Truthful, Pareto Optimal Exchange Without Money

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- This will be the first lecture on "Mechanism Design"
- Designing the rules of the game to achieve our gaols.
- We'll begin our study with the classical "House Allocation Problem" by Shapley and Scarf.
- And study the Top Trading Cycles Algortihm (attributed to David Gale).

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5. Houses are a toy example. Kidney exchange is a real one (needs a solution without money).

A Model

1. There are n agents $i \in P$ who each come to market with a good h_i.
2. Each agent has a strict preference ordering $\succ_i$ over all of the goods $h_1, \ldots, h_n$. (i.e. for every pair j, k either $h_j \succ_i h_k$ or $h_k \succ_i h_j$, and this ordering is transitive – so each agent just has a rank order list of goods. In particular, this ranking includes an agents own good h_i.

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We wish to design an algorithm which will induce a game played by the players. The algorithm will take as input the reported preferences $\succ_i$ of each player, and output a permutation μ of the goods. This induces a game: the strategy space for each player is the set of preference orderings $\succ_i$, the utility function is defined by their true preferences.

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An allocation μ is *Pareto sub-optimal* if there exists an allocation ν such that for every i:

$$\nu(i) \succeq_i \mu(i)$$

and for some j;

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i.e. everybody is at least as happy with their allocation in ν, and at least one person is strictly happier. In this case, we say that ν *Pareto-dominates* μ.
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It should not be possible to simultaneously improve for everyone.

What about Incentives?

Definition

A is individually rational if for every player i, every preference vector $\succ_i$, and every set of reports of the other players $\succ_{-i}$, if $\mu = A(\succ_i, \succ_{-i})$ then:

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Definition

A mechanism A is dominant-strategy incentive compatible if it is a dominant strategy for everyone to report their true preferences. i.e. if for all $\succ_i, \succ_{-i}, \succ_i'$, if

$$\mu = A(\succ_i, \succ_{-i}) \quad \text{and } \nu = A(\succ_i', \succ_{-i})$$

then $\mu(i) \succeq_i \nu(i)$

Top Trading Cycles

Algorithm 1 The top trading cycles algorithm

TTC$(\succ_1, \ldots, \succ_n)$

Let $S_1 = P$ be the set of all agents. Set a counter $t = 1$.

while $|S_i| > 0$ **do**

Construct a graph $G_t = (V_t, E_t)$ where $V_t = S_t$ and for each $i, j \in V_t$, the directed edge $(i, j) \in E_t$ if and only if $h_j \succ_i h_k$ for all other $k \in V_t$. i.e. this is the graph that results when every agent "points to" their favorite remaining good.

Find any cycle C_t in G_t and clear all trades along it: i.e. for every directed edge $(i, j) \in C_t$ set $\mu(i) = j$.

Set $S_{t+1} = S_t$ and remove all cleared agents: for each $i : (i, j) \in C_t$, set $S_{t+1} \leftarrow S_{t+1} - \{i\}$. Increment t $(t \leftarrow t + 1)$.

end while

Output μ.

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Lemma

In each graph G_t constructed by the algorithm, there is at least one cycle C_t, and every agent is part of at most one cycle.

4. **Proof**: by construction, G_t is a directed graph in which every vertex has out-degree exactly one. (So by starting at any vertex and following edges forward, we must find a cycle).

Interlude: Example

5 agents:

$\succ_1$: $2 \succ 5 \succ 3 \succ 1 \succ 4$

$\succ_2$: $3 \succ 1 \succ 5 \succ 4 \succ 2$

$\succ_3$: $1 \succ 2 \succ 3 \succ 4 \succ 5$

$\succ_4$: $1 \succ 3 \succ 5 \succ 4 \succ 2$

$\succ_5$: $4 \succ 1 \succ 3 \succ 2 \succ 5$

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$$\mu(1) = 2, \mu(2) = 3, \mu(3) = 1, \mu(4) = 5, \mu(5) = 4$$

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Theorem

The Top Trading Cycles algorithm produces a Pareto optimal allocation μ on every input $\succ$.

Proof

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3. Next: every agent TTC cleared in cycle C_2 must receive an identical allocation in ν: since these agents are receiving their first choice good from the set $P - C_1$ in μ, and $\nu(i) = \mu(i)$ for every $i \in C_1$

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4. Inductively, if $\nu(i) = \mu(i)$ for every $i \in C_1 \cup \ldots \cup C_k$ for $k \leq t$, then We must also have that $\nu(i) = \mu(i)$ for every $i \in C_{t+1}$.

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5. Continuing through $t = n$, we have that $\mu = \nu$, a contradiction.

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The Top Trading Cycles Algorithm is Dominant Strategy Incentive Compatible.

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5. But that can't happen...

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6. Tada!

Thanks!

See you next class — stay healthy, and wear a mask!