Motivation

- Preference relations $\prec$ contain no information about “by how much” one candidate is preferred.
- Idea: Use money to measure this.
- Use money also for transfers between players “for compensation”.

Second Price Auctions
Incentive Compatible Mechanisms
VCG Mechanisms
Setting

Formalization:

- Set of alternatives $A$.
- Set of $n$ players $N$.
- Valuation functions $v_i : A \rightarrow \mathbb{R}$ such that $v_i(a)$ denotes the value player $i$ assigns to alternative $a$.
- Payment functions specifying amount $p_i \in \mathbb{R}$ that player $i$ pays.
- Utility of player $i$: $u_i(a) = v_i(a) - p_i$. 
1 Second Price Auctions
Second Price Auctions

Second price auctions:

- There are \( n \) players bidding for a single item.
- Player \( i \)'s private valuations of item: \( w_i \).
- Desired outcome: Player with highest private valuation wins bid.
- Players should reveal their valuations truthfully.
- Winner \( i \) pays price \( p^* \) and has utility \( w_i - p^* \).
- Non-winners pay nothing and have utility 0.
Second Price Auctions

Formally:

\[ A = N \]

\[ v_i(a) = \begin{cases} w_i & \text{if } a = i \\ 0 & \text{else} \end{cases} \]

What about payments? Say player \( i \) wins:

- \( p^* = 0 \) (winner pays nothing): bad idea, players would manipulate and publicly declare values \( w'_i \gg w_i \).
- \( p^* = w_i \) (winner pays his valuation): bad idea, players would manipulate and publicly declare values \( w'_i = w_i - \varepsilon \).
- **better**: \( p^* = \max_{j \neq i} w_j \) (winner pays second highest bid).
Vickrey Auction

Definition (Vickrey Auction)
The winner of the **Vickrey Auction** (aka second price auction) is the player $i$ with the highest declared value $w_i$. He has to pay the second highest declared bid $p^* = \max_{j \neq i} w_j$.

Proposition (Vickrey)
Let $i$ be one of the players and $w_i$ his valuation for the item, $u_i$ his utility if he truthfully declares $w_i$ as his valuation of the item, and $u'_i$ his utility if he falsely declares $w'_i$ as his valuation of the item. Then $u_i \geq u'_i$.

Proof
See
2 Incentive Compatible Mechanisms
Idea: Generalization of Vickrey auctions.

Preferences modeled as functions $v_i : A \rightarrow \mathbb{R}$.

Let $V_i$ be the space of all such functions for player $i$.

Unlike for social choice functions: Not only decide about chosen alternative, but also about payments.
Mechanisms

Definition (Mechanism)
A mechanism \( \langle f, p_1, \ldots, p_n \rangle \) consists of
- a social choice function \( f : V_1 \times \cdots \times V_n \rightarrow A \) and
- for each player \( i \), a payment function \( p_i : V_1 \times \cdots \times V_n \rightarrow \mathbb{R} \).

Definition (Incentive Compatibility)
A mechanism \( \langle f, p_1, \ldots, p_n \rangle \) is called incentive compatible if for each player \( i = 1, \ldots, n \), for all preferences \( v_1 \in V_1, \ldots, v_n \in V_n \) and for each preference \( v_i' \in V_i \),

\[
v_i(f(v_i, v_{-i})) - p_i(v_i, v_{-i}) \geq v_i(f(v_i', v_{-i})) - p_i(v_i', v_{-i}).
\]
3 VCG Mechanisms

- Clarke Pivot Rule
- Examples
If \( \langle f, p_1, \ldots, p_n \rangle \) is incentive compatible, truthfully declaring one’s preference is a dominant strategy.

The Vickrey-Clarke-Groves mechanism is an incentive compatible mechanism that maximizes “social welfare”, i.e., the sum over all individual utilities \( \sum_{i=1}^{n} v_i(a) \).

Idea: Reflect other players’ utilities in payment functions, align all players’ incentives with goal of maximizing social welfare.
VCG Mechanisms

Definition (Vickrey-Clarke-Groves mechanism)

A mechanism \( \langle f, p_1, \ldots, p_n \rangle \) is called a Vickrey-Clarke-Groves mechanism (VCG mechanism) if

1. \( f(v_1, \ldots, v_n) \in \arg\max_{a \in A} \sum_{i=1}^{n} v_i(a) \) for all \( v_1, \ldots, v_n \) and

2. there are functions \( h_1, \ldots, h_n \) with \( h_i : V_{-i} \rightarrow \mathbb{R} \) such that
   
   \[ p_i(v_1, \ldots, v_n) = h_i(v_{-i}) - \sum_{j \neq i} v_j(f(v_1, \ldots, v_n)) \]

   for all \( i = 1, \ldots, n \) and \( v_1, \ldots, v_n \).

Note: \( h_i(v_{-i}) \) independent of player \( i \)'s declared preference \( \Rightarrow \)

\[ h_i(v_{-i}) = c \] constant from player \( i \)'s perspective.

Utility of player \( i \)

\[ v_i(f(v_1, \ldots, v_n)) + \sum_{j \neq i} v_j(f(v_1, \ldots, v_n)) - c = \sum_{j=1}^{n} v_j(f(v_1, \ldots, v_n)) - c = \text{social welfare} - c. \]
VCG Mechanisms

Theorem (Vickrey-Clarke-Groves)
Every VCG mechanism is incentive compatible.

Proof
Let \( i, v_{-i}, v_i \) and \( v'_i \) be given. Show: Declaring true preference \( v_i \) dominates declaring false preference \( v'_i \).

Let \( a = f(v_i, v_{-i}) \) and \( a' = f(v'_i, v_{-i}) \).

Utility player \( i = \begin{cases} v_i(a) + \sum_{j \neq i} v_j(a) - h_i(v_{-i}) & \text{if declaring } v_i \\ v_i(a') + \sum_{j \neq i} v_j(a') - h_i(v_{-i}) & \text{if declaring } v'_i \end{cases} \)

Alternative \( a = f(v_i, v_{-i}) \) maximizes social welfare
\[ v_i(a) + \sum_{j \neq i} v_j(a) \geq v_i(a') + \sum_{j \neq i} v_j(a'). \]

\[ v_i(f(v_i, v_{-i})) - p_i(v_i, v_{-i}) \geq v_i(f(v'_i, v_{-i})) - p_i(v'_i, v_{-i}). \]
Clarke Pivot Rule

- So far: payment functions $p_i$ and functions $h_i$ unspecified.
- One possibility: $h_i(v_{-i}) = 0$ for all $h_i$ and $v_{-i}$.
  Drawback: Too much money distributed among players (more than necessary).
- Further requirements:
  - Players should pay at most as much as they value the outcome.
  - Players should only pay, never receive money.
Individual Rationality, Positive Transfers

Definition (individual rationality)
A mechanism is individually rational if all players always get a nonnegative utility, i.e., if for all $i = 1, \ldots, n$ and all $v_1, \ldots, v_n$,

$$v_i(f(v_1, \ldots, v_n)) - p_i(v_1, \ldots, v_n) \geq 0.$$ 

Definition (positive transfers)
A mechanism has no positive transfers if no player is ever paid money, i.e., for all preferences $v_1, \ldots, v_n$,

$$p_i(v_1, \ldots, v_n) \geq 0.$$
Clarke Pivot Function

Definition (Clarke pivot function)

The Clarke pivot function is the function

\[ h_i(v_{-i}) = \max_{b \in A} \sum_{j \neq i} v_j(b). \]

- This leads to payment functions

\[ p_i(v_1, \ldots, v_n) = \max_{b \in A} \sum_{j \neq i} v_j(b) - \sum_{j \neq i} v_j(a) \]

for \( a = f(v_1, \ldots, v_n) \).

- Player \( i \) pays the difference between what the other players could achieve without him and what they achieve with him.

- Each player internalizes the externalities he causes.
Clarke Pivot Function

Example

- **Players** \( N = \{1, 2\} \), **alternatives** \( A = \{a, b\} \).
- **Values**: \( v_1(a) = 10 \), \( v_1(b) = 2 \), \( v_2(a) = 9 \) and \( v_2(b) = 15 \).
- **Without player 1**: \( b \) best, since \( v_2(b) = 15 > 9 = v_2(a) \).
- **With player 1**: \( a \) best, since 
\[
    v_1(a) + v_2(a) = 10 + 9 = 19 > 17 = 2 + 15 = v_1(b) + v_2(b).
\]
- **With player 1**, other players (i.e., player 2) lose
\[
    v_2(b) - v_2(a) = 6 \text{ units of utility}.
\]

\( \Rightarrow \) **Clarke pivot function** \( h_1(v_2) = 15 \)

\( \Rightarrow \) **payment function**

\[
p_1(v_1, \ldots, v_n) = \max_{b \in A} \sum_{j \neq 1} v_j(b) - \sum_{j \neq 1} v_j(a) = 15 - 9 = 6.
\]
Clarke Pivot Rule

Lemma (Clarke pivot rule)
A VCG mechanism with Clarke pivot functions has no positive transfers. If \( v_i(a) \geq 0 \) for all \( i = 1, \ldots, n \), \( v_i \in V_i \) and \( a \in A \), then the mechanism is also individually rational.

Proof
Let \( a = f(v_1, \ldots, v_n) \) be the alternative maximizing \( \sum_{j=1}^n v_j(a) \), and \( b \) the alternative maximizing \( \sum_{j \neq i} v_j(b) \).

Utility of player \( i \): \( u_i = v_i(a) + \sum_{j \neq i} v_j(a) - \sum_{j \neq i} v_j(b) \).

Payment function for \( i \): \( p_i(v_1, \ldots, v_n) = \sum_{j \neq i} v_j(b) - \sum_{j \neq i} v_j(a) \).

Since \( b \) maximizes \( \sum_{j \neq i} v_j(b) \): \( p_i(v_1, \ldots, v_n) \geq 0 \) (no positive transfers).
Clarke Pivot Rule

Proof (ctd.)

Individual rationality: Since $v_i(b) \geq 0$,

$$u_i = v_i(a) + \sum_{j \neq i} v_j(a) - \sum_{j \neq i} v_j(b) \geq \sum_{j=1}^{n} v_j(a) - \sum_{j=1}^{n} v_j(b).$$

Since $a$ maximizes $\sum_{j=1}^{n} v_j(a)$,

$$\sum_{j=1}^{n} v_j(a) \geq \sum_{j=1}^{n} v_j(b)$$

and hence $u_i \geq 0$.

Therefore, the mechanism is also individually rational. \qed
Vickrey Auction as a VCG Mechanism

- $A = N$. Valuations: $w_i$, $v_a(a) = w_a$, $v_i(a) = 0$ ($i \neq a$).
- $a$ maximizes social welfare $\sum_{i=1}^{n} v_i(a)$ iff $a$ maximizes $w_a$.
- Let $a = f(v_1, \ldots, v_n) = \arg\max_{j \in A} w_j$ be the highest bidder.
- Payments: $p_i(v_1, \ldots, v_n) = \max_{b \in A} \sum_{j \neq i} v_j(b) - \sum_{j \neq i} v_j(a)$.
- But $\max_{b \in A} \sum_{j \neq i} v_j(b) = \max_{b \in A \backslash \{i\}} w_b$.
- Winner pays value of second highest bid:
  \[
p_a(v_1, \ldots, v_n) = \max_{b \in A} \sum_{j \neq a} v_j(b) - \sum_{j \neq a} v_j(a)
  = \max_{b \in A \backslash \{a\}} w_b - 0 = \max_{b \in A \backslash \{a\}} w_b.
  \]
- Non-winners pay nothing: For $i \neq a$,
  \[
p_i(v_1, \ldots, v_n) = \max_{b \in A} \sum_{j \neq i} v_j(b) - \sum_{j \neq i} v_j(a)
  = \max_{b \in A \backslash \{i\}} w_b - w_a = w_a - w_a = 0.
  \]
Example: Bilateral Trade

- **Seller** $s$ offers item he values with $0 \leq w_s \leq 1$.
- **Potential** buyer $b$ values item with $0 \leq w_b \leq 1$.
- **Alternatives** $A = \{\text{trade, no-trade}\}$.
- **Valuations:**
  \[
  v_s(\text{no-trade}) = 0, \quad v_s(\text{trade}) = -w_s, \\
  v_b(\text{no-trade}) = 0, \quad v_b(\text{trade}) = w_b.
  \]
- VCG mechanism maximizes $v_s(a) + v_b(a)$.
- We have
  \[
  v_s(\text{trade}) + v_b(\text{trade}) = w_b - w_s, \\
  v_s(\text{no-trade}) + v_b(\text{no-trade}) = 0
  \]
  i.e., trade maximizes social welfare iff $w_b \geq w_s$. 

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Example: Bilateral Trade (ctd.)

- **Requirement:** if *no-trade* is chosen, neither player pays anything:

\[ p_s(v_s, v_b) = p_b(v_s, v_b) = 0. \]

- To that end, choose Clarke pivot function for **buyer**:

\[ h_b(v_s) = \max_{a \in A} v_s(a). \]

- **For seller:** Modify Clarke pivot function by an additive constant and set

\[ h_s(v_b) = \max_{a \in A} v_b(a) - w_b. \]
Example: Bilateral Trade (ctd.)

- For alternative *no-trade*,

\[ p_s(v_s, v_b) = \max_{a \in A} v_b(a) - w_b - v_b(\text{no-trade}) \]
\[ = w_b - w_b - 0 = 0 \quad \text{and} \]
\[ p_b(v_s, v_b) = \max_{a \in A} v_s(a) - v_s(\text{no-trade}) \]
\[ = 0 - 0 = 0. \]

- For alternative *trade*,

\[ p_s(v_s, v_b) = \max_{a \in A} v_b(a) - w_b - v_b(\text{trade}) \]
\[ = w_b - w_b - w_b = -w_b \quad \text{and} \]
\[ p_b(v_s, v_b) = \max_{a \in A} v_s(a) - v_s(\text{trade}) \]
\[ = 0 + w_s = w_s. \]
Example: Bilateral Trade (ctd.)

- Because $w_b \geq w_s$, the seller gets at least as much as the buyer pays, i.e., the mechanism subsidizes the trade.
- Without subsidies, no incentive compatible bilateral trade possible.
- **Note:** Buyer and seller can exploit the system by colluding.
Example: Public Project

- Project costs $C$ units.
- Each citizen $i$ privately values the project at $w_i$ units.
- Government will undertake project if $\sum_i w_i > C$.
- Alternatives: $A = \{\text{project, no-project}\}$.
- Valuations:

\[
    v_G(\text{project}) = -C, \quad v_G(\text{no-project}) = 0,
    v_i(\text{project}) = w_i, \quad v_i(\text{no-project}) = 0.
\]

- VCG mechanism with Clarke pivot rule: for each citizen $i$,

\[
h_i(v_{-i}) = \max_{a \in A} \left( \sum_{j \neq i} v_j(a) + v_G(a) \right)
= \begin{cases} 
    \sum_{j \neq i} w_j - C, & \text{if } \sum_{j \neq i} w_j > C \\
    0, & \text{otherwise.}
\end{cases}
\]
Example: Public Project (ctd.)

- Citizen $i$ pivotal if $\sum w_j > C$ and $\sum_{j\neq i} w_j \leq C$.
- Payment function for citizen $i$:

$$p_i(v_{1..n}, v_G) = h_i(v_{-i}) - \left(\sum_{j\neq i} v_j(f(v_{1..n}, v_G)) + v_G(f(v_{1..n}, v_G))\right)$$

- Case 1: Project undertaken, $i$ pivotal:

$$p_i(v_{1..n}, v_G) = 0 - \left(\sum_{j\neq i} w_j - C\right) = C - \sum_{j\neq i} w_j$$

- Case 2: Project undertaken, $i$ not pivotal:

$$p_i(v_{1..n}, v_G) = \left(\sum_{j\neq i} w_j - C\right) - \left(\sum_{j\neq i} w_j - C\right) = 0$$

- Case 3: Project not undertaken:

$$p_i(v_{1..n}, v_G) = 0$$
Example: Public Project (ctd.)

- I.e., citizen $i$ pays nonzero amount

$$C - \sum_{j \neq i} w_j$$

only if he is pivotal.

- He pays difference between value of project to fellow citizens and cost $C$, in general less than $w_i$.

- Generally,

$$\sum_i p_i(\text{project}) \leq C$$

i.e., project has to be subsidized.
Example: Buying a Path in a Network

- Communication network modeled as $G = (V, E)$.
- Each link $e \in E$ owned by different player $e$.
- Each link $e \in E$ has cost $c_e$ if used.
- **Objective**: procure communication path from $s$ to $t$.
- **Alternatives**: $A = \{p \mid p \text{ path from } s \text{ to } t\}$.
- **Valuations**: $v_e(p) = -c_e$, if $e \in p$, and $v_e(p) = 0$, if $e \not\in p$.
- **Maximizing social welfare**: minimize $\sum_{e \in p} c_e$ over all paths $p$ from $s$ to $t$.
- **Example**:

![Diagram of a network with nodes and links]

- \(c_a = 4\)
- \(c_d = 12\)
- \(c_b = 3\)
- \(c_e = 5\)
Example: Buying a Path in a Network (ctd.)

- For $G = (V, E)$ and $e \in E$ let $G \setminus e = (V, E \setminus \{e\})$.

- VCG mechanism:

  $$h_e(v_{-e}) = \max_{p' \in G \setminus e \atop e' \in p'} \sum_{e' \in p'} -c_{e'}$$

  i.e., the cost of the cheapest path from $s$ to $t$ in $G \setminus e$.
  (Assume that $G$ is 2-connected, s.t. such $p'$ exists.)

- Payment functions: for chosen path $p = f(v_1, \ldots, v_n)$,

  $$p_e(v_1, \ldots, v_n) = h_e(v_{-e}) - \sum_{e' \in p \atop e' \neq e} -c_{e'}.$$ 

  - Case 1: $e \not\in p$. Then $p_e(v_1, \ldots, v_n) = 0$.
  - Case 2: $e \in p$. Then

    $$p_e(v_1, \ldots, v_n) = \max_{p' \in G \setminus e \atop e' \in p'} \sum_{e' \in p'} -c_{e'} - \sum_{e' \in p \atop e' \neq e} -c_{e'}.$$
Example: Buying a Path in a Network (ctd.)

- Example:

![Diagram of a network with nodes s, i, and t, and arcs a, b, d, and e, with costs c_a = 4, c_b = 3, c_d = 12, and c_e = 5.]

- Cost along b and e: 8
- Cost without e: 3
- Cost of cheapest path without e: 15 (along b and d)
- Difference is payment: \(-15 - (-3) = -12\)
  - i.e., owner of arc e gets paid 12 for using his arc.

- Note: Alternative path after deletion of e does not necessarily differ from original path at only one position. Could be totally different.
Summary

- New preference model: with money.
- VCG mechanisms generalize Vickrey auctions.
- VCG mechanisms are incentive compatible mechanisms maximizing social welfare.
- With Clarke pivot rule: even no positive transfers and individually rational (if nonnegative valuations).
- Various application areas.