556–57
promises and, 212
threats and, 212, 231
Crémer, Jacques, 473, 480, 482
Dalkey, N., 547, 641, 654
Dantzig, George, 417
Das Gupta, Partha, 518, 520, 742
David, H. A., 348
delayed-acceptance algorithm
college-admissions model, 407
job-assignment model, 410n17, 410n18
marriage market, 385
properties of, 386–87
salaries, with, 420–21
stability of resulting match, 388–40, 407, 410, 422
Dekel, Eddie, 498, 520, 630
Demange, Gabrielle, 428
Demske, Joel, 97
dictatorial voting-rule function, 427. See also Gibbard–Satterthwaite theorem
direct-revelation mechanism and truth telling, 341, 435, 738
divinity and universal divinity, 652–53
dominance
extensive-form games, in, 542–43
iterated, 493–500
rationalizability and, 503–4
strict, 491
weak, 491
dominance solvability, 12, 496
Nash equilibrium and, 508–10
dominated messages, test of (restrictions on off-path beliefs), 649–50
double limits, 194
drainage-tract model (or, Maxco–Gambit)
equilibria for, 361–63
formulation of, 354–55
Dutta, Prajit, 681, 728
Dye, Ron, 178
dynamic-programming tools for repeated games, 658–59
Echenique, Federico, 397, 428

For general queries contact webmaster@press.princeton.edu.
economic engineering, 380
Edgeworth, Francis Ysidro, 29
education as a signal. See Spence’s job-market signaling model
enduring private information in repeated games
prisoners’ dilemma and, 724–26
threat game and, 710–18, 724
trust game and, 718–23
English (button) auction
conditionally independent signals and, 369
private values and, 350–51
wallet game and, 359–61
entry deterrence, 4, 232–34. See also chain-store parable; chain-store paradox
choice of technology and, 232
entrants inferring incumbent’s cost structure and, 232–23
threat of predation and, 233–34
everenvelope theorem(s)
Berge’s theorem and, 744
classic version, 744–45
integrated form of, 747–49
moving constraint sets, 747
reason for name, 743
epistemic game theory, 7, 605, 630
equilibrium outcomes instead of equilibria, 637–39
equilibrium-value domination and the intuitive criterion, 651–52
exemplifying modeling, 2
extended-on-path consistency of beliefs, 570–71
extensive-form games
actions in, 523–24
behaviorally mixed strategies in, 536–40
complete and perfect information in, 552–56
definition of, 521–25
diagramming, 525–29
dominance in, 542–43
existence of Nash equilibria, 545
final (or terminal) nodes, 522
game tree for, 521–23
histories in, 522
information sets in, 524–25
initial nodes in, 522
Kuhn’s theorem for, 539–40, 545
mixed strategies in, 526
Nash equilibrium in, 542–43
Nature as a participant, 521, 523, 525
non-finite games, 543–44
paths in, 522
payoffs in, 525
perfect recall, with, 529–32
predecessor nodes, 522
probabilities in, 525
reduced strategies for, 534–35
strategically equivalent representations, 546–47
strategies in, 532–34
successor nodes, 522
tree structure, 521–23
Zermelo’s theorem for, 544
first best (definition), 44
first-mover advantage in entry deterrence, 234
first-order stochastic dominance, 61–62
first-price auctions
conditionally independent signals and, 369–71
drainage-tract model and, 362–63
private values and, 335–37
wallet game and, 358–59
Fisher, Franklin, 2, 9, 566n, 682
focal points and equilibria, 274–75, 513–15
folk theorems
basic structure, 672–73
bottom-line meaning of, 682–83
classic version, 679–81
grim punishment with stage-game
    Nash equilibrium, 673–74
minmax payoffs for, 675–78
subgame perfection for, 369–81
forward induction, 632, 636
free-rider problem, 34
## Index

<table>
<thead>
<tr>
<th>Name</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Friedman, James</td>
<td>256, 728</td>
</tr>
<tr>
<td>Fuchs, William</td>
<td>204, 206</td>
</tr>
<tr>
<td>Gale, David</td>
<td>381, 385, 390n, 402n, 405, 426, 427, 428, 432</td>
</tr>
<tr>
<td>Galichon, Alfred</td>
<td>419</td>
</tr>
<tr>
<td>game tree</td>
<td>521–23</td>
</tr>
<tr>
<td>gang-of-four paper</td>
<td>725n</td>
</tr>
<tr>
<td>Geanakoplos, John</td>
<td>440, 481</td>
</tr>
<tr>
<td>General Electric Corporation</td>
<td>220, 225–27, 230, 256</td>
</tr>
<tr>
<td>generalized game</td>
<td>488</td>
</tr>
<tr>
<td>generalizing theory</td>
<td>2</td>
</tr>
<tr>
<td>generic payoffs and probabilities</td>
<td>553n</td>
</tr>
<tr>
<td>Gentzkow, Matthew</td>
<td>178–79</td>
</tr>
<tr>
<td>Gibbard, Alan</td>
<td>436, 481, 742</td>
</tr>
<tr>
<td>Gibbard–Satterthwaite theorem</td>
<td>436–43, 440–43</td>
</tr>
<tr>
<td>proof</td>
<td>440–43</td>
</tr>
<tr>
<td>real-life voting systems and</td>
<td>439</td>
</tr>
<tr>
<td>statement</td>
<td>438, 483</td>
</tr>
<tr>
<td>Gilli, Mario</td>
<td>603</td>
</tr>
<tr>
<td>Glicksberg, I. L.</td>
<td>517</td>
</tr>
<tr>
<td>Glicksberg’s existence theorem for Nash equilibria</td>
<td>16, 518</td>
</tr>
<tr>
<td>Govinden, Hari</td>
<td>654</td>
</tr>
<tr>
<td>Green, Edward</td>
<td>3, 4, 222–25, 256, 703, 723</td>
</tr>
<tr>
<td>Green, Jerry</td>
<td>97, 173, 482</td>
</tr>
<tr>
<td>grim punishment</td>
<td>217</td>
</tr>
<tr>
<td>grim strategy (definition)</td>
<td>660</td>
</tr>
<tr>
<td>grim versus grim in the repeated prisoners’ dilemma</td>
<td>665–66</td>
</tr>
<tr>
<td>Grossman, Sanford</td>
<td>48n, 67, 97</td>
</tr>
<tr>
<td>Groves, Theodore</td>
<td>481</td>
</tr>
<tr>
<td>Gul, Faruk</td>
<td>201, 206, 292, 298, 300, 312, 322, 440, 481</td>
</tr>
<tr>
<td>Hammond, Peter</td>
<td>742</td>
</tr>
<tr>
<td>Harrington, Joseph</td>
<td>219n, 225, 228, 256</td>
</tr>
<tr>
<td>Harris, Milton</td>
<td>742</td>
</tr>
<tr>
<td>Harsanyi, John</td>
<td>604, 630</td>
</tr>
<tr>
<td>Harsanyi doctrine</td>
<td>610</td>
</tr>
<tr>
<td>Hart, Oliver</td>
<td>48n, 67, 97</td>
</tr>
<tr>
<td>Hart, Sergiu</td>
<td>322</td>
</tr>
<tr>
<td>Hatfield, John</td>
<td>397, 424, 428, 459</td>
</tr>
<tr>
<td>Hendon, Ebbe</td>
<td>573, 603</td>
</tr>
<tr>
<td>Hendricks, Ken</td>
<td>322</td>
</tr>
<tr>
<td>hidden action</td>
<td>36–37</td>
</tr>
<tr>
<td>hidden information and repeated play</td>
<td>689–703</td>
</tr>
<tr>
<td>Hillas, Jon</td>
<td>654</td>
</tr>
<tr>
<td>holdup</td>
<td>211–12, 243</td>
</tr>
<tr>
<td>Holmstrom, Bengt</td>
<td>59, 74, 81–83, 89–94, 97, 101, 205, 206</td>
</tr>
<tr>
<td>Holmstrom informativeness principle</td>
<td>59–60, 67, 83</td>
</tr>
<tr>
<td>Hopenhayn, Hugo</td>
<td>229, 256</td>
</tr>
<tr>
<td>Hungarian method</td>
<td>417n, 456</td>
</tr>
<tr>
<td>immediate-action rationality</td>
<td>570–72</td>
</tr>
<tr>
<td>imperfect information (games of)</td>
<td>619</td>
</tr>
<tr>
<td>imperfect observability and repeated play</td>
<td>689–703</td>
</tr>
<tr>
<td>incentives. See principal–agent model</td>
<td></td>
</tr>
<tr>
<td>incomplete information</td>
<td>3, 4, 7, 610–23</td>
</tr>
<tr>
<td>common knowledge and</td>
<td>620–23</td>
</tr>
<tr>
<td>player “types,” 617</td>
<td></td>
</tr>
<tr>
<td>independence of irrelevant alternatives in the Nash bargaining solution</td>
<td>315</td>
</tr>
<tr>
<td>independent of irrelevant alternatives and nonmanipulability</td>
<td>440–43</td>
</tr>
<tr>
<td>information sets</td>
<td>524–25</td>
</tr>
<tr>
<td>instrumental reputation</td>
<td></td>
</tr>
<tr>
<td>building a reputation</td>
<td>726–27</td>
</tr>
<tr>
<td>examples</td>
<td>703–4</td>
</tr>
<tr>
<td>noise and inability to monitor</td>
<td>708–9</td>
</tr>
<tr>
<td>predation and</td>
<td>236</td>
</tr>
<tr>
<td>relational contracts and</td>
<td>251</td>
</tr>
<tr>
<td>threat game and</td>
<td>707–8</td>
</tr>
<tr>
<td>trust game and</td>
<td>704–7</td>
</tr>
<tr>
<td>insurance-market model with two types</td>
<td></td>
</tr>
<tr>
<td>anticipatory equilibrium for</td>
<td>142</td>
</tr>
<tr>
<td>game-theoretic models of</td>
<td>147</td>
</tr>
<tr>
<td>monopoly</td>
<td>145–47</td>
</tr>
<tr>
<td>perfect competition</td>
<td>135–42</td>
</tr>
<tr>
<td>reactive equilibrium for</td>
<td>142</td>
</tr>
</tbody>
</table>
Riley equilibrium, 142
  single-crossing property and, 133–34
insurance markets
  adverse selection in, 106, 122–25
  screening, 106
intuitive criterion, 652–53
  bilateral bargaining and, 309
  signaling in insurance markets and, 158–66
Jackson, Matthew, 448, 481
Jacobsen, Hans Jorgen, 573, 603
Jehle, Geoffrey, 545
Jewitt, Ian, 97
job design, 82–83
job-assignment model (many-to-one matching markets), 409–10
  deferred-acceptance algorithm for, 410n17, 410n18
  formulation, 382
  salaries and, 410–24
  stable matches for, 410
  substitutable preferences for, 403–5
  job-market signaling. See Spence’s job-market signaling model
Kahn, Charles, 206
Kalai–Smorodinsky bargaining solution, 321
Kamenica, Emir, 178–79
Kelso, Alexander, 410, 423, 428, 432, 459
kinked-demand model, 144, 176
Klemperer, Paul, 372, 481
Knoer, Elsie, 419, 456, 459
Kohlhberg, Elon, 158, 351n, 603, 638, 640–43, 654
Kreps, David, 6, 98, 125, 158, 173, 238, 242, 254n, 257, 322, 591n, 600, 603, 630, 654, 710n, 713n, 725, 727, 729
Krishna, Vijay, 374, 481, 678, 728
Kuhn, Harold, 417n, 454, 540, 545
Kuhn’s theorem, 539–40, 545
Laffont, Jean-Jacques, 306, 482
Lazear, Edward, 97, 243
  learned behavior, 511–12
Leonard, Herman, 457
Levin, Jonathan, 97
Levine, David, 238, 246n, 257, 512, 520, 557, 684, 703, 714, 717–18, 719, 728
Li, Shengwu, 351n
  linear incentives, 37, 73–94
  benchmarking and, 87–88
  colluding agents and, 86–87
  justification incentives, 78–80
  multitasking and, 80–83
  parametric model for, 74–78
  relative performance evaluation and, 83–87
Linhart, Peter, 312, 322
  lonely hearts club theorem, 401, 429
Ma, Ching-to, 97
Macleod, W. Bentley, 97
Mailath, George, 655, 728
  mandatory retirement, 243
  manipulable voting-rule function (definition), 437
  many-to-one matches. See college-admissions model; job-assignment model
market for lemons. See Akerlof’s market for lemons
market segmentation, 220, 230–31
marriage market
  deferred-acceptance algorithm for, 385–93
  formulation, 381
  lattice structure of stable matches, 394–401
  lonely hearts club theorem for, 401
  side-optimality of matches, 389–92
  stability of matches (and the core), 389
Maskin, Eric, 444, 481, 518, 520, 679, 679n13, 703, 728, 729, 742
  Maskin’s theorem for Nash implementation, 446–47
matching markets, 4.  See also college-admissions model, job-assignment model; marriage market contexts for, 381–83
issues in, 380
multilateral matches, 383
ongoing matches, 383
   See also drainage-tract model
McAfee, Preston, 479, 482
McLean, Richard, 473, 480, 482
mechanism (definition), 435
mechanism design, 4, 327, 338, 434
bilateral bargaining and (Myerson–Satterthwaite theorem), 474–79
direct-revelation mechanism, 435
Gibbard–Satterthwaite theorem, 436–46
Maskin’s theorem for Nash implementation, 446–47
optimal auctions, 461–73
revelation principle and, 435
social-choice context, 435
truth telling and, 435
Vickrey–Clarke–Groves (VCG) mechanism, 448–61
Mertens, Jean-Francois, 158, 351n, 618, 630, 638, 640–43, 654, 728
Milgrom, Paul, 69, 74, 81–83, 89–94, 97,
   101, 178, 205, 211n, 233, 238, 257, 327, 367, 373, 374, 397, 424, 428, 459, 482, 620, 710n, 713n, 715, 729, 749
minmax payoffs, 675–78
mixed strategies
behaviorally mixed, 536–41
extensive-form games, for, 536
definition, 490–91
Kuhn’s theorem for, 539–40
simple, 490–91
Molinari, Cristina, 603
monotone-likelihood property, 63–64
affiliation and, 366–67
definition, 365
stochastic dominance, versus, 64, 363–64
Mookerjee, Dilip, 97
Moore, John, 97, 482
moral hazard, 4, 35–37
Morgenstern, Oscar, 520, 547
“most natural” bargaining context, 300–312, 474.  See also bilateral bargaining
Muller, Eitan, 443, 481
Muller–Satterthwaite theorem, 443
multitasking, 37, 80–83, 95, 97
Myerson, Roger, 308, 423n, 461, 474, 479, 601, 603, 654, 742
Myerson–Satterthwaite theorem, 474–79
VCG mechanism and, 475n
Myerson’s theorem (optimal auctions), 467–70
Nagaraja, H. N., 348
Nalebuff, Barry, 97
Nash, John, 313, 322, 520
Nash bargaining solution, 269, 313–21
axioms for, 314–15
problem definition, 313–14
Rubinstein’s alternating-offer game and, 317–21
solution definition and proof, 316–17
Nash equilibrium
definition, 504–5
dominance solvability and, 508–10
existence, 516–18
extensive-form games and, 542–45
focal point for behavior, 513–14
learned behavior, as, 511–12
mutual interest versus safety, 511
“obvious way to play,” as a necessary condition for, 506
social custom, 512–13
uniqueness as justification for, 510–11
Nash implementation of social choice correspondences (Maskin’s theorem), 444–48
never-a-weak-best-response test (for strategic stability), 645–47
no-trade theorems, 609–10
noncooperative game theory, 5–7
norms of behavior, 212, 255–56
"obvious way to play" (as justifying Nash equilibrium), 508–16
off-path information set. See also beliefs at information sets; sequential rationality definition, 550
on-path information sets
consistency of beliefs at, 569
definition, 550
one-sided bargaining, 270–73
OPEC (Organization of Petroleum Exporting Countries), 220, 224–25
optimal auctions, 344–50, 461–73
ironing, 473
Myerson’s theorem for, 467–70
nonindependent private values and, 473
participation constraints for, 466
reserve prices and, 344–50
revelation principle for, 462–66
virtual valuations, definition, 467
virtual valuations, interpretation, 471–73
Ortega-Reichart, A., 374
Osborne, Martin, 319, 322
Ostrovsky, Michael, 397, 428, 548
Oviedo, Jorge, 397, 428
participation constraints, ex ante and interim, 466
bilateral bargaining, in, 477–78
mechanism design, in, 740–41
optimal auctions, for, 466
partnership (one-to-one) matching model
with division of profits (Shapley–Shubik, Crawford–Knoer)
defered acceptance algorithm for, 421–22
definitions for, 414–15
existence of stable match and lattice characterization, 416–18
social efficiency of, 415
stability of match, 414–15
Pathak, Parag, 428
Pearce, David, 224, 231, 256, 520, 703, 738
perfect Bayesian equilibrium, 558, 579
perfect public-signal equilibrium, 216–17
definitions for, 700–701
examples, 689–700
existence, 702
perfect recall, 529–32
Perry, Motty, 309, 311, 322
personal decision trees, 573–79
fundamental rules for, 576
off-path beliefs and, 578
phases-of-the-moon conspiracy, 220
piece-rate pay, 35
Porter, Michael, 225n, 230, 256
Porter, Robert, 3, 4, 222–25, 256, 703, 728
predation 225n, 233–35. See also chain-store parable
price competition. See Bertrand model
price leadership, 220, 230
price-mediated match
defined, 411
existence of, 413
social efficiency of, 413
principal–agent model, 4, 37. See also linear incentives
Berge’s theorem and, 57–58
comparative statics, 47–48, 73
continuum of actions, 68–73
effort-incentives model, 62–70
existence of solutions for, 51–56
first-best, 43–45, 62
first-order, complementary-slackness conditions for, 58–59
first-order approach, 68–73
fundamental tradeoff (risk-sharing versus incentive), 46–47, 94
general model, 48–57
Holmstrom informativeness principle, 59–60, 83
increasing wages, 62–63, 66–67
limited liability and, 95–96, 101–2
linear incentive schemes, 73–94
multitasking in, 80–83, 95, 97
production interdependencies and, 96
risk-neutral agent and, 45–46, 94–96
simple model of, 38–48
subgame perfection and, 40, 56–57
prisoners’ dilemma, 492. See also repeated prisoners’ dilemma

private-values auctions

colluding bidders, 351–52
different contextual assumptions, 311
dynamic auctions (Dutch and English), 350–51
first-price auction, 333–37
reserve prices, 344–50
revenue equivalence, 337–44
second-price (or Vickrey) auction, 332–33
promise game. See trust game
proper equilibrium, 600-602, 642–43
proper subgame (definition), 549. See also
subgame-perfect equilibrium
proper-subgame (and extended-proper-subgame) consistency of beliefs, 580–1

quantity competition. See Cournot model

Rabin, Matthew, 74
Radner, Roy, 312, 322
rat race, 204–5
ratchet effect, 204–5
rationalizability, 500–504

correlated assessments for, 501–3
dominance, versus, 503–4
Raviv, Artur, 742
reactive equilibrium, 143
reciprocity, 4
reduced strategies (in extensive-form games), 534–35
Reinganum, Jennifer, 176
relational contracting, 242–56
community enforcement and, 254
multilateral, 253–54
norms of behavior and, 255–56
trading favors and, 246–53
trust game and, 244–46
Reny, Philip, 440, 479, 481, 482, 545, 603
repeated-play models. See also repeated prisoners’ dilemma
catalog of variations, 655–58

enduring private information and,
709–26
finite horizon equilibria, 684–89
fixed discount factor less than 1, 683–84
imperfect observability, hidden information, and perfect public equilibria, 689–703
instrumental reputation and, 703–9
repeated prisoners’ dilemma
dynamic programming tools for, 658–59
finite horizon, 724–26
formulation, 659–60
grim versus grim, 665–66
inefficient equilibria, 670–72
one-round-of-compensation strategy, 667–68
strategies for, 660
tit-for-tat, best response(s) to, 661–63
tit-for-tat versus tit-for-tat, 664–65
two-rounds-of-punishment strategy, 666–67

Repullo, Rafael, 447, 481
reputation. See instrumental reputation
responsive preferences
college-admissions problem, in, 406
definition of, 403
revelation principle(s), 736–43
associated incomplete-information game, 737–38
auctions and, 340–42, 467–69, 735–36
contingent outcomes (definition), 736
direct-revelation mechanism
(definition), 738
general mechanism (definition), 737
inalienable rights and, 740–41
Nash-equilibrium revelation principle, 739
participation constraints and, 740–41
questions posed, 737
setting for, 735
truth telling (definition), 738–39
variations in setting, 445–46, 742
weak-dominance revelation principle, 739

Riley, John, 143–45, 173, 292, 322

For general queries contact webmaster@press.princeton.edu.
Riley outcome (and equilibrium), 144, 160–61, 204
Roberts, John, 178, 211n3, 233, 238, 257, 471, 473, 482, 710n, 713n, 725, 729
Rogerson, William, 70, 97
rollback, 553
roommate problem (lack of stable match), 393, 419
Rosen, Sherwin, 97
Ross, Stephen, 97
Roth, Alvin, 275, 315n, 322, 380n, 405, 390–91, 422, 426, 427, 428, 514–15, 520
Rothschild, Michael, 105, 135–42, 148, 158, 166, 173, 177
Rubinstein, Ariel, 4, 275, 277n8, 285, 300, 312, 319, 322, 556, 679, 728
Rubinstein's alternating-offers bargaining model, 275–85
basic result, 275
bottom-line judgment, 285
finite horizons, 377–79
Nash bargaining solution and, 317–21
variations on, 279–86
rural hospital theorem, 380n, 408–9, 431
Salanié, Bernard, 419
Samuelson, William, 303, 306, 322, 479, 655, 728
Satterthwaite, Mark, 308, 312, 322, 423n, 436, 443, 474, 479, 482, 742
Schelling, Thomas, 520
Schlesinger, Myron, 97
Schoumaker, Françoise, 275, 315n, 322, 514–15, 520
screening
bargaining, in, 309
economic concept of, 126–29
insurance markets, in, 135–48
versus signaling, 158, 166
second-price (Vickrey) auctions
conditionally independent signals and, 367–68
drainage-tract model and, 361–62
private values and, 332–33
reserve prices and private values, for, 345–52
wallet game and, 357
Segal, Ilya, 428, 749
self-confirming equilibria, 592–94
Selten, Reinhard, 237n27, 257, 322, 557, 559n, 594, 598–99, 654
Selten's horse, 559n
separating hyperplane theorem, 7
sequential equilibrium, 558, 579, 588–89, 599, 642
sequential rationality (definition), 562–65
immediate-action rationality, versus, 570–73
objections to, 565–68
Shaked, Avner, 276, 322
Shapley, Lloyd, 321, 322, 381, 385, 390n, 402n, 405, 411, 416, 422, 426, 432, 679, 728
Shavell, Steven, 97
Shubik, Martin, 411, 416, 422, 456, 459
signaling, 3, 4, 106, 148–66. See also cheap talk; Spence's job-market signaling model
bargaining, in, 309
competitive equilibrium with two types, 149–66
education, with, 106
game-theoretic models of, 154–66
intuitive criterion and, 158-66
sequentially rational wage offers and, 156–66
versus screening, 158, 166
signaling games, 648
Simon, Herbert, 243, 257
single crossing, 130–34
insurance markets, in 133–34
Spence's job-market model, in, 150
Siniscalchi, Marciano, 498, 520, 630
Skrzypacz, Andrzej, 204, 206, 219n, 225, 228, 229, 254n, 256
Sloth, Birgitte, 573, 603
Smith, Adam, 219, 256
Smith, Lones, 681, 728
Smorodinsky, Meir, 321, 322

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Index

Sobel, Joel, 105, 167, 170–71, 173, 184, 201n, 206, 273, 309, 322, 654
social custom, 512–13
Sonnenschein, Hugo, 201–6
Sorin, Sylvain, 728, 729
Spence, A. Michael, 3, 4, 105, 148, 158, 173, 177
Spence’s job-marketsignaling model, 148–66
competitive equilibrium for, 149–54
game-theoretic version of, 154–66
intuitive criterion and, 158–62
Riley outcome in, 160
sequentially rational wage offers and, 156–62
versus screening, 166
stable match
bilateral-match problem, 414–19
college-admissions model, for, 406–7
core and, 389
\(h\)-stable matches, 422
individual rationality of, 392–93, 426
job-assignment model and, 409–10
lattice structure of, 394–96
marriage market and, 368–93
roommate problem and, 393, 419
side-optimal matches for, 389–92, 407, 410, 416
Tarski’s fixed-point theorem and, 397–401
Stacchetti, Ennio, 224, 231, 256, 703, 708
stag-hunt game, 511n, 591
Ståhl, I., 277n, 322
Stigler, George, 256
Stiglitz, Joseph, 97, 105, 135–42, 145, 148, 158, 166, 173, 177
stochastic dominance (definition), 61–62
monotone-likelihood property, versus, 64, 363–65
Stokey, Nancy, 97, 173, 206, 630
strategic delay in bargaining, 309–12
strategic-form games (definition), 487
bimatrix games, 488
mixed strategies for, 490
strategic stability, 632, 636
definition, 643
desiderata, 640
inadequacy of sequential, trembling-hand, and proper equilibrium concepts, 642–43
invariance to reduced strategic form, 640–41
never-a-weak-best-response test, for, 645–47
overview of program, 640–41
possible reward versus possible risk and, 644
strategically equivalent extensive forms, 546–47
reduced strategic form, 534–35
strategic stability and, 640–41
strong positive association, 443
subgame-perfect equilibrium
definition, 549–51
existence of, 551–52
substitutable preferences
definition, 404
job-assignment problem and, 409
origins of, 423n26, 428
Sugaya, Takao, 231, 703, 728
Sultan, Ralph, 220n13, 256, 263n
Sutton, John, 276, 322
Swinkels, Jeroen, 204, 206
Takahashi, Ichiro, 184, 201n, 206, 273, 309, 322
Tarski’s fixed-point theorem, 397
tenure decision, 243–44
Thaler, Richard, 74
Thompson, F. B., 547, 641, 654
threat game, 235, 548, 704, 707–8, 718–23
Tiebot equilibrium, 34
tit-for-tat strategy
best response to, 661–63
definition, 660
tit-for-tat versus tit-for-tat, 664–65
Toyota Production System, 211, 253

For general queries contact webmaster@press.princeton.edu.
trading-favors game, 246–55
all-favors equilibrium, 247
asking for favors, 249–50
community enforcement, 254
finite-horizon, 250–51
intermediate-lived opponent, 251
Pareto efficient equilibria, 249, 267
quality of performance, 254–55
short-lived opponent, 251
trembling-hand perfect equilibrium, 594–600, 632
agent-strategic form and, 597–600
trust game, 557, 704–7, 710–18, 724
relational contracting and, 244–46
truth telling, 435, 738–39
Turnbull, Stephen, 97
two-sided demand game, 273–75, 300–308
dynamics, 274
focal equilibria for, 274–75

unimprovable strategies, 215
used-car market. See Akerlof’s market for lemons

Välimäki, Juuso, 482
value iteration, 278
Van Damme, Eric, 204, 206, 322, 654
Vickrey, William, 374, 481
Vickrey auction. See second-price (Vickrey) auctions
Vickrey–Clarke–Grove (VCG mechanism), 448–61, 475n
auctions and, 454–60
practicality of, 460–61
virtual valuations, 467

interpretation of marginal-revenue function, 471–73
von Neumann, John, 520, 547
von Stackelberg, Heinrich, 104
voting mechanisms (real-life), 436–37
voting-rule function
defined, 437
dictatorial, 437
manipulable, 437

wallet-game context
English (button) auction equilibrium, 359–61
first-price equilibrium, 358–59
formulation, 352–53
second-price equilibrium, 357

war of attrition
chain-store context, 325
continuous time, 290–91, 292–300
dictionary definition, 291–92
discrete-time, 287–90
Watson, Joel, 482
Weber, Robert, 367, 374
Weiss, Andrew, 220, 225–27, 230, 256
Wilde, Louis, 176
Wilson, Charles, 143–44, 173, 322
Wilson, Robert, 201, 206, 238, 242, 257, 322, 327, 374, 600, 603, 654, 700n, 713n, 725, 727, 729
winner’s curse, 120–21, 355–56
Winter, Eyal, 322
Wolinsky, Asher, 322
Zame, William, 600, 603
Zamir, Shmuel, 618, 630, 728
Zermelo, E., 557, 678
Zermelo’s theorem, 554