

GAME THEORY: DYNAMIC GAMES OF INCOMPLETE INFORMATION

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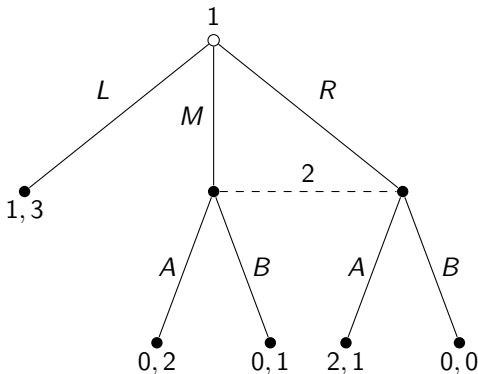
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Table of Contents

1. Introducing example
2. Preliminaries
3. Belief requirements
4. Perfect Bayesian Nash Equilibrium
5. Signaling games

Introducing example

Consider the following game inspired by Selten (1975):

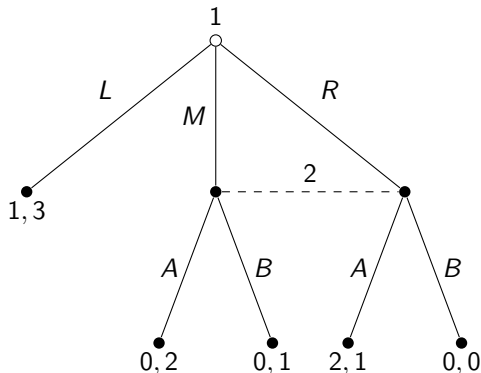


Player 2 observes whether player 1 played L or not.

▷ But cannot distinguish M from R

Introducing example

It can be seen as a dynamic game of **imperfect** information.

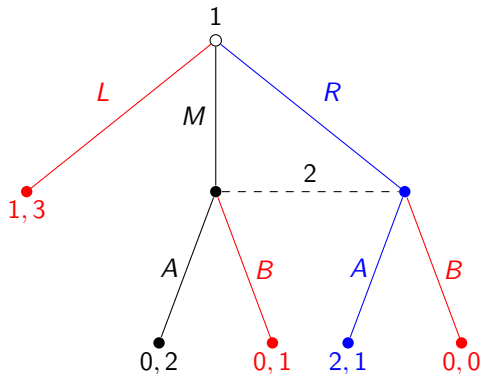


$1 \backslash 2$	A	B
L	1,3	1,3
M	0,2	0,1
R	2,1	0,0

Introducing example

There are **two pure-strategy Nash Equilibria** in this game:

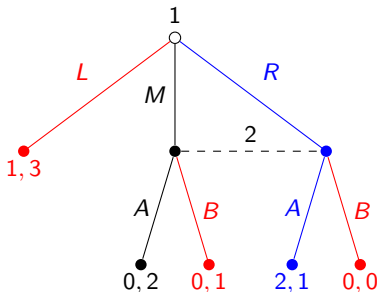
▷ (L, B) and (R, A)



$1 \backslash 2$	A	B
L	$1, \underline{3}$	<u>$1, 3$</u>
M	$0, \underline{2}$	$0, 1$
R	<u>$2, 1$</u>	$0, 0$

Introducing example

Do you find the pure-strat. NE (L, B) *satisfactory*?



In (L, B) , P2 *threatens* P1 to play B if the latter chooses M or R .

- ▷ B is a **non-credible threat**
- ▷ If P1 plays M or R instead, P2 would prefer A in both cases (dominant strat)

Introducing example

(L, B) is a well-defined pure-strategy NE but we do not really like it.

- ▷ Seems *implausible*
- ▷ It is **not sequentially rational**

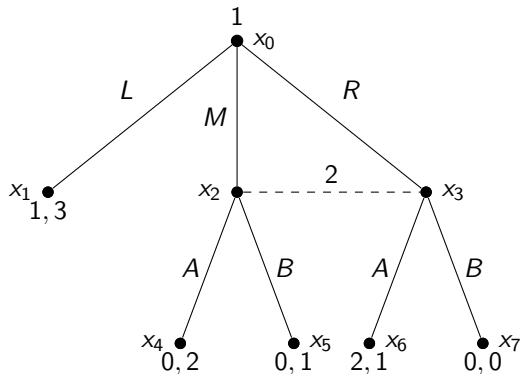
But it is a **dynamic game**.

- ▷ We have already seen that NE is not a *satisfactory* equilibrium concept for dynamic games.

That is why we introduced the notions of **subgames** and **subgame-perfect NE**.

- ▷ Let us apply this concept in the example!

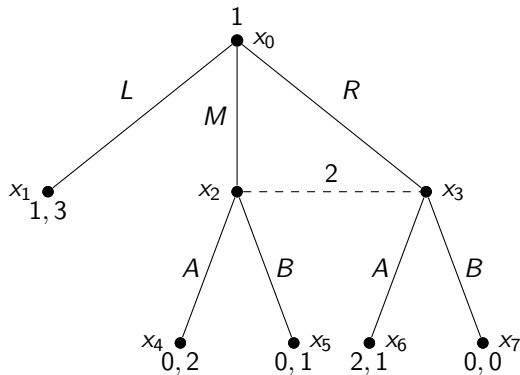
Introducing example



Extensive form:

- $N = \{1, 2\}$
- $A_1 = \{L, M, R\}$, $A_2 = \{A, B\}$
- $X_1 = \{x_0\}$, $X_2 = \{x_2, x_3\}$
- $I_1 = \{\{x_0\}\}$, $I_2 = \{\{x_2, x_3\}\}$
- $r = \{x_0\}$
- $T = \{x_1, x_4, x_5, x_6, x_7\}$

Introducing example



Extensive form:

- $N = \{1, 2\}$
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\Rightarrow Only **one** subgame:
▷ The game itself!

Introducing example

Applying the **refinement** of subgame perfection **to this game**:

- ▷ Subgame-perfect NE \Leftrightarrow Nash Equilibrium

It means that the subgame perfection refinement **has no bite** in this example.

- ▷ Applying it does not help removing the *unsatisfactory* Nash equilibrium (L, B) .

We have to create another **refinement** to tackle this issue.

- ▷ It will be the **Perfect Bayesian Equilibrium**

Table of Contents

1. Introducing example
2. Preliminaries
3. Belief requirements
4. Perfect Bayesian Nash Equilibrium
5. Signaling games

Preliminaries

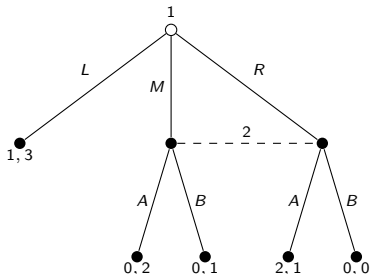
We would like to *get rid of* (L, B) .

The idea is to restore the notion of **non-credible threat** to *improper subgames*.

We must then find a way for P2 to **distinguish** one node from another even when their information set does not allow it.

Beliefs are the key.

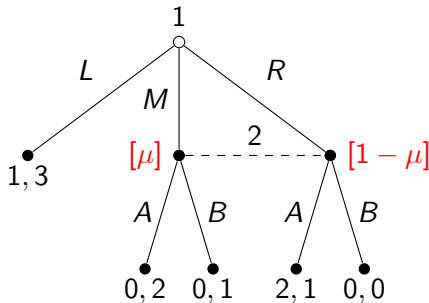
- ▷ We will allow P2 to **form beliefs on the probability** that M and R have been played by P1.
- ▷ And therefore to have a **strategy that depends on those beliefs**.



Preliminaries

For instance, assume that if P1 does not play L.

- ▷ P2 believes that M occurs with probability $\mu \in [0, 1]$ and R with probability $1 - \mu$.



Preliminaries

P2's **expected payoff** when playing:

▷ $A: \mu \cdot 2 + (1 - \mu) \cdot 1 = \mu + 1$

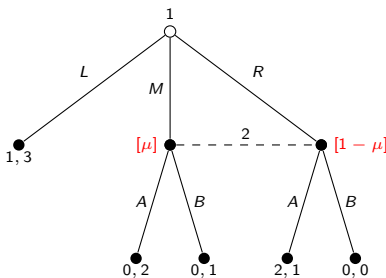
▷ $B: \mu \cdot 1 + (1 - \mu) \cdot 0 = \mu$

For any $\mu \in [0, 1]$:

▷ P2 prefers to play A

Whatever P2's the belief,
B is not a best-response anymore.

This is enough to get rid of (L, B)



Preliminaries

Allowing P2 to have **beliefs on indistinguishable nodes** of their information set “solves” our problem of **non-credible threats**.

Natural questions:

1. Is it **reasonable** to assume that players have beliefs on indistinguishable nodes?
2. Where are those beliefs coming from?

Both questions will be answered by the new equilibrium concept.

- ▷ Key-feature: Beliefs will now be **considered part of the equilibrium**.
- ▷ Beliefs will emerge **endogenously** together with strategies.

Table of Contents

1. Introducing example
2. Preliminaries
3. Belief requirements
4. Perfect Bayesian Nash Equilibrium
5. Signaling games

Beliefs and sequential rationality

Previous example: Useful to identify the **failure of subgame perfection** when the information set of a player is **not a singleton**.

Our goal is to define a setting in which we can say things like:

- ▷ “Player i is not **sequentially rational**”
- ▷ At every node where i plays, even if the information set **is not a singleton**

And then **apply this refinement** to Bayesian Nash equilibria of the game to remove *unreasonable* ones.

- ▷ As we did with subgame perfection: Take all the NE of the game and keep only those surviving subgame perfection (i.e. that are sequentially rational).

Methodology

We want to **refine** the concept of BNE.

To this end, we are going to impose

- ▷ **four requirements** on beliefs.

Finally, we will **impose those requirements** on BNE strategy profiles.

- ▷ and we will obtain a new equilibrium concept: **Perfect BNE**.

Decision nodes and information sets

Notation:

- ▷ X_i denote the set of player i 's decision nodes
- ▷ H_i denote the set of player i 's information sets
 - ▷ It is a partition of X_i

Example: Assume that in some extensive-form game player i 's decision nodes are in $X_i = \{x_1, x_2, x_4, x_6\}$.

H_i can be any partition of X_i , for instance:

- ▷ $H_i = \{\{x_1\}, \{x_2\}, \{x_4\}, \{x_6\}\}$: All singletons
- ▷ $H_i = \{\{x_1, x_2\}, \{x_4\}, \{x_6\}\}$: x_1 and x_2 are not distinguishable
- ▷ $H_i = \{\{x_1, x_2, x_4\}, \{x_6\}\}$: only x_6 or “not x_6 ” is distinguishable
- ▷ $H_i = \{\{x_1, x_2, x_4, x_6\}\}$: nothing is distinguishable

System of beliefs

Definition: In an extensive-form game, a **system of beliefs** μ is a probability distribution over decision nodes within each information set.

Formally, for every player $i \in N$, every information set $h \in H_i$ and every of its decision node $x \in h$, $\mu(x) \in [0, 1]$ is the probability that player i assigns to decision node x when player i moves to information set h .

Where $\sum_{x \in h} \mu(x) = 1$ for every $h \in H_i$, $i \in N$.

Example: Take $H_i = \{\{x_1, x_2, x_4\}, \{x_6\}\}$, $h_1 := \{\{x_1, x_2, x_4\}\}$ and $h_2 := \{\{x_6\}\}$ then the system of beliefs **may** assign:

$$\triangleright \mu(x_1) = 2/3, \mu(x_2) = 1/6, \mu(x_4) = 1/6 \Rightarrow \sum_{x \in h_1} \mu(x) = 1$$

$$\triangleright \mu(x_6) = 1$$

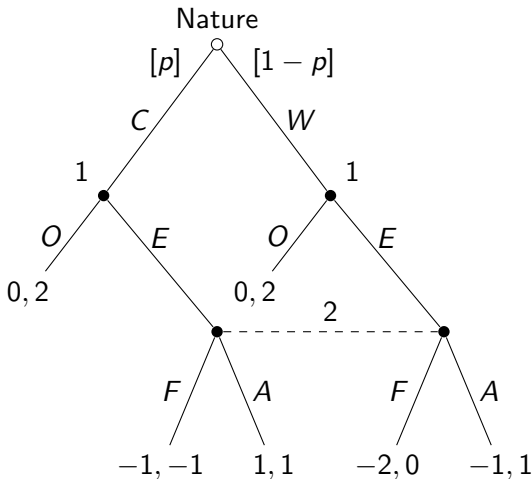
Beliefs: Requirement 1

Requirement 1: Every player has well-defined beliefs over their decision nodes at every of their information set (singleton or not)

That is, the game is endowed with a **complete system of beliefs**

Requirement 1: An Example

Consider the following game (Tadelis, 2013):



Requirement 1: An Example

A system of beliefs must assign a probability to x_1 , x_2 , x_3 and x_4 .

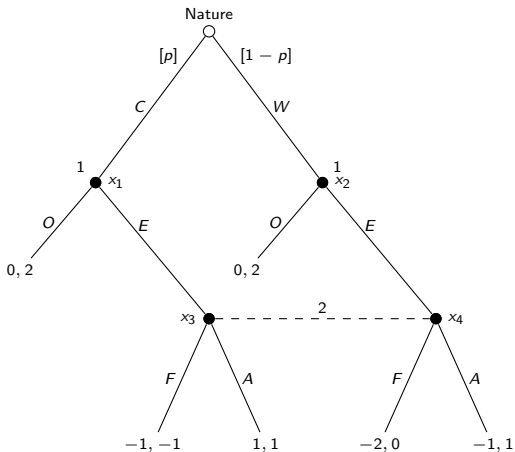
We have

$$\triangleright \mu(x_1) = \mu(x_2) = 1$$

$$\triangleright \mu(x_3) \in [0, 1]$$

$$\triangleright \mu(x_4) \in [0, 1]$$

$$\triangleright \mu(x_3) + \mu(x_4) = 1$$



Beliefs: Where do they come from?

We have imposed a **system of beliefs** but how are they determined?

- ▷ Are they imposed by exogenous elements?
- ▷ Can players “choose” their beliefs?

We are going to allow for both in some way.

- ▷ **Exogenously:** Beliefs are partly determined by Nature.
- ▷ **Endogenously:** Beliefs are partly determined by **players' strategies**.

Beliefs: Consistency constraints

We impose some **consistency constraints** on beliefs.

- ▷ **Exogenously:** Beliefs must be consistent with Bayes' rule (we will be more specific later).
- ▷ **Endogenously:** Beliefs must be consistent with how we anticipate other players' strategies.

Reminder: Bayes' rule

Let $(\Omega, \mathcal{F}, \mathbb{P})$ denote a probability space

For any two events $A, B \in \mathcal{F}$ such that $\mathbb{P}(B) \neq 0$ we have

$$\mathbb{P}(A \mid B) = \frac{\mathbb{P}(A, B)}{\mathbb{P}(B)}$$

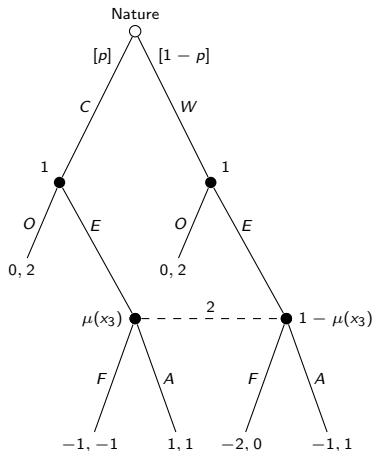
Beliefs: Consistency constraints

Go back to the example

- ▷ Constraints on $\mu(x_3)$?

Assume P1 plays EO , i.e.:

- ▷ When P1 is C : chooses E
- ▷ When P1 is W : chooses O



Beliefs: Consistency constraints

Go back to the example

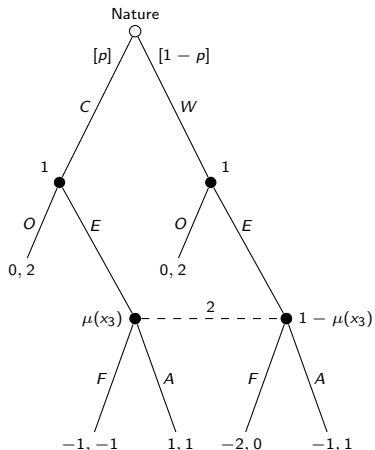
- ▷ Constraints on $\mu(x_3)$?

Assume P1 plays EO , i.e.

- ▷ When P1 is C : chooses E
- ▷ When P1 is W : chooses O

Belief consistency (endogenous):

- ▷ $\mu(x_3) = \mathbb{P}(\text{P1 is } C \mid E)$
- ▷ $1 - \mu(x_3) = \mathbb{P}(\text{P1 is } W \mid E)$

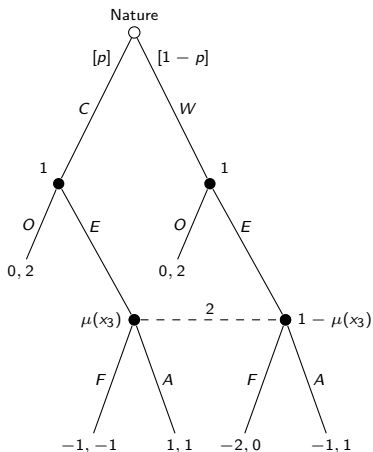


Beliefs: Consistency constraints

Therefore if P1 plays *EO* we must have:

- ▷ $\mu(x_3) = 1$.
- ▷ If P2 observes that the game reached this stage, it must be that P1 is **not** *W*.

P2's beliefs must be **consistent** with what P2 thinks P1 will play.



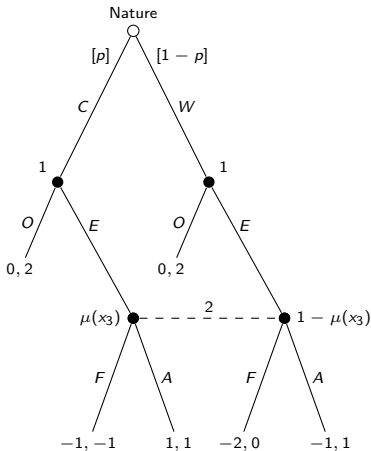
Beliefs: Consistency constraints

This also means that if $P1$ considers playing EO

- ▷ Anticipates that $\mu(x_3) = 1$.
- ▷ Can therefore anticipate that $P2$ **will play A following E** .

Then when $P1$ considers a **deviation** from EO .

- ▷ $P1$ could try to play E when W .
- ▷ $P2$ would **wrongly** believe that $P1$ is C and would play A .
- ▷ $P1$ therefore knows that this **deviation would not be profitable**



Beliefs: Consistency constraints

The above example illustrates an **endogenous consistency** requirement.

- ▷ When a player reaches a decision node for which the information set is not a singleton it must form a belief for each decision node that is **consistent** with the other players' strategies.

But it must also be **consistent with exogenous elements** such as Nature draw.

- ▷ We do not see it in the previous example
- ▷ See next slide

Beliefs: Consistency constraints

Consider the following case: P2 thinks that P1 of type

- ▷ C : chooses E with **probability** $\sigma_C \Leftrightarrow \mathbb{P}(E \mid C) = \sigma_C$
- ▷ W : chooses E with **probability** $\sigma_W \Leftrightarrow \mathbb{P}(E \mid W) = \sigma_W$

What should be $\mu(x_3)$?

- ▷ Assume P2 observes that P1 played E .
- ▷ Then, P2 must then infer how likely it is that P1 is C given that they played E .

Formally,

$$\mu(x_3) = \mathbb{P}(\text{Nature has chosen } C \mid \text{P1 played } E).$$

Beliefs: Consistency constraints

Using Bayes' rule we have that:

$$\begin{aligned}\mu(x_3) &= \mathbb{P}(\text{Nature has chosen } C \mid \text{P1 played } E) \\ &= \frac{\mathbb{P}(\text{Nature has chosen } C \text{ AND P1 played } E)}{\mathbb{P}(\text{P1 played } E)}.\end{aligned}$$

With lighter notations:

$$\mu(x_3) = \frac{\mathbb{P}(C \text{ AND } E)}{\mathbb{P}(E)}.$$

Beliefs: Consistency constraints

Using **Bayes' rule** once again and the **law of total probability** we have:

$$\begin{aligned}\mu(x_3) &= \frac{\mathbb{P}(C \text{ AND } E)}{\mathbb{P}(E)} \\&= \frac{\mathbb{P}(E | C)\mathbb{P}(C)}{\mathbb{P}(E | C)\mathbb{P}(C) + \mathbb{P}(E | W)\mathbb{P}(W)} \\&= \frac{\sigma_C \cdot p}{\sigma_C \cdot p + \sigma_W \cdot (1 - p)}\end{aligned}$$

Reminder:

- ▷ $\mathbb{P}(A, B) = \mathbb{P}(A | B)\mathbb{P}(B)$ for any two $A, B \in \mathcal{F}$
- ▷ $\mathbb{P}(A) = \sum_i \mathbb{P}(A | B_i)\mathbb{P}(B_i)$ where $(B_i)_{i=1}^m$ is a partition of \mathcal{F}

Beliefs: Consistency constraints

Notice that the belief

$$\mu(x_3) = \frac{\sigma_C \cdot p}{\sigma_C \cdot p + \sigma_W \cdot (1 - p)},$$

depends both on

- ▷ P1's strategy: **Endogenous** consistency
- ▷ Nature's draw: **Exogenous** consistency

Rational players form their beliefs using **both of these elements**.

Notice also that if we set $\sigma_C = 1$ and $\sigma_W = 0$.

- ▷ P1 chooses E when C and O when W with **certainty**.

- ▷ Then
$$\mu(x_3) = \frac{1 \cdot p}{1 \cdot p + 0 \cdot (1 - p)} = 1.$$

Equilibrium path: On and off

We are almost ready to state our **second and third requirements** on beliefs.

But first, consider the following definition.

Definition (Tadelis, 2013): Let $\sigma^* = (\sigma_1^*, \dots, \sigma_n^*)$ be a Bayesian Nash Equilibrium profile in a game of incomplete information. We say that an information set is **on the equilibrium path** if given σ^* and given the distribution of types, it is reached with **positive probability**.

By opposition, an information set is said to be **off the equilibrium path** if given σ^* , it is reached with **zero probability**.

Equilibrium path: Example

Example:

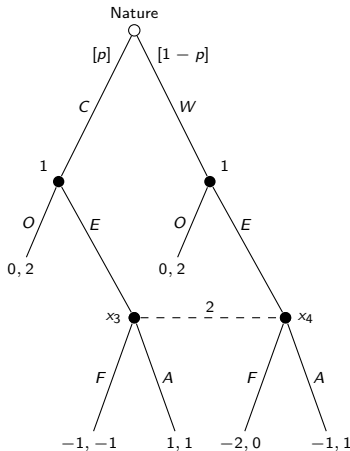
Consider first that P1 chooses EO .

- ▷ With prob. p , P1 is C and plays E .
- ▷ With prob. $1 - p$, P1 is W and plays O .

\Rightarrow The information set $h_1 = \{x_3, x_4\}$ is reached with positive probability p .

If EO

were part of a BNE, we would say that h_1 is **on the equilibrium path** of this BNE.



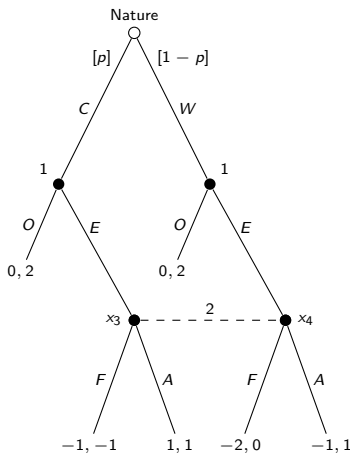
Equilibrium path: Example

Example: Consider now that P1 chooses OO

- ▷ With prob. p , P1 is C and plays O .
- ▷ With prob. $1 - p$, P1 is W and plays O .

⇒ The information set $h_1 = \{x_3, x_4\}$ is **never reached** with positive probability.

If OO were part of a BNE, we would say that h_1 is **off the equilibrium path** of this BNE.



Equilibrium path: On and off

Whether an information set is **on or off the equilibrium path** is not exogenous.

- ▷ It is determined by the players' actions.

We are now ready to state our **second and third requirements** on beliefs.

- ▷ One for beliefs **on** the equilibrium path.
- ▷ One for beliefs **off** the equilibrium path.

Beliefs: Requirement 2

Requirement 2 (Tadelis, 2013): For any BNE strategy profile σ^* , in all *information sets* that are **on** the equilibrium path, beliefs must be **consistent with Bayes' rule**.

That is, players must form their beliefs using both the

- ▷ **exogenous constraints** (nature);
- ▷ and the **endogenous constraints** (other players' strategies).

When Bayes is off path

What about information sets that are **off the equilibrium path**?

- ▷ Can't we **apply Bayes' rule** as well?
- ▷ Not always!

Recall that if P1's strategy is OO .

- ▷ Then $h_1 = \{x_3, x_4\}$ is **never reached**.

Assume that P2 **believes** that P1 plays OO .

- ▷ But surprisingly **observes** that $h_1 = \{x_3, x_4\}$ **is reached**!

Trying to apply Bayes' rule gives: $\mu(x_3) = \frac{0 \cdot p}{0 \cdot p + (1 - p) \cdot 0} = \frac{0}{0}!$

When Bayes is off path

Clearly, applying Bayes' rule **fails** as $\mu(x_3) = \frac{0}{0}$ is **undefined**.

But you might wonder: **Why should we care?**

- ▷ It never happens at equilibrium, so why is that a problem?

When Bayes is off path

To see why, assume P2 believes that P1 plays OO so that Bayes' rule **does not apply to assign beliefs** to $h_1 = \{x_3, x_4\}$.

- ▷ P1 will compute their payoff with OO knowing that P2 will believe that h_1 is never reached.
- ▷ But if P1 wants to see if they could deviate from that and play EO for instance.
- ▷ Then, h_1 would be reached with positive probability.
- ▷ But as it is unexpected for P2, $\mu(x_3)$ is not defined by Bayes' rule.
- ▷ So that P1 is unable to know what will happen and to compute their payoff if they play E .

When Bayes is off path

Therefore, if $\mu(x_3)$ is undefined, we are unable to fully compute **how P1 could deviate** from OO .

That is why we will impose that there also exists beliefs over nodes of information sets that are **off the equilibrium path**.

We can now state our **third requirement**.

Beliefs: Requirement 3

Requirement 3 (Tadelis, 2013): At information sets that are **off the equilibrium path**, any belief can be assigned to which Bayes' rule does not apply.

In other words:

- ▷ If Bayes' rule can be applied: **Apply it!**
- ▷ Otherwise: $\mu(x)$ **can be anything in** $[0, 1]$ for x at an off equilibrium path information set.

Notice that there is room for some **arbitrary choices** here.

- ▷ We might obtain different solutions if we **choose different beliefs** off the equilibrium path!

Beliefs: Requirement 4

We can finally state our **fourth requirement** on beliefs.

Requirement 4 (Tadelis, 2013): Given their beliefs, players' strategies must be **sequentially rational**. That is, in every information set players will play a **best response** to their beliefs.

With this requirement, we restore the possibility to evaluate whether a move is **sequentially rational** or not at every information set, including those that contain more than one decision node.

Table of Contents

1. Introducing example
2. Preliminaries
3. Belief requirements
4. Perfect Bayesian Nash Equilibrium
5. Signaling games

Perfect Bayesian Nash Equilibrium: Definition

Finally, we can define what is a **Perfect Bayesian Nash Equilibrium**.

Definition: A **Perfect Bayesian Nash Equilibrium** consists of a Bayesian Nash Equilibrium profile $\sigma^* = (\sigma_1^*, \dots, \sigma_n^*)$ together with a system of beliefs μ that satisfy Requirements 1,2,3 and 4.

In other words, a **PBNE** is a BNE such that players are **sequentially rational** at every information set.

PBNE: Beliefs and strategies

In BNE, beliefs were **purely exogenous**.

- ▷ Strategies **depended** on beliefs.
- ▷ But beliefs **were independent** of strategies.

The fundamental feature of PBNE is that beliefs and strategies are **both part of the equilibrium outcome**.

- ▷ Strategies **depend** on beliefs
- ▷ Beliefs **depend** $\left\{ \begin{array}{l} \text{on Nature (what is given)} \\ \text{on strategies (what other players might do)} \end{array} \right.$

Beliefs emerge **endogenously**.

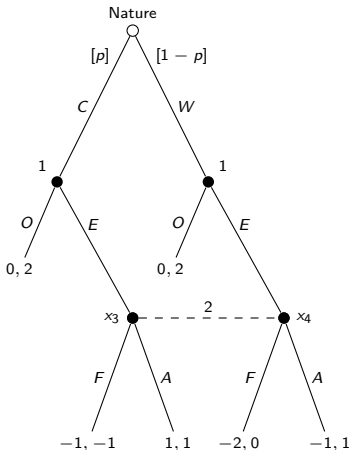
Perfect Bayesian Nash Equilibrium: An example

PBNE of this game with $p = 0.5$.

First, let us find the BNEs.

- ▷ We can compute the merged payoff matrix as follows.

1 \ 2	F	A
EE	$(-1, -2) ; -\frac{1}{2}$	$(1, -1) ; 1$
EO	$(-1, 0) ; \frac{1}{2}$	$(1, 0) ; \frac{3}{2}$
OE	$(0, -2) ; 1$	$(0, -1) ; \frac{3}{2}$
OO	$(0, 0) ; 2$	$(0, 0) ; 2$



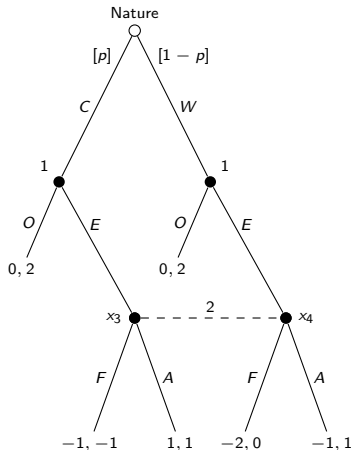
PBNE: An example

PBNE of this game with $p = 0.5$

First, let us find the BNEs

- ▷ We can compute the merged payoff matrix as follows

1 \ 2	F	A
EE	$(-1, -2) ; -\frac{1}{2}$	$(\underline{1}, -1) ; \underline{1}$
EO	$(-1, \underline{0}) ; \frac{1}{2}$	$(\underline{1}, \underline{0}) ; \underline{\frac{3}{2}}$
OE	$(\underline{0}, -2) ; \underline{1}$	$(0, -1) ; \underline{\frac{3}{2}}$
OO	$(\underline{0}, \underline{0}) ; \underline{2}$	$(0, \underline{0}) ; \underline{2}$



PBNE: An example

Two BNE: (OO, F) and (EO, A) .

Consider (OO, F) :

- ▷ The information set $h_1 = \{x_3, x_4\}$ is **off the equilibrium path**.
- ▷ It means that $\mu(x_3)$ can be anything in $[0, 1]$ (Requirement 3).

However, assume that for some reason P2 observes $E \Rightarrow h_1$ is reached.

For any $\mu(x_3) \in [0, 1]$, P2's expected payoff is:

- ▷ $\mu(x_3) \cdot (-1) + (1 - \mu(x_3)) \cdot 0 = -\mu(x_3)$ if P2 plays F
- ▷ $\mu(x_3) \cdot 1 + (1 - \mu(x_3)) \cdot 1 = 1$ if P2 plays A

PBNE: An example

- ▷ $\mu(x_3) \cdot (-1) + (1 - \mu(x_3)) \cdot 0 = -\mu(x_3)$ if P2 plays F
- ▷ $\mu(x_3) \cdot 1 + (1 - \mu(x_3)) \cdot 1 = 1$ if P2 plays A

Then it is clear that P2 **will play** A for any value of $\mu(x_3)$.

In other words, (OO, F) is such that

- ▷ P2 is **not sequentially rational** (Requirement 4).

The BNE profile (OO, F) **does not survive** the PBNE refinement.

PBNE: An example

Consider now (EO, A) :

- ▷ The information set $h_1 = \{x_3, x_4\}$ is **on the equilibrium path**.
- ▷ Belief $\mu(x_3) = 1$ as only C chooses E .

P2 is then **certain** that observing E means that P1 is C .

So if P2 reaches h_1 .

- ▷ **Best response is A .**

Are we done?

PBNE: An example

Are we done?

- ▷ Not yet, we also have to verify that ***EO* is a best response to *A* and belief $\mu(x_3) = 1$.**

Fix *A* and $\mu(x_3) = 1$.

1. P1 deviates to *EE*

- ▷ P2 would always believe that P1 is *C*.
- ▷ P2 would then always play *A*.

Not sequentially rational for P1.

- ▷ When reaching x_2 , P1 knows that P2 will play *A*.
- ▷ Better playing *O*

PBNE: An example

Still fix A and $\mu(x_3) = 1$.

2. P1 deviates to OE

If P1 reaches x_1 and plays O .

- ▷ Not sequentially rational
- ▷ Would be better to play E so that P2 plays A

If P1 reaches x_2 and plays E .

- ▷ P2 will believe that P1 is C
- ▷ P2 will play A
- ▷ Not sequentially rational for P1 to play E at x_2

PBNE: An example

Still fix A and $\mu(x_3) = 1$.

3. P1 deviates to OO

If P1 reaches x_1 and plays O .

- ▷ Not sequentially rational
- ▷ Would be better to play E so that P2 plays A

PBNE: An example

Therefore:

- (EO, A) and $\mu(x_3) = 1$ is the **only PBNE** of the game.
- The other BNE profile is not sequentially rational according to our requirements.

PBNE: Introducing Example solution

Let us go back to the introducing example.

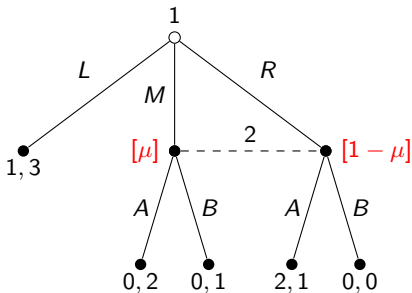
Recall: Two BNE.

▷ (L, B)

▷ (R, A)

We have found that for any $\mu \in [0, 1]$.

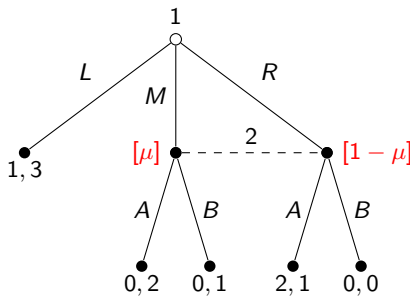
▷ A is a dominant strategy if we reach P2's information set.



PBNE: Introducing Example solution

Consider (L, B) .

- ▷ Information set is off the equilibrium path.
- ▷ Belief μ can be anything (requirement 3).
- ▷ But for any μ , A is a dominant strategy.



Then B is not sequentially rational.

- ▷ (L, B) is not a PBNE.

PBNE: Introducing Example solution

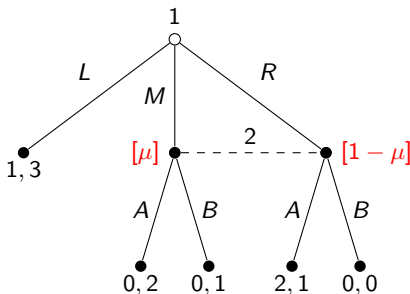
Consider (R, A) .

- ▷ Information set is on the equilibrium path.
- ▷ A is a dominant strat.
- ▷ P1 prefers R to M .
- ▷ Belief must be $\mu = 0$.

P1 can play:

- ▷ L and obtain 1.
- ▷ R and obtain 2 (better).

Therefore, (R, A) and $\mu = 0$ is a PBNE.



Other refinements

There exists **other refinements** of BNE.

For instance, “**sequential equilibrium**” is the most famous other one.

- ▷ Due to Kreps and Wilson (1982)

Sequential equilibrium is stronger than PBNE.

- ▷ Essentially a PBNE with **more requirements** on beliefs that are off the equilibrium path .
- ▷ Every sequential equilibrium is a PBNE, but the reverse does not hold.

In many applications, the two are equivalent.

- ▷ We will restrict to those cases

Table of Contents

1. Introducing example
2. Preliminaries
3. Belief requirements
4. Perfect Bayesian Nash Equilibrium
5. Signaling games

Signaling games

A very important type of dynamic games of incomplete information:

- ▷ **Signaling games.**

They have some **distinguishable features**, which are, informally:

- ▷ P1 privately knows **payoff-relevant** information for P2
- ▷ No way to **certify** the information
- ▷ P1 will try to **signal** their information through their action
- ▷ Signaling is possible when actions are **credible signals**

Examples: Education, advertising, war games and sometimes even biological evolution!

Signaling games: Main Setting

The main setting for (two-player) signaling games is as follows:

1. Nature chooses a type. Only P1 learns it. But both P1 and P2's payoff depends on it;
2. P1 has at least as many actions as they have types (rich action space). Each action has some **cost**;
3. **Timing:** P1 plays first. P2 observes P1's action (but not type) and responds to it;
4. P2 updates their beliefs about P1's type thanks to their belief about P1's strategy and the observed action.

Signaling games: Classes of PBE

There are two important classes of PBE in signaling games.

1. Pooling equilibria

- ▷ All types of P1 choose the same action, i.e., P1 *pools together* all their types in the same action.
- ▷ P2 **cannot infer** anything about P1's type as their action is **non-revealing**.
- ▷ P2 must then best respond using only **exogenous information** about P1's type.

Signaling games: Classes of PBE

The other class is

2. Separating equilibria

- ▷ Each of P1's type chooses a **different action**.
- ▷ P2 can **perfectly infer** P1's type from their action.
- ▷ P2 can then respond *as if* they were perfectly informed about P1's type.

In that case, we say that P1's action **reveals** their type

Signaling games: Pooling and Separating

Separating equilibria seem very powerful.

- ▷ P1 cannot provide **hard proof** of their type but can only send a **signal**.
- ▷ Yet, P2 becomes **perfectly informed**.
- ▷ All information is **revealed**!

Signaling games: Pooling and separating

Separating seems **too good to be true**. What could go wrong?

- ▷ Recall that both P1 and P2's payoff depend on P1's type
- ▷ Maybe they do not have **aligned interests**?
- ▷ When P2 learns the information, they may take an action that does not please P1
- ▷ P1 might then have an **incentive to lie/manipulate information** so that P2 responds in a way that P1 prefers
- ▷ But a **rational P2 will anticipate** this possibility
- ▷ So if P1 has an incentive to lie, **P2 should not believe that P1's action reveals their type**

Signaling games: Pooling and Separating

The **existence** of a separating equilibrium therefore **relies** on the **credibility of P1's signal**.

If both players' interests are aligned.

- ▷ P1's signal is **always credible**.

If both players' interests are **not aligned**.

- ▷ We must check that P1 **does not want to manipulate information**.
- ▷ This will crucially rely on whether **sending wrong signals is costly** enough for P1.

Separating and Pooling: Previous example

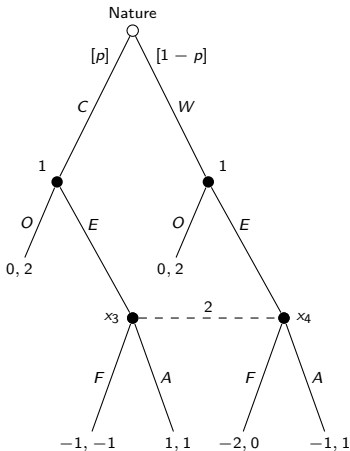
In the previous example:

The BNE: (OO, F) is a **pooling equilibrium**.

- ▷ Choice of $P1$ gives no information of their type.

The PBNE: (EO, A) is a **separating equilibrium**.

- ▷ If $P1$ plays E : $P2$ can perfectly infer that $P1$ is C .
- ▷ If $P1$ plays O : $P2$ can perfectly infer that $P1$ is W .



A famous game: Education as a signal

Famous signaling game: Education game **proposed by Spence (1973)**.

Spence's idea is that education is a **signal of productivity**.

- ▷ Job recruiters **cannot observe** workers' productivity.
- ▷ An individual can spend time and effort studying to get a diploma.
- ▷ It is **less costly** to get the diploma for **more productive** individuals.

Additional assumption: Education has no effect on productivity.

- ▷ i.e., education is nonproductive, only a loss of time and efforts.
- ▷ seems unrealistic but not a problem, assuming education is productive would not change the result.

A famous game: Education as a signal

Big picture:

- ▷ Investing in education is **very** costly for individuals with a low level of productivity.
- ▷ We expect that **only** highly productive individuals invest in education.
- ▷ Therefore, **education signals productivity**.

The obvious problem to this reasoning is

- ▷ Low types must not be incentivized to get the diploma to pretend they are high types.

A famous game: Education as a signal

Setting (Tadelis, 2013, p.319):

Nature draws P1's type: With probability p , P1 is of type $t_1 = H$ (High); otherwise P1 is $t_1 = L$ (Low) with probability $1 - p$.

P1 plays first (after Nature):

- ▷ P1 is the future employee
- ▷ P1 can choose to study for an undergraduate degree U only or to continue studying to obtain a graduate degree D
- ▷ To obtain U : Individual cost is normalized to 0
- ▷ To obtain D : It costs $c_H = 2$ and $c_L = 5$ to type H and L , respectively

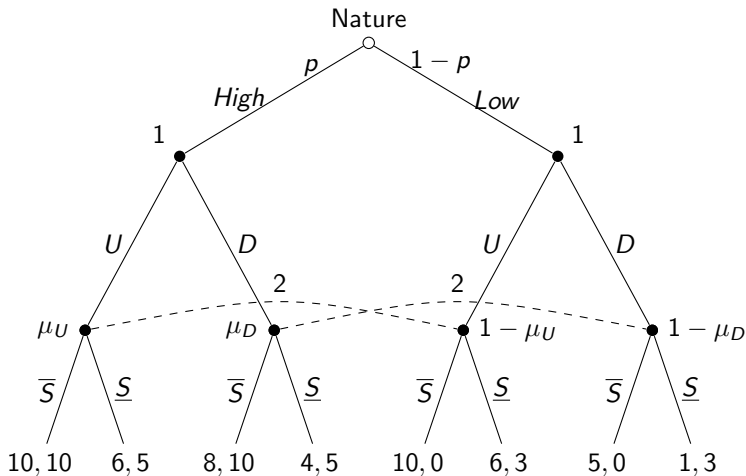
A famous game: Education as a signal

P2 observes $a_1 \in A_1 = \{U, D\}$ but not t_1

- ▷ P2 is the employer, plays after observing $a_1 \in A_1 = \{U, D\}$
- ▷ P2 must assign the employee to one of two possible tasks:
 $a_2 \in \{\underline{S}, \bar{S}\}$
- ▷ \underline{S} is *less skilled* task than \bar{S} : The market wage for performing \underline{S} is $\underline{w} = 6$ and the one for \bar{S} is $\bar{w} = 10$
- ▷ P2's net profit depends on the following task-productivity assignment (independent of U and D):

	\bar{S}	\underline{S}
H	10	5
L	0	3

A famous game: Education as a signal



A famous game: Education as a signal

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	\bar{S}	\underline{S}
H	10	5
L	0	3

A famous game: Education as a signal

We define a **system of beliefs**:

- ▷ μ_U : P2's belief that P1 is H after observing U .
- ▷ μ_D : P2's belief that P1 is H after observing D .

They will be determined both by

- ▷ Nature
- ▷ P1's strategy

A famous game: Education as a signal

First, let us find the BNEs when $p = \frac{1}{4}$.

There are **two pure-strategy BNE**:

- ▷ (UU, \underline{SS}) (Pooling)
- ▷ (DU, \overline{SS}) (Separating)

The proof is left as an exercise

- ▷ See Tadelis (2013), p.322

A famous game: Education as a signal

Consider the separating equilibrium $(DU, \bar{S}\underline{S})$

- ▷ All information sets are on the equilibrium path

$$\begin{aligned}\mu_U = \mathbb{P}(H \mid U) &= \frac{\mathbb{P}(U \mid H)\mathbb{P}(H)}{\mathbb{P}(U \mid H)\mathbb{P}(H) + \mathbb{P}(U \mid L)\mathbb{P}(L)} \\ &= \frac{0 \cdot p}{0 \cdot p + 1 \cdot (1 - p)} \\ &= 0\end{aligned}$$

When P2 observes U , they believe that P1 is L with certainty

A famous game: Education as a signal

Now for μ_D

$$\begin{aligned}\mu_D = \mathbb{P}(H \mid D) &= \frac{\mathbb{P}(D \mid H)\mathbb{P}(H)}{\mathbb{P}(D \mid H)\mathbb{P}(H) + \mathbb{P}(D \mid L)\mathbb{P}(L)} \\ &= \frac{1 \cdot p}{1 \cdot p + 0 \cdot (1 - p)} \\ &= 1\end{aligned}$$

When P2 observes D , they believe that P1 is H with certainty

A famous game: Education as a signal

For beliefs $\mu_U = 0$ and $\mu_D = 1$, it is clear that

- ▷ \bar{S} is a BR to D ($10 > 5$)
- ▷ \underline{S} is a BR to U ($3 > 0$)

For beliefs $\mu_U = 0$, $\mu_D = 1$ and $\bar{S}\underline{S}$:

- ▷ P1 of type H : Prefers D to U ($8 > 6$)
- ▷ P1 of type L : Prefers U to D ($6 > 5$)

Therefore $(DU, \bar{S}\underline{S})$ is a (separating) PBNE

A famous game: Education as a signal

Consider the pooling equilibrium (UU, \underline{SS})

- ▷ The information set for nodes after D is off the equilibrium path

For the one on the equilibrium path

- ▷ $\mu_U = p = \frac{1}{4}$
- ▷ that is, this belief for P2 is only constituted by the **exogenous information**
- ▷ Because P1 **reveals nothing** by playing U for each of their type

A famous game: Education as a signal

Consider the pooling equilibrium (UU, \underline{SS})

- ▷ Information set for nodes after D : off the equilibrium path
- ▷ Information set for nodes after U : on the equilibrium path

For the one **on** the equilibrium path

- ▷ $\mu_U = p = \frac{1}{4}$
- ▷ that is, this belief for P2 is only constituted by the **exogenous information**
- ▷ Because P1 **reveals nothing** by playing U for each of their type

A famous game: Education as a signal

For the one **off** the equilibrium path:

- ▷ μ_D can be anything between $[0, 1]$.

Let us compute P2's best response to observing D for belief $\mu_D \in [0, 1]$

- ▷ Playing \bar{S} : $10\mu_D + 0(1 - \mu_D) = 10\mu_D$
- ▷ Playing \underline{S} : $5\mu_D + 3(1 - \mu_D) = 2\mu_D + 3$

Therefore P1 prefers
$$\begin{cases} \bar{S} & \text{if } \mu_D \geq \frac{3}{8} \\ \underline{S} & \text{if } \mu_D \leq \frac{3}{8} \end{cases}$$

A famous game: Education as a signal

Therefore, for \underline{S} to be a BR for P2 it must be the case that

$$\mu_D \leq \frac{3}{8}$$

This means that (UU, \underline{SS}) is a PBNE only if beliefs off the equilibrium path $\mu_D \in [0, \frac{3}{8}]$