Mechanism Design Theory: How to Implement Social Goals

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Theory of Mechanism Design –

"engineering" part of economic theory

- much of economic theory devoted to:
  - understanding existing economic institutions
  - explaining/predicting outcomes that institutions generate
  - positive, predictive

- mechanism design – reverses the direction
  - begins by identifying desired outcomes (goals)
  - asks whether institutions (mechanisms) could be designed to achieve goals
  - if so, what forms would institutions take?
  - normative, prescriptive

Outcome

depends on context

- for a government
  - choice of public goods such as
    - infrastructure (e.g., highways)
    - national security/defense
    - environmental protection
    - public education
- for an electorate
  - candidate to fill public office
- for an auctioneer – selling collection of assets
  - allocation of assets across bidders and corresponding payments by bidders
- for a home buyer and a builder contemplating constructing a house
  - specification of house's characteristics and builder's remuneration

Which outcome "desirable" or "optimal" also context-dependent:

- for government
  - public good choice that maximizes "net social surplus" (social benefit minus cost)
- for electorate
  - candidate that would beat all others in head-to-head competition
- for auctioneer
  - allocation that puts assets into hands of bidders who value them most
  - allocation that maximizes seller's revenue from sales
- home buyer and builder
  - deal (house specification and remuneration) for which no other deal is preferred by both buyer and seller

Mechanism designer: the one who chooses the institution (procedure, mechanism, game) that determines outcome

- in public good case: government
- in political case: framers of political constitution
- in auction case: auctioneer
- in house case: buyer and seller *themselves*

- in public good case, if government knows at *outset* which choice of public goods is optimal,
  - then simple mechanism for achieving it:

    government can pass law mandating that choice
- similarly, if auctioneer knows which bidders value assets most,
  - can simply give assets to those bidders

Problem: government or auctioneer *won't* (ordinarily) *have* this information

- surplus-maximizing choice of public goods depends on citizens' *preferences* over all possible alternative public good choices
  - no special reason why government should know these preferences
- likewise, wouldn't expect auctioneer to know bidders' values for assets
- fundamental difficulty for mechanism designers in general:

don't know optimal outcomes (at outset)

- So have to proceed more *indirectly*

  i.e., to design mechanisms that *themselves* generate this information
- Much of my own work and that of many others has addressed questions:

  When is it possible to design such mechanisms?

  What form do mechanisms take?

  And when is it *not* possible to find such mechanisms?

That it is *ever* possible to design such mechanisms may seem surprising

How can mechanism designer attain optimal outcome without even knowing what it is?

So consider simple concrete example:

Consider society with

- 2 consumers of energy – Alice and Bob

- Energy authority – must choose public energy source
  - gas
  - oil
  - nuclear power
  - coal

Two states of world

state 1 consumers weight future lightly (future relatively unimportant)

state 2 consumers weight future heavily (future relatively important)

Alice – cares mainly about convenience

In state 1: favors gas over oil, oil over coal, and coal over nuclear

In state 2: favors nuclear over gas, gas over coal, and coal over oil

− technical advances expected to make gas, coal, and especially nuclear easier to use in future compared with oil

Bob – cares more about safety

In state 1: favors nuclear over oil, oil over coal, and coal over gas

In state 2: favors oil over gas, gas over coal, and coal over nuclear

− disposal of nuclear waste will loom large

− gas will become safer

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	nuclear	oil
oil	oil	gas	gas
coal	coal	coal	coal
nuclear	gas	oil	nuclear

- energy authority
  - wants source that makes good compromise between consumers' views
  - so, oil is social optimum in state 1
  - gas is social optimum in state 2
- but suppose authority *does not know* state
  - then doesn't know whether oil or gas better

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	nuclear	oil
oil	oil	gas	gas
coal	coal	coal	coal
nuclear	gas	oil	nuclear
oil optimal		gas optimal	

- authority could ask Alice or Bob about state
  - but Alice has incentive to say "state 2" *regardless* of truth

    always prefers gas to oil

    gas optimal in state 2
  - Bob always has incentive to say "state 1"

    always prefers oil to gas

    oil optimal state 1

  So, simply asking consumers to reveal actual state too naive a mechanism

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	nuclear	oil
oil	oil	gas	gas
coal	coal	coal	coal
nuclear	gas	oil	nuclear
social optimum: oil		social optimum: gas	

Authority can have consumers participate in the mechanism given by table

		Bob	
		oil	coal
Alice		nuclear	gas

- Alice – can choose top row or bottom row
- Bob – can choose left column or right column
- outcomes given by table entries
- If state 1 holds
  - Alice will prefer top row if Bob plays left column
  - Bob will prefer left column if Alice plays top row
  - so (Alice plays top, Bob plays left) is Nash equilibrium
    - neither participant has incentive to change unilaterally to another strategy
  - In fact, it is *unique* Nash equilibrium
    - so good prediction of what Alice and Bob will do

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	nuclear	oil
oil	oil	gas	gas
coal	coal	coal	coal
nuclear	gas	oil	nuclear
social optimum: oil		social optimum: gas	

		Bob
		oil	coal
Alice	nuclear	gas

So, in state 1:

- expect that
  - Alice will play top strategy
  - Bob will play left strategy
- outcome is oil
- oil is social optimum

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	nuclear	oil
oil	oil	gas	gas
coal	coal	coal	coal
nuclear	gas	oil	nuclear
social optimum: oil		social optimum: gas	

		Bob
		oil	coal
Alice		nuclear	gas

Similarly, in state 2:

- expect that
  - Alice will play bottom strategy
  - Bob will play right strategy
- outcome is gas
- gas is social optimum

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	nuclear	oil
oil	oil	gas	gas
coal	coal	coal	coal
nuclear	gas	oil	nuclear
social optimum: oil		social optimum: gas	

	Bob	
Alice	oil	coal
	nuclear	gas

- Thus, in *either state*, mechanism achieves social optimum, even though
  - mechanism designer doesn't know the state herself
  - Alice and Bob interested in own ends (not social goal)
- We say that mechanism *implements* the designer's goals (oil in state 1, gas in state 2)
- More generally, in any given setting, determining
  - *whether* or not mechanism designer's goals can be implemented
  - and, if so, *how*

  are major tasks of mechanism design theory

- Intellectual origins of mechanism design:

  Utopian socialists of 19th century

  – repulsed by evils of capitalism
  – believed they could do better
- More direct influence: Planning Controversy of 1930s
  – O. Lange and A. Lerner
    central planning can replicate and even surpass free markets
  – F. von Hayek and L. von Mises
    strenuously denied this possibility
- Controversy important and fascinating but
  – lacked conceptual precision
    crucial terms like "centralization" and "decentralization" not defined
  – lacked technical apparatus, e.g.,
    game theory
    mathematical programming
    to assess each side's claims

Hurwicz (1960), (1972)

- first to give unambiguous definitions of all important concepts
- first to show how technical tools could obtain clear conclusions about issues in debate

Work inspired by Hurwicz has produced consensus that

- von Hayek and von Mises were correct (i.e., market *is* "best" mechanism) in settings where
  - large number of agents (buyers and sellers)

    so that no single agent has much power
  - no significant "externalities"

    other people's consumption or production of a good does not affect *your* consumption or production
- but better mechanisms than market *are* possible if either assumption violated
  - e.g., when goods are *public* (second assumption violated)

    if some people "consume" national security, *everyone* does

Enormous literature derives from Hurwicz

two branches

- particular highly structured settings
  - public goods
  - auctions
  - contracts
- analysis at a *general* level

My own work has fallen in both categories

- today emphasize general results

Hurwicz introduced notion:

social goals being implemented by mechanism

- saw simple example – choosing optimal energy source
- notion of implementation prompts general questions:

  when can social goals be implemented?

  if implementable, *what* mechanism will do so?

  when can social goals *not* be implemented?

- struggled with these questions in mid-1970s
- after (embarrassingly) long time, realized that *monotonicity* of social goals is key to implementation
  - if social goals are not monotonic, then they are not implemetable
  - if social goals *are* monotonic, then (almost) implementable -- need mild additional condition
- monotonicity of social goals:
  - suppose outcome *a* is optimal outcome in state 1
  - if *a* doesn't fall in anyone's ranking (vis à vis any other outcome) in going from state 1 to 2, then *a remains* optimal in state 2
  - but if *a does* fall in someone's ranking

    then *a* need not remain optimal

Consider example from before:

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	nuclear	oil
oil	oil	gas	gas
coal	coal	coal	coal
nuclear	gas	oil	nuclear
oil optimal		gas optimal	

- optimal outcome in state 1 is oil (according to social goals)
- oil doesn't remain optimal in state 2
- however, oil *falls* in Alice's ranking (relative to nuclear and coal)
- so social goals *are* monotonic
  - and implementable (as saw earlier)

Modify example a little

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	gas	nuclear
oil	oil	oil	oil
coal	coal	nuclear	coal
nuclear	gas	coal	gas
oil optimal		nuclear optimal	

- note nuclear is attractive option in state 2
  - although ranked third by Alice, ranked first by Bob
  - so nuclear reasonable social goal in state 2
- however, social goals *not* monotonic
  - oil optimal in state 1
  - oil doesn't fall in either person's ranking in going from state 1 to state 2
  - but oil *not* optimal in state 2
- thus, in modified example, social goals cannot be implemented by *any* mechanism

State 1		State 2	
Alice	Bob	Alice	Bob
gas	nuclear	gas	nuclear
oil	oil	oil	oil
coal	coal	nuclear	gas
nuclear	gas	coal	oil
oil optimal		nuclear optimal	

To see *why* social goals not implementable,

- suppose, to contrary, there *is* an implementing mechanism
- in that mechanism
  - Alice will play some strategy s_A in state 1
  - Bob will play some strategy s_B in state 2
  - strategies (s_A, s_B) will result in outcome *oil*
- But Alice and Bob will use *same* strategies (s_A, s_B) in state 2
  - only thing Alice prefers to oil is gas
  - but Alice can't have alternative strategy that leads to gas - - would have used it in state 1
  - so won't deviate from s_A in state 2
  - similarly Bob won't deviate from s_B
- so mechanism leads to oil in state 2
  - doesn't implement social goals after all

We have:

Theorem 1: If social goals are implementable, they must be *monotonic*

- in original example, social goals monotonic and implementable
- not always true
  - examples of monotonic social choice rules that are *not* implementable
- still, if additional mild condition imposed, monotonicity *guarantees* implementability

No veto power

- suppose all individuals − except possibly one − agree that outcome *a* is *best possible* outcome (nothing better)
- then *a* must be optimal
  - i.e., remaining individual can't veto it
- quite weak
  - suppose outcome ↔ distribution of economic goods across individuals
  - then each individual wants all goods for himself
  - so no veto power condition *automatically* satisfied

Theorem 2: Suppose "society" has at least 3 individuals

If social goals satisfy monotonicity and no veto power, then implementable

- proof too complicated to present here
  - *constructive*: given social goals, recipe given for explicitly designing mechanism
- Why at least 3 individuals?
  - earlier example had 2 people
  - but implementation, in general, more difficult for 2 than for 3 or more people
  - mechanism

    gives people incentive to do what they ought to do

    "punishes" individual for deviating

    if only 2 people and one has deviated

    may be hard to tell who has deviated and who hasn't

    problem resolved with 3 or more people: deviator sticks out

Conclusions

- very brief introduction to mechanism design theory
- of course, much, much more to it
  - other facets in Leo's and Roger's talks
- attraction for me: theory intellectually engaging
  - and also socially useful
- remains lively
  - almost half century after Hurwicz (1960), still active and important part of economic theory
- will be interesting to see where it goes next!