Models in Microeconomic Theory

Part I (Chapters 1–7) presents models of an economic agent, discussing abstract models of preferences, choice, and decision making under uncertainty, before turning to models of the consumer, the producer, and monopoly. Part II (Chapters 8–14) introduces the concept of equilibrium, beginning, unconventionally, with the models of the jungle and an economy with indivisible goods, and continuing with models of an exchange economy, equilibrium with rational expectations, and an economy with asymmetric information. Part III (Chapters 15–16) provides an introduction to game theory, covering strategic and extensive games and the concepts of Nash equilibrium and subgame perfect equilibrium. Part IV (Chapters 17–20) gives a taste of the topics of mechanism design, matching, the axiomatic analysis of economic systems, and social choice.

The book focuses on the concepts of model and equilibrium. It states models and results precisely, and provides proofs for all results. It uses only elementary mathematics (with almost no calculus), although many of the proofs involve sustained logical arguments. It includes about 150 exercises.

With its formal but accessible style, this textbook is designed for undergraduate students of microeconomics at intermediate and advanced levels.

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Cover design by Martin J. Osborne

Models in Microeconomic Theory
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18 Matching

Consider the following problem. Some individuals in a society are $X$’s and others are $Y$’s. Every individual of each type has to be matched with one and only one individual of the other type. For example, managers have to be matched with assistants, or pilots have to be matched with copilots. Each $X$ has preferences over the $Y$’s and each $Y$ has preferences over the $X$’s. Every individual prefers to be matched than to remain unmatched. We look for matching methods that result in sensible outcomes given any preferences.

18.1 The matching problem

We denote the set of $X$’s by $X$ and the set of $Y$’s by $Y$ and assume that they have the same number of members. Each $x \in X$ has a preference relation over the set $Y$ and each $y \in Y$ has a preference relation over the set $X$. We assume that all preferences are strict (no individual is indifferent between any two options).

**Definition 18.1: Society and preference profile**

A society $(X, Y)$ consists of finite sets $X$ and $Y$ (of individuals) with the same number of members. A preference profile $(\succeq^i)_{i \in X \cup Y}$ for the society $(X, Y)$ consists of a strict preference relation $\succeq^i$ over $Y$ for each $i \in X$ and a strict preference relation $\succeq^i$ over $X$ for each $i \in Y$.

A matching describes the pairs that are formed. Its definition captures the assumption that each individual has to be matched with exactly one individual of the other type.

**Definition 18.2: Matching**

A matching for a society $(X, Y)$ is a one-to-one function from $X$ to $Y$. For a matching $\mu$ and $x \in X$ we refer to $(x, \mu(x))$ as a match.

We discuss matching methods, which map preference profiles into matchings. That is, a matching method specifies, for each preference profile, who is matched with whom.
Definition 18.3: Matching method

A matching method for a society is a function that assigns a matching to each preference profile for the society.

The following example treats one side (the Y’s), like the houses in the models of Chapter 8, and takes into account only the preferences of the X’s.

Example 18.1: Serial dictatorship

The X’s, in a pre-determined order, choose Y’s, as in the serial dictatorship procedure. Each X chooses from the Y’s who were not chosen by previous X’s. This procedure always results in a matching, and thus defines a matching method.

Here are two more examples of matching methods.

Example 18.2: Minimizing aggregate rank

For any pair \((x, y)\) consisting of an X and a Y, let \(n_x(y)\) be y’s rank in x’s preferences and let \(n_y(x)\) be x’s rank in y’s preferences. Attach to each pair \((x, y)\) a number \(I(x, y) = \alpha(n_x(y), n_y(x))\), where \(\alpha\) is a function increasing in both its arguments (for example \(\alpha(n_1, n_2) = n_1 + n_2\)). The number \(\alpha(n_x(y), n_y(x))\) is a measure of the dissatisfaction of individuals x and y with their match. The matching method chooses the matching that minimizes the sum of \(I(x, y)\) over all pairs \((x, y)\) (or one such matching if more than one exists).

Example 18.3: Iterative selection of the best match

Start by choosing a pair for which the value of \(I(x, y)\) defined in Example 18.2 is minimal over all pairs \((x, y)\). Remove the members of the chosen pair from X and Y and choose a pair for which the value of \(I(x, y)\) is minimal over the smaller sets. Continue iteratively in the same way.

18.2 The Gale-Shapley algorithm

We now consider a matching method that has an interesting description and some attractive properties. The algorithm that defines it has two versions, one in which the X’s initiate matches, and one in which the Y’s do so. We describe the former.
Stage 1

(a) Each $X$ chooses her favorite $Y$.

(b) Each $Y$ chosen by more than one $X$ chooses her favorite $X$ among those who chose her.

(c) $X$’s chosen by $Y$’s are tentatively matched with them; remaining individuals are unmatched.

(d) Unmatched $X$’s choose their favorite $Y$’s among the $Y$’s who haven’t rejected them.

Stage 2

At the start of stage $t + 1$, tentative matches exist from stage $t$, and some individuals are unmatched. Each unmatched $X$ chooses her favorite $Y$ among those who have not rejected her in the past. Some of the $Y$’s thus chosen may already be tentatively matched with $X$’s. (In the example in Figure 18.1, that is the case in Stage 2 for 4.) Each $Y$ chooses her favorite $X$ from the set consisting of the $X$ with whom she was tentatively matched at the end of stage $t$ and the unmatched $X$’s who chose her, resulting in new tentative matches.

Stopping rule

The process ends when every $X$ is tentatively matched with a $Y$, in which case the tentative matches become final.

The following definition specifies the algorithm formally, but if you find the previous description clear you may not need to refer to it.
Procedure: Gale-Shapley algorithm

Given a society \((X, Y)\), the Gale-Shapley algorithm for \((X, Y)\) in which \(X\)'s initiate matches, denoted \(GS^X\), has as input a preference profile \((\succeq^i)_{i \in X \cup Y}\) for \((X, Y)\) and generates a sequence \((g_t, R_t)_{t=0, 1, \ldots}\) where

- \(g_t : X \to Y \cup \{\text{unmatched}\}\) is a function such that no two \(X\)'s are mapped to the same \(Y\)
- \(R_t\) is a function from \(X\) to subsets of \(Y\).

A pair \((g_t, R_t)\) is the state of the algorithm at the end of stage \(t\). If \(g_t(x) \in Y\) then \(g_t(x)\) is the \(Y\) with whom \(x\) is tentatively matched and \(R_t(x)\) is the set of all \(Y\)'s who rejected \(x\) through stage \(t\).

**Definition of** \((g_0, R_0)\)

Every \(X\) is unmatched and every set \(R_0(x)\) is empty:

- \(g_0(x) = \text{unmatched}\) for all \(x \in X\)
- \(R_0(x) = \emptyset\) for all \(x \in X\).

**Definition of** \((g_{t+1}, R_{t+1})\) given \((g_t, R_t)\)

For each \(y \in Y\) let

\[
A_{t+1}(y) = \{x \in X : y \text{ is best in } Y \setminus R_t(x) \text{ according to } \succeq^x\}.
\]

That is, \(A_{t+1}(y)\) is the set of the \(X\)'s who choose \(y\) in stage \(t + 1\). (Note that if \(g_t(x) = y\) then \(x \in A_{t+1}(y)\).)

Now

\[
g_{t+1}(x) = \begin{cases} y & \text{if } x \text{ is best in } A_{t+1}(y) \text{ according to } \succeq^y \\ \text{unmatched} & \text{otherwise} \end{cases}
\]

and

\[
R_{t+1}(x) = \begin{cases} R_t(x) & \text{if } g_{t+1}(x) \in Y \\ R_t(x) \cup \{y \in Y : x \in A_{t+1}(y)\} & \text{if } g_{t+1}(x) = \text{unmatched}. \end{cases}
\]

Thus \(R_{t+1}(x)\) is equal to \(R_t(x)\) unless \(x\) is rejected at stage \(t\) by some \(y \in Y\), in which case that \(y\) (and only her) is added to \(R_t(x)\).

**Stopping rule**

The process ends at stage \(T\) if \(g_T(x) \in Y\) for all \(x \in X\).
The description of the algorithm talks of individuals choosing matches. But that language should not be taken literally. We use it simply to describe the algorithm attractively (as we did for serial dictatorship). The Gale-Shapley algorithm simply defines a function that attaches a matching to every preference profile. Soon we prove that the algorithm indeed always ends with a matching, but first we give an example.

**Example 18.4**

Consider the society with four X’s and four Y’s and the following preference profiles, where X’s are shown in green and Y’s in orange.

<table>
<thead>
<tr>
<th></th>
<th>1:</th>
<th>2:</th>
<th>3:</th>
<th>4:</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>1(\succ)4(\succ)2(\succ)3</td>
<td>2:</td>
<td>3:</td>
<td>4:</td>
</tr>
<tr>
<td>2</td>
<td>2(\succ)3(\succ)1(\succ)4</td>
<td>2(\succ)</td>
<td>4(\succ)1</td>
<td>3(\succ)</td>
</tr>
<tr>
<td>3</td>
<td>4(\succ)2(\succ)3(\succ)1</td>
<td>4(\succ)3 (\succ)2(\succ)1</td>
<td>4:</td>
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<tr>
<td>4</td>
<td>4(\succ)3(\succ)1(\succ)2</td>
<td>1(\succ)4 (\succ)3(\succ)2</td>
<td>1(\succ)</td>
<td></td>
</tr>
</tbody>
</table>

**X’s initiate matches**

We first apply \(G_{S_X}^\text{X} \) (where X’s initiate matches) to this preference profile.

**Stage 1:** 1 chooses 1, 2 chooses 2, and both 3 and 4 choose 4. 4 prefers 4 to 3 and thus rejects 3 and keeps 4. That is, \(g_1(1) = 1\), \(g_1(2) = 2\), \(g_1(3) = \text{unmatched}\), and \(g_1(4) = 4\), and \(R_1(1) = \emptyset\), \(R_1(2) = \emptyset\), \(R_1(3) = \{4\}\), and \(R_1(4) = \emptyset\).

```
1 ----> 1
2 ----> 2
3 ----> 3
4 ----> 4
```

**Stage 2:** 3 chooses 2, who is tentatively matched with 2. 2 prefers 3 to 2 and so rejects 2. That is, \(g_2(1) = 1\), \(g_2(2) = \text{unmatched}\), \(g_2(3) = 2\), and \(g_2(4) = 4\), and \(R_2(1) = \emptyset\), \(R_2(2) = \{2\}\), \(R_2(3) = \{4\}\), and \(R_2(4) = \emptyset\).

```
1 ----> 1
2 ----> 2
3 ----> 3
4 ----> 4
```

**Stage 3:** 2 chooses 3. Every Y is now matched with a unique X, and the process ends. We have \(g_3(1) = 1\), \(g_3(2) = 3\), \(g_3(3) = 2\) and \(g_4(4) = 4\).

```
1 ----> 1
2 ----> 2
3 ----> 3
4 ----> 4
```
Y’s initiate matches Now we apply $GS^Y$ to the profile.

Stage 1: 1 and 2 choose 3, 3 chooses 4, and 4 chooses 1. 3 prefers 2 to 1 and so rejects 1.

Stage 2: 1 chooses 1, who prefers 1 to 4 and so rejects 4.

Stage 3: 4 chooses 4, who prefers 4 to 3 and so rejects 3.

Stage 4: 3 chooses 3, who prefers 2 to 3 and so rejects 3.

Stage 5: 3 chooses 2. Every $X$ is now matched with a unique $Y$, and the process ends.

Note that the matchings in these two examples are the same. But don’t jump to conclusions: for many preference profiles the matchings generated by $GS^X$ and $GS^Y$ differ.

We now show that for every profile of preferences the algorithm is well defined and eventually terminates in a matching.

**Proposition 18.1: Gale-Shapley algorithm yields a matching**

For any society and any preference profile for the society, the Gale-Shapley algorithm is well defined and generates a matching.
18.3 The Gale-Shapley algorithm and stability

We consider the algorithm $GS^X$, in which $X$‘s initiate matches. The argument for $GS^Y$ is analogous.

We first show that the algorithm is always well defined. That is, we argue that for no preference profile does $GS^X$ have a stage $t$ at which some $x \in X$ has been rejected by all $Y$‘s (that is, $R_t(x) = Y$). Note that when a $Y$ rejects an $X$, she remains tentatively matched with some other $X$. Thus if some $x \in X$ has been rejected after stage $t$ by every $Y$, then every $Y$ is tentatively matched with an $X$. But the number of members of $X$ is the same as the number of members of $Y$, so it must be that $x$ is tentatively matched (that is $g_t(x) \in Y$), and in particular has not been rejected by $g_t(x)$, a contradiction.

We now show that the algorithm terminates. At each stage at which the algorithm continues, at least one $X$ is rejected. Thus if the algorithm did not stop, we would reach a stage at which one of the $X$‘s would have been rejected by every $Y$, which we have shown is not possible.

Finally, the algorithm terminates when no $X$ is unmatched, so that the outcome is a matching.

18.3 The Gale-Shapley algorithm and stability

We now consider properties of the matching generated by the Gale-Shapley algorithm. We classify a matching as unstable if there are two individuals who prefer to be matched with each other than with the individuals with whom they are matched. That is, matching $\mu$ is unstable if for some $x \in X$ and $y \in Y$ with $y \not\succ x \mu(x)$, $x$ prefers $y$ to $\mu(x)$ (the $Y$ with whom $x$ is matched) and $y$ prefers $x$ to $\mu^{-1}(y)$ (the $X$ with whom $y$ is matched). In this case both $x$ and $y$ want to break the matches assigned by $\mu$ and match with each other. A matching is stable if no such pair exists.

**Definition 18.4: Stable matching**

For a society $(X, Y)$ and preference profile $(\succeq^i)_{i \in X \cup Y}$, a matching $\mu$ is stable if there is no pair $(x, y) \in X \times Y$ such that $y \succ x \mu(x)$ and $x \succ y \mu^{-1}(y)$.

To illustrate the concept of stable matching we give an example showing that the serial dictatorship algorithm, in which the members of $X$ sequentially choose members of $Y$ from those who were not chosen previously, may generate an unstable match.
Example 18.5

Consider a society $\{\{1, 2, 3\}, \{1, 2, 3\}\}$ with the following preferences.

1: $1 \succ 2 \succ 3$
2: $1 \succ 2 \succ 3$
3: $1 \succ 2 \succ 3$

1: $2 \succ 3 \succ 1$
2: $3 \succ 2 \succ 1$
3: $1 \succ 3 \succ 2$

Apply the serial dictatorship algorithm in which the $X$’s choose $Y$’s in the order 1, 2, 3. The algorithm yields the matching in which each $i \in X$ is matched to $i \in Y$. This matching is unstable because $2 \in X$ and $1 \in Y$ both prefer each other to the individual with whom they are matched.

We now show that the Gale-Shapley algorithm generates a stable matching.

**Proposition 18.2: Gale-Shapley algorithm yields a stable matching**

For any society and any preference profile for the society, the Gale-Shapley algorithm generates a stable matching.

**Proof**

Consider a society $(X, Y)$ and preference profile $(\succeq_i)_{i \in X \cup Y}$. Denote by $\mu$ the matching generated by the algorithm $GS^X$. Assume that for $x \in X$ and $y \in Y$, individual $x$ prefers $y$ to $\mu(x)$ ($y \succ^x \mu(x)$). Then at some stage before $x$ chose $\mu(x)$, she must have chosen $y$ and have been rejected by her in favor of another $X$. Subsequently, $y$ rejects an $X$ only in favor of a preferred $X$. Thus it follows that $y$ prefers $\mu^{-1}(y)$, the $X$ with whom she is eventually matched, to $x$. We conclude that no pair prefers each other to the individual with whom she is assigned by $\mu$, so that $\mu$ is stable.

Many matchings may be stable. The $GS^X$ algorithm finds one stable matching and $GS^Y$ finds another, possibly the same and possibly not. Is it better to be on the side that initiates matches? Is any stable matching better for one of the $X$’s than the matching generated by $GS^X$? The next result answers these questions: for each $x \in X$ the matching generated by $GS^X$ is at least as good for $x$ as any other stable matching, and in particular is at least as good as the matching generated by $GS^Y$.

**Proposition 18.3: $GS^X$ algorithm yields best stable matching for $X$’s**

For any society and any preference profile for the society, no stable matching is better for any $X$ than the matching generated by the $GS^X$ algorithm.
18.3 The Gale-Shapley algorithm and stability

Proof

Let $\mu$ be the (stable) matching generated by $GS^X$ for the society $(X, Y)$ and preference profile $(\succ^i)_{i \in X \cup Y}$. Suppose that $\psi$ is another stable matching and $\psi(x) \succ^x \mu(x)$ for some $x \in X$. Let $X^*$ be the set of all $x \in X$ for whom $\psi(x) \succ^x \mu(x)$. For each $x \in X^*$ denote by $t(x)$ the stage in the $GS^X$ algorithm at which $x$ chooses $\psi(x)$ and is rejected by her. Let $x_0 \in X^*$ for whom $t(x_0)$ is minimal among the $x \in X^*$. Let $y_0 = \psi(x_0)$ and let $x_1 \in X$ be the individual $y_0$ chose when she rejected $x_0$ in the $GS^X$ algorithm. That is, at stage $t(x_0)$ individuals $x_0$ and $x_1$ choose $y_0$, who rejects $x_0$ in favor of $x_1$ ($x_1 \succ^{y_0} x_0$). Let $\psi(x_1) = y_1$.

If $y_0 \succ^{x_1} y_1$ then each member of the pair $(x_1, y_0)$ prefers the other member to the individual assigned her by $\psi$, contradicting the stability of $\psi$. Therefore $y_1 \succ^{x_1} y_0$. But then in the $GS^X$ algorithm $x_1$ must choose $y_1$ and be rejected before stage $t(x_0)$, so that $t(x_1) < t(x_0)$, contradicting the minimality of $t(x_0)$.

We complement this result with the observation that for each $Y$ no stable matching is worse than the matching generated by the $GS^X$ algorithm.

**Proposition 18.4: $GS^X$ algorithm yields worst stable matching for $Y$'s**

For any society and any preference profile for the society, no stable matching is worse for any $Y$ than the matching generated by the $GS^X$ algorithm.

Proof

Consider a society $(X, Y)$ and suppose that for the preference profile $(\succ^i)_{i \in X \cup Y}$ the algorithm $GS^X$ leads to the (stable) matching $\mu$. Suppose another stable matching $\psi$ is worse for some $y \in Y$: $x_2 = \psi^{-1}(y) \prec^y \mu^{-1}(y) = x_1$. Let $y_1 = \psi(x_1)$.

\[
\begin{array}{ccc}
\mu & \psi \\
y \leftrightarrow x_1 & y \leftrightarrow x_2 \\
& y_1 \leftrightarrow x_1 \\
\end{array}
\]

By Proposition 18.3, $y = \mu(x_1) \succ^{x_1} \psi(x_1) = y_1$. Given $x_1 \succ^y \psi^{-1}(y) = x_2$, $x_1$ and $y$ prefer each other to the individuals with whom they are matched in $\psi$, contrary to the assumption that $\psi$ is stable.
Problems

1. *Stable matching and Pareto stability.*
   a. Show that any stable matching is Pareto stable. That is, for no preference profile is another matching (stable or not) better for one individual and not worse for every other.
   b. Give an example of a Pareto stable matching that is not stable.

2. *Pareto stability for the X’s.* Show that the outcome of the $GS^X$ algorithm is weakly Pareto stable for the X’s. That is, no other matching is better for every X.

3. *All X’s have the same preferences.* Assume that all X's have the same preferences over the Y’s.
   a. How many stages does the $GS^X$ algorithm take?
   b. Which serial dictatorship procedure yields the same final matching as the $GS^X$ procedure?
   c. Show that in this case $GS^X$ and $GS^Y$ lead to the same matching.

4. *Matching with unequal groups.* Group A has $m$ members and group B has $n$ members, with $m < n$. Each individual has strict preferences over the members of the other group. Let $GS^A$ be the Gale-Shapley algorithm in which the A’s initiate the matches and let $GS^B$ be the algorithm in which the B’s initiate the matches.
   a. Show that if $m = 1$ then $GS^A$ and $GS^B$ yield the same matching.
   b. Explain why $GS^A$ and $GS^B$ do not necessarily yield the same matching if $m = 2$.
   c. Show that in both $GS^A$ and $GS^B$ every individual in A is matched with one of her $m$ most preferred members of B.

5. *Clubs.* Assume that $3n$ students have to be allocated to three programs, each with capacity $n$. Each student has strict preferences over the set of programs and each of the programs has strict preferences over the students. Describe an algorithm similar to the Gale-Shapley algorithm, define a notion of stability, and show that for any preference profile your algorithm ends with a stable matching.
6. *Manipulation*. The Gale-Shapley algorithm is not *strategy-proof* and thus is not immune to manipulation. Specifically, if each individual is asked to report preferences and the $GS^X$ algorithm is run using the reported preferences, then for some preference profiles some individual is better off, according to her true preferences, if she reports preferences different from her true preferences.

To see this possibility, consider the following preference profile for a society with three $X$'s and three $Y$'s.

<table>
<thead>
<tr>
<th></th>
<th>1: 1 ≻ 2 ≻ 3</th>
<th>1: 2 ≻ 3</th>
<th>1: 2 ≻ 1 ≻ 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>2: 2 ≻ 1 ≻ 3</td>
<td>2: 1 ≻ 2 ≻ 3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3: 1 ≻ 2 ≻ 3</td>
<td>3: 1 ≻ 2 ≻ 3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Show that 1 can benefit by reporting preferences different from her true preferences.

7. *The roommate problem*. A society contains $2n$ individuals. The individuals have to be partitioned into pairs. Each individual has a (strict) preference over the other individuals. An assignment $\mu$ is a one-to-one function from the set of individuals to itself such that if $\mu(i) = j$ then $\mu(j) = i$. An assignment is stable if for no pair of individuals does each individual prefer the other member of the pair to her assigned partner. Construct an example of a preference profile (with four individuals) for which no assignment is stable.

Notes

The chapter is based on *Gale and Shapley (1962)*.