What Goes Around Comes Around:
A theory of strategic indirect reciprocity in networks*

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Abstract

We consider strategic interaction on a network of heterogeneous long-term relationships. The bilateral relationships are independent of each other in terms of actions and realized payoffs, and we assume that information regarding outcomes is private to the two parties involved. In spite of this, the network can induce strategic interdependencies between relationships, which facilitate efficient outcomes. We derive necessary and sufficient conditions that characterize efficient equilibria of the network game in terms of the architecture of the underlying network, and interpret these structural conditions in light of empirical regularities observed in many social and economic networks.

Key words: network enforcement, private monitoring, small-worlds, triadic closure

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1 Introduction

Relationships in which individuals exchange favors, share information or trade risks are ubiquitous in social and economic life. These relationships rarely occur in isolation and networks provide a useful way to represent a system of such relations. But do networks also play a substantive role in determining how the relationships function? The interactions between individuals in a network often seem to rely on the principle of indirect reciprocity – the idea that *"You scratch my back and I'll scratch someone else's" or "I scratch your back and someone else will scratch mine"* (Nowak and Sigmund, 2005) – and this suggests that networks may play an important institutional role in coordinating behavior and pooling resources across relationships. But how does indirect reciprocity amongst self-interested economic actors work? How do we make sense of this kind of behavior in a strategic network environment?

In this paper, we show that a network of long-term relationships can facilitate strategic indirect reciprocity when there is heterogeneity in the net benefits from bilateral relations. We derive endogenous strategic connections between relationships and show that a network may sustain efficient outcomes even when each relationship in isolation could not. The relevant constraints are determined by the architecture of the underlying network and the monitoring capabilities across relationships. Our focus is on the case of private information, where individuals only observe the outcomes in their own relationships. The resulting network game can therefore be viewed as a dynamic game of perfect private monitoring (see Kandori, 2002). Under this information structure, we characterize equilibria of a network game in terms of structural properties of the network and provide an intuitive rationale for the small-worlds network structure observed in many real-world networks.[1] Essentially, we show that strategic indirect reciprocity via a network can help to sustain efficient outcomes in a system of asymmetric relations, and that small-worlds are particularly conducive to such network effects because close connectivity enables robust enforcement with low demands on individual monitoring.

An implicit intuition from much of the existing literature on network games is that networks matter if and only if individuals are required to take the same action in all bilateral connections (see, e.g., Galeotti et al., forthcoming; Ballester et al., 2006; Bramoulle and Kranton, forthcoming; Goyal and Moraga-Gonzalez, 2001; Jackson, 2008, chap. 9).[2] As

[1]The key features of small-worlds networks include significant clustering of nodes, small average distances between nodes, and degree distributions with small mean but high variance. Such network structures are the most pervasive regularity observed in empirical network studies (see, e.g., Watts and Strogatz, 1998).

[2]Two important exceptions are Goyal et al. (2008) and Goyal (2005), in which the players can choose link-specific actions.

an exogenous constraint on how individuals act, this seems inappropriate in many of the network settings we are interested in. We impose no *a priori* constraints on how individuals behave in different relationships. Instead, the critical feature of the network in our model is that it connects heterogeneous components. All constraints on how individuals act are derived endogenously from the strategic network interaction. As in other work on network games, our view of the underlying network follows the structural view in sociology, where networks are regarded as a primitive of the social or economic environment. Our interest is in the institutions (or norms) that can evolve on such a network, and how these change the incentives regarding behavior in individual relationships. There is an additional growing literature in economics that studies network formation games, modeling the creation of network ties as an organic process (see, for example, Jackson 2005, 2008; Bala and Goyal, 2000). In many settings, insights from network games and network formation games are complementary. For example, the underlying network in our model could be viewed as the outcome of a network formation process that precedes the analysis in this paper. How the resulting network influences strategic interactions is then important for understanding incentive constraints in the formation process. However, modeling an explicit formation process is a distinct exercise which we hope to inform but do not directly address.[3]

Our approach leads to a new perspective on the role of networks in supporting cooperative outcomes, which is applicable in a number of relevant settings. Consider, for example, a network of bilateral relationships which serve as a medium for the exchange of "goods" that cannot be traded in markets, either because the nature of the good makes it arduous to write and enforce formal contracts (such as for information, goods of uncertain quality, or political favors) or because market institutions are underdeveloped (such as the insurance markets in developing countries). In the absence of a central market mechanism, exchange in isolated relationships would be restricted to satisfy a double coincidence of wants because outcomes must be incentive compatible given direct strategic reciprocity between individuals. However, a network provides opportunities for strategic indirect reciprocity across relations, allowing *quid pro quo* to be established across a number of relationships together rather than one relationship at a time. Whenever bilateral exchange does not exhaust the trading opportunities presented by collective exchange, the network can therefore play an important institutional role. The network can pool asymmetries across relationships while still allowing verification of informal agreements to occur within the bilateral relations.[4]

[3]Vega-Redondo et al. (2005) and Vega-Redondo (2006) study models which go in this direction. Both study network formation processes driven by the idea that the resulting network plays an institutional role in enforcement mechanisms.

[4]Kranton (1996) analyzes the conflict between direct reciprocity (through repeated bilateral interaction) and decentralized monetary trade as two institutions of exchange in an economy. We emphasize that re-

As a specific example of the type of network environment we have in mind, consider the networks of information-sharing relationships that exist between firms in many industries and regions, particularly high-innovation industries. Generally, the purpose of these business relationships is to share information acquired in the course of daily business operations, including knowledge of consumer tastes, experience in hiring workers, managerial and technological know-how, as well as information about cultural, political and legal norms (Jarillo, 1988; Bloch, 2008; Mowery et al., 1996).[5] It is clear that the information shared in these relationships is valuable, but sharing the information also involves substantial costs, including direct costs of acquisition, storage and transmission, time spent identifying valuable information with one's partners, as well as the considerable indirect cost of giving up competitive advantage (Easterby-Smith et al., 2008). The fact that information is shared with remarkable ease and frequency between firms in many industries is somewhat of a paradox because the contractual enforcement of agreements is usually impossible in this context (Hagedoorn, 2002). While the persistent exchange of valuable information above and beyond a bilateral *quid pro quo* could be attributed to a number of factors, including altruism or bad management practice, the bilateral perspective taken in much of the management science literature does not take account of the fact that such relationships are often embedded in dense clusters of other, similar relations.[6]

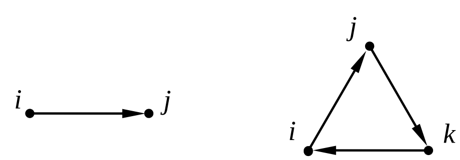


Figure 1: (a) Bilateral relationship (left), (b) Strong triangle network (right).

ciprocal exchange may be necessary for goods that are not easily traded in decentralized markets (such as information or favors), or when such markets are underdeveloped, and formalize *indirect* reciprocity in a network of individuals as a means of realizing more efficient exchange by trading off asymmetries in wants; in fact, Kranton suggests this intuition in her conclusion (pg. 846).

[5]Formal and informal information-sharing relationships of this type have become so commonplace that historical scholars now refer to systems of such relations as a primary form of industrial organization, on par with the hierarchical structure and the competitive market (Thorelli, 1996; Lamoreaux et al., 2003).

[6]For a network-based view of strategic business alliances built on dyadic exchanges, see Gulati, 1998. Other examples of networks in which "exchange" is (at least in part) organized through repeated pair-wise interactions include informal social insurance networks in developing countries (Bloch et al, 2008; Bramoulle and Kranton, 2007; Fafchamps and Gubert, 2007), cartels and other collusion networks (Bernheim and Whinston, 1990), political alliances (Knoke, 1990), systems of international relations and trade agreements (Rauch, 1999), and the interconnections between financial institutions (Economides, 1993; Allen and Babus, 2008; Mayer, 2008).

A network perspective allows us to rationalize cooperative behavior, like information-sharing between firms, informal insurance or the exchange of favors, even when there is no apparent bilateral *quid pro quo*. The basic intuition can be explained informally by looking at the networks in Figure 1. Figure 1(a) depicts an isolated bilateral relationship. The nodes (i and j) are players. The arc ij represents a long-term relationship that is asymmetric in the sense that it is more valuable to player j than to player i. To fix ideas we can think of ij as an information-sharing relationship between firms, where in each period $t = 0, 1, ..., \infty$ firms can decide whether to share information with their partner, benefits are derived from the information obtained from one's partner, and the transmission of information in each period is costly. The relationship is asymmetric if the net benefits of information sharing do not coincide for the two partners. If all agreements must be enforced through direct reciprocity, the incentive constraints on information-sharing are determined by the payoffs of the player who benefits less from information-sharing (here player i). However, consider what can happen if relationship ij is embedded in a network like the "strong triangle" of Figure 1(b). If all firms in this network share information with both partners, each firm receives low value from one relationship and high value from another. Hence each firm is potentially better off under information sharing than the firm i in the isolated bilateral relationship ij. Also, a firm that reneges on an informal agreement can now be punished by direct reciprocity (j punishes i for i's deviation on ij) *and* indirect reciprocity (j reneges on k after i's deviation on ij, and k then reneges on i following j's deviation on jk). Strategic indirect reciprocity implies that firm i gets punished on the relationship ki, which is of high value to firm i. Even if *a priori* firm i can choose whether to share information with firms j and k independently, the network mechanism imposes an endogenous strategic constraint on these choices that can change the incentives in each relationship.

We formulate a stylized network model that allows us to precisely identify relevant constraints on such *network enforcement mechanisms*. In our model, relationships are long-term and players are self-interested and forward looking. To focus on the network interaction we keep bilateral relationships simple. The only decision facing each partner of a specific bilateral interaction is whether to *maintain* the relationship, or *sever* it. As a result, at time t, player i faces a decision with respect to all relationships in his neighborhood that were maintained by both partners up to $t-1$. On all such relationships, player i can decide to continue the relationship to $t+1$ or sever it permanently. In some sense, the assumption that severance is permanent can be viewed as fixing a particular direct reciprocity mechanism (how players respond directly to a deviation by their partner), allowing us to focus on the role of strategic indirect reciprocity (how players respond in *other* relationships following deviation from a partner).[7] The assumption is not needed to illustrate the possibility of equilibria with network enforcement, but it allows us to draw sharper inferences about the topology of networks on which such mechanism are particularly viable.

In addition to allowing players to choose different actions in each of their bilateral interactions, we assume in our main analysis that play in each bilateral relationship is *private information* to the two parties involved.[8] This assumption captures a constraint that is important in the settings we have in mind, where the nature of bilateral exchange makes the monitoring of relationships difficult for a third party. In the strong triangle network example from Figure 1(b) private monitoring means that player i observes the status of arcs ij and ki, but does not observe the status of arc jk. The status of the unobserved arc does not affect player i's realized payoffs, but when there are strategic network externalities it can be crucial to his expected payoffs from a given strategy. When a player maintains low value relationships because of the possibility of indirect punishment on high value relationships, private information implies that strategies are *conditional* on the unobserved status of other relations. However, players can infer this status from observations on the relationships in their own neighborhood. Interdependencies between even distant relationships in the network are thereby established by strategic connections in the overlapping neighborhoods of individuals.

An equilibrium of the network game requires that individual incentives in local neighborhoods be consistent with the global interdependencies of a network enforcement mechanism, and vice versa. The connection between local and global interactions implies that the network plays a dual role in our analysis. On the one hand, networks encode institutions that support indirect reciprocity via network enforcement mechanisms, and thereby *foster* cooperation in bilateral relationships. On the other hand, the network is an underlying structure that *constrains* the local and global interaction opportunities of individuals. Equilibrium

[7]Our model could be translated into an multi-player, infinitely repeated game with private monitoring, in which bilateral relationships are infinitely repeated Prisoner's Dilemmas (IRPDs) if we allowed for severance to be reversible. This framework would increase the complexity of the analysis without yielding significant additional insights. There are papers in the literature on dynamic games with private monitoring where similar irreversibility assumptions are crucial to demonstrate existence of equilibrium (see, e.g., Compte 2002), but it is easily verified that this is not the case in the network game at hand. In particular, the insights from all examples considered in this paper are easily replicated when bilateral relationships are modeled as IRPDs. One can also replicate all the existence results given in the paper to show that infinite cooperation is possible in a network even when it is not incentive compatible in a bilateral, asymmetric IRPD. The relevant sufficient conditions easily follow from the results given in this paper.

[8]Private information in this paper pertains to knowledge about the status of other relationships in a known network. This is in contrast to a few recent papers that consider incomplete knowledge about the network itself, including Galeotti et al., forthcoming, Galeotti (2006), and McBride (2006).

conditions in the network game clearly identify this duality and relate incentives in localized interactions to the architecture of the global network. In small networks, the effect of private monitoring constraints is limited, but as networks become large (in terms of the distance between nodes) private information makes network enforcement increasingly difficult. The idea that the small-worlds structure of real networks has an institutional justification is found, informally, in a large literature in sociology, management science and elsewhere. But, to our knowledge, our paper is the first to establish formally how network interactions can support the enforcement of indirect reciprocity when there are no exogenous restrictions on choices across relationships, and to relate the small-worlds structure to the fact that closely connected networks allow this to be achieved with a more robust form of decentralized monitoring.[9]

The remainder of the paper is organized as follows. Section 2 presents the model; we begin with the formal model of a bilateral relationship and then embed bilateral relationships in a network. To account for the dynamic structure and informational asymmetries, we analyze the game using perfect Bayesian equilibrium and a belief-free refinement. It is instructive to also consider the game under *public information* as a benchmark, where perfect Bayesian equilibrium is equivalent to the requirement of subgame perfection. Section 3 gives an extended example to highlight some key features of network enforcement, and to contrast the implications of public and private network enforcement. Section 4 gives the general analysis of the network game under public information, and Section 5 presents the full analysis of network enforcement under private information. Section 6 considers the belief-free refinement. Section 7 concludes. Proofs are available in an extended working paper that also gives a number of additional results (Mihm et al., 2009).

[9]Raub and Weesie (1990) is a seminal reference from the sociology literture on networks, which has a similar motivation to our work. The network enforcement mechanisms we study are also related to the community enforcement mechanisms studied in Kandori (1992) in the sense that both approaches provide strategic foundations for indirect reciprocity (see also Ghosh and Ray, 1996, and Deb, 2008, which relax the strong monitoring assumptions in Kandori). However, the environment in our paper is quite different from the random matching environment studied in this literature. We study strategic interactions in a fixed network of long-term bilateral relationships. Indirect reciprocity is important in this type of environment when relationships are asymmetric, such that cooperation in individual relationships is not incentive compatible because the long term benefits are not high enough to induce cooperation from one of the partners.

2 Model

2.1 Bilateral relationships

We first give the formal definition of a bilateral interaction. In a bilateral relationship, two individuals (the partners) can exchange favors over time, $t = 0, ..., \infty$. Individuals maintain relationships to receive a benefits, which are normalized to 1 (without loss of generality) and bestowed on both partners in every period the relationship is maintained. An isolated bilateral relationship is depicted graphically by an *arc* connecting two *nodes* (the partners) as in Figure 1(a). The *direction* in the graphical representation reflects an asymmetry: One partner, j, pays a low cost $\underline{c} \in (0, 1)$ to maintain the relationship in every period, while the other partner, i, pays a higher cost $\bar{c} \in (\underline{c}, 1)$. This implies that the net benefit of a maintained relationship differs across partners. In Figure 1(a), the net benefit of relationship ij is greater for j than for i.[10] Partners choose whether to maintain or sever a relationship simultaneously in each period. A player who unilaterally severs in some period $\tau \geq 0$ obtains benefit without cost in τ, while their partner incurs cost without benefit. If both sever, both incur no cost and receive no benefit. In either case, a severing by either party eliminates all possibility of interaction between i and j for $t > \tau$. This reflects the idea that if an informal agreement is broken, the bilateral relationship as it currently stands ends. Finally, we assume that partners are impatient but not myopic, and discount exponentially with common discount factor $\delta \in (0, 1)$.

An isolated bilateral relationship can be viewed as a simple two-player game. Both partners, i and j, need to choose some time period $\tau \in \{0, 1, ..., \infty\}$ in which to sever the relationship ij. The payoffs if, for example, player i severs in τ and j severs in $\tau' > \tau$ are illustrated in Table 1.

time period	payoff to player i	payoff to player j
$t < \tau$	$1 - \bar{c}$	$1 - \underline{c}$
$t = \tau$	1	$-\underline{c}$
$t > \tau$	0	0

Table 1: payoff table for ij (example)

Note that when $\delta \geq \bar{c}$ both players are willing to maintain the relationship *ad infinitum*

[10] Asymmetry is at the heart of our analysis, but the specific form chosen here is not essential. We could allow for asymmetries in benefits without any change in the results, because only net benefits matter for the analysis. With some additional effort it is also possible to allow for the case $\bar{c} > b$.

as long as they believe their partner will also do so. If $\delta < \underline{c}$ both players will sever the relationship in any case, even though the symmetric outcome in which both do so is strictly Pareto dominated. Finally, there exists a robust range of discount factors, $\Delta := (\underline{c}, \bar{c})$, in which – absent strategic considerations – j would be willing to maintain the relationship with i, but severance is a strictly dominant strategy for i. In this last case, maintenance of the relationship is not an equilibrium outcome precisely because of the asymmetry in the relative value of the relationship.

In this model of a bilateral relationship we have reduced the strategic problem to one of maintaining the relationship (e.g., upholding an information-sharing agreement) or severing (e.g., reneging on the agreement). This model of bilateral relationships is simple enough to make the network analysis tractable and to capture two stylized features of economic and social relationships in many network environments: (1) a trade-off between individual incentives and cooperative outcomes, and (2) an asymmetry in the net benefits from the relationship. In information-sharing relationships, for example, there is often an inherent tension between the short-term competitive advantage that can be obtained by withholding information from a partner firm, and the benefits of cooperative information sharing over the long-run. Moreover, asymmetries arise because firms often specialize in very different types of information. While two firms could adjust the information they share to try and establish a *quid pro quo*, empirical observations suggest that firms in real information sharing networks often do not (Vicente et al., 2008; Sammarra and Biggiero, 2008). To make sense of information sharing under such circumstances, we recognize that bilateral relationships are not isolated but are embedded in networks, and argue that *quid pro quo* can be established by pooling asymmetries across relationships.

2.2 Network enforcement

In our model of a network game, bilateral relationships are embedded in a network of other, similar relations. A network can be represented graphically by a directed graph (or *digraph*) as in the strong triangle network of Figure 1(b). Nodes in the digraph represent players (here players i, j and k), and arcs represent bilateral relationships (here relationships ij, jk and ki). The direction of an arc indicates the asymmetry in each relationship. For example, in the strong triangle network, i incurs a higher cost than j to maintain ij but a lower cost than k for the maintenance of relationship ki. The objective of our analysis is to identify the range of discount factors for which any subset of relations in a given underlying network can be *fully maintained*, i.e. maintained for all $t = 0, ..., \infty$. Note that for $\delta < \bar{c}$ full maintenance of any relationship requires network enforcement because full maintenance of a strategically isolated bilateral relationship is not incentive compatible. We characterize the critical discount factor that determines whether a subset of relations can be fully maintained in an equilibrium in terms of the parameters $\underline{c}$ and $\bar{c}$, and the structural properties of the network architecture. We also determine when the critical discount factor is in Δ, where network enforcement is essential. The analysis is self-contained but requires some notation. We therefore precede a formal definition of the network game with a short example that illustrate the nature of the network analysis.

To illustrate how embedding relationships in a network can effect incentives, we return to the example of a strong triangle network from Figure 1(b). Let $\bar{c} = 0.9$ and $\underline{c} = 0.5$, so that an isolated bilateral relationship (such as ij in Figure 1(a)) can be maintained if and only if $\delta \geq \bar{c} = 0.9$. Now consider the strong triangle network, replicated in Figure 2(a), and suppose for now that actions on all arcs are publicly observed. The strategy profile where all players "maintain all arcs as long as no severance has been observed anywhere in the network, and sever all arcs immediately otherwise" is feasible give this information structure. It is also easily verified that this strategy profile is a subgame perfect equilibrium of the network game (defined formally in Section 2.4) on the strong triangle network as long as $\delta \geq (\bar{c} + \underline{c})/2 = 0.7$. Hence, for $\delta \in [0.7, 0.9)$, any relationship in the strong triangle network can be fully maintained if and only if the whole network is fully maintained.

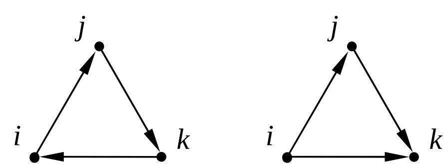


Figure 2: (a) Strong triangle network (left), (b) Weak triangle network (right).

To illustrate why network structure might impose constraints on network enforcement, consider now the weak triangle network in Figure 2(b). This network differs from the strong triangle by the direction of the asymmetry in the relationship between i and k. We say that a node is a *source* with respect to a digraph if it has at least one out-arc but no in-arcs in the network, and that a node is a *sink* when it has at least one in-arc but no out-arcs in the network. Hence, in Figure 2, the strong triangle has no sources or sinks, while node i is a source with respect to the weak triangle and node k is sink. Note that for the source in the weak triangle, node i, maintenance of either relationship is incentive compatible only if $\delta \geq 0.9$, regardless of the strategy followed by other players. This is exactly the incentive condition for maintenance of an isolated bilateral relationship and, under the assumption that players have a common discount factor, network enforcement therefore does extend the opportunity for maintenance in the weak triangle.

Of course, the insight from the weak triangle network generalizes and an absence of sources is therefore a necessary condition for equilibria featuring network enforcement. While this condition looks like a local network property (i.e., one that can be verified by looking only at the neighborhoods of individual nodes), it does have global implications. We say that a consecutive sequence of nodes and arcs is a *cycle* if it begins and ends with the same node, and we can travel from one node to another following the direction of the arcs in the cycle (a formal definition is given in Section 2.3). We get a global implication from the absence of sources condition because all (non-trivial) digraphs that have no sources must have a cycle subdigraph. To see why, suppose that D has no sources and start with an arbitrary node, j_1, that has at least one connection to another node in D (the existence of such a node is meant by non-trivial). Node j_1 has an in-arc, $j_2 j_1$ because j_1 is not a source. Since j_2 is not a source, there must also exist $j_3 j_2$ in D. Likewise there must exist $j_4 j_3$, and so on. However, since the digraph D is finite, eventually we must find an arc $j_{n+1} j_n$ where $j_{n+1} \in \{j_1, ..., j_{n-1}\}$. Hence, we have found at least one cycle in D, and the existence of a cycle is therefore a minimal condition on global network architecture derived by looking only at the incentives of individuals in their own network neighborhoods. The objective of the sequel is to determine exactly what additional local and global restrictions apply to network enforcement, especially when we introduce restrictions on information. These constraints are crucial to a good understanding of network enforcement because, while public information may be a reasonable approximation in small networks such as the strong triangle, extrapolation based on this assumption to arbitrarily large networks identifies network enforcement mechanisms that place untenable monitoring requirements on individuals.

2.3 Network notation

This section introduces some basic network notation that will be used in later sections. A network is represented formally by a digraph, D, which consists of two finite, non-empty sets: A *set of nodes* $N(D)$ representing players, and a *set of arcs* $A(D)$ representing bilateral relationships.[11] Arcs inherently represent an asymmetric relationship between two nodes, and are graphically represented by an arrow. $ij \in A(D)$ is a generic arc, where $i, j \in N(D)$, and where the order ij indicates that i is the head of the arc and j is the tail (see the digraph in Figure 1(b)). $ij \in A$ is an *out-arc* for i and an *in-arc* for j, and we say that i is *adjacent* to j, and j is adjacent from i (or, simply, that i and j are adjacent in D). The *node*

[11] Where no confusion will result, we write $D = (N(D), A(D)) = (N, A)$. Likewise, for subdigraph D' we use the notation $A' = A(D')$ and $N' = N(D')$.

assignment function $\iota : 2^{A(D)} \to 2^{N(D)}$ assigns to each subset of arcs of digraph D the set of nodes that are adjacent to or from an arc in that set. We denote the set of all possible arc sets connecting nodes $N(D)$ by $\mathcal{A}(D)$. $D' \subset D$ is called a *subdigraph* if $N(D') \subset N(D)$, $A(D') \subset A(D)$ and $\iota(A(D')) \subset N(D')$.

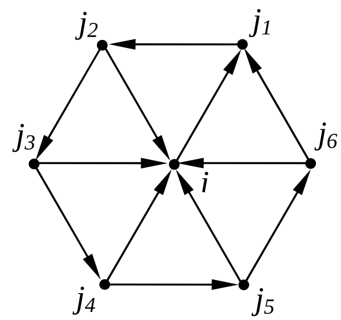


Figure 3: Wheel ($D^W_{6,1}$).

As an example of a network consider the digraph $D^W_{6,1}$ depicted in Figure 3. This digraph is an example of a wheel network. Wheel networks can be viewed as stylized models of many information sharing networks which often have a centralized structure with one node at the center (sometimes called a *sponsor*) connected to many nodes on the outside which are less densely connected to each other (called *peripheral nodes*). We will use wheel networks to illustrate key insights of strategic interactions on networks in later sections, but for now we use the particular network $D^W_{6,1}$ to introduce some important digraph notation. For example, we see that $D^W_{6,1}$ has an interesting subdigraph, $D^{W\prime}_{6,1} = \left(N\left(D^{W\prime}_{6,1}\right), A\left(D^{W\prime}_{6,1}\right)\right) = (\{j_1, ..., j_6\}, \{j_1j_2, ..., j_5j_6, j_6j_1\})$, which is the cycle network connecting nodes on the periphery. Both of these networks satisfy the only *ex-ante* restriction we impose on network structure, given by the following assumption.

Assumption 1 *In a network game on D, (1) $A(D)$ has no self-loops, (2) $A(D)$ has no parallel arcs, and (3) $A(D)$ has no anti-parallel arcs.*

(1) rules out arcs of the form ii, which would be nonsensical in our context. (2) and (3) imply that the bilateral relationship between any nodes i and j is always unique. If nodes represent firms and arcs are information-sharing relationships, (2) and (3) express the idea that all interactions between two firms are summarized in one relationship, and that all relationships in the network exhibit the same asymmetries. This saves us from distinguishing between cases in stating results, which would be cumbersome without leading

to any additional insights. Given this assumption, it is also unambiguous to denote by $\underline{ij}$ either ij or ji, depending on which of these is in the network.

The following notation is used to describe means of traveling through a digraph. Let i and j be (not necessarily distinct) nodes of a digraph D. A finite, alternating and directed sequence

$$i = i_0, i_0j_1, j_1, \ldots, j_{k-1}, j_{k-1}j_k, j_k = j$$

of nodes and arcs, is called a *ij-path* (of length k) if no node is repeated. It is called a *cycle* (of length k) if $i = j$ but no other node is repeated. In digraph $D^W_{6,1}$, the sequence $j_6, j_6j_1, j_1, j_1j_2, j_2$ is a j_6j_2-path (of length 2), while the sequence

$$j_6, j_6j_1, j_1, j_1j_2, j_2, \ldots, j_5, j_5j_6, j_6$$

is a cycle (of length 6).

The *underlying graph* $G(D)$ of digraph D is obtained by replacing the set of arcs of D with a set of undirected edges. Most of the terms defined for digraphs have a natural counterpart for undirected graphs. A node i is said to be connected to a node j in a graph G if there exists an ij-path in G.[12] A graph G is connected if every two of its nodes are connected. A digraph D is *connected* (or weakly connected), if $G(D)$ is connected. The relation 'is connected to' is an equivalence relation on the set of nodes of a graph G, and every subgraph induced by the nodes in a resulting equivalence class is called a connected component of G, or simply a component.

For a connected digraph D, the *distance* $d_D(i,j)$ between two nodes i and j is the minimum of the lengths of the ij-paths of D. So, for instance, in $D^W_{6,1}$, $d_{D^W_{6,1}}(j_1,j_4) = 3$. If there is no ij-path in D, we define $d_D(i,j) = \infty$.[13] $d_D(i,j|\, A')$ is the distance between nodes i and j when travel is restricted to paths that use every arc in A' exactly once (set $d_D(i,j|\, A') = \infty$ when this is impossible). $d_D(i,j|\, \neg A')$ is the distance between nodes i and j when travel is restricted to paths that do not use any arc in A' (set $d_D(i,j|\, \neg A') = \infty$ when this is impossible). In digraph $D^W_{6,1}$, While $d_{D^W_{6,1}}(j_4,j_1) = 2$, $d_D(j_4,j_1|\, \{j_4j_5\}) = d_D(j_4,j_1|\, \neg\{ij_1\}) = 3$. Additionally, note that $d_D(j_4,j_1|\, \neg\{ij_1, j_6j_1\}) = \infty$. The undirected distance functions $d_{G(D)}(i,j)$, $d_{G(D)}(i,j|\, A')$, $d_{G(D)}(i,j|\, \neg A')$ on a (undirected) graph are given in the analogous way by following the shortest undirected distance.

The following notation is used to describe the neighborhood of a node i in a digraph. The *outdegree* $od_D(i)$ is the number of nodes that are adjacent from i in subdigraph D, i.e.

[12] An ij-path in a graph G is defined as for a digraph but without the restriction on direction.

[13] For the statement of results, it is convenient for us to work in the extended integers $\mathbf{N} \cup \{\infty\}$. We follow the convention that $f(\infty)$ denotes $\lim_{x\to\infty} f(x)$ and use this notation only when the limit is well-defined.

$od_D(i) = |\{j \in N(D) - i : ij \in A(D)\}|$. The *indegree* $id_D(i)$ is the number of nodes adjacent to i, i.e., $id_D(i) = |\{j \in N(D) - i : ji \in A(D)\}|$. The *ratio* of outdegree to indegree is denoted $r_D(i) := od_D(i)/id_D(i)$. To ensure that the ratio is well defined, let $r_D(i) = \infty$ if $od_D(i) > id_D(i) = 0$ and $r_D(i) = 0$ if $od_D(i) = id_D(i) = 0$. The *η-neighborhood* of node i in D is $NE^{\eta}_D(i) = \{lk \in A|\min\{d_{G(D)}(i,k|\{lk\}), d_{G(D)}(i,l|\{lk\})\} \leq \eta\}$. For example, in $D^W_{6,1}$, $od_{D^W_{6,1}}(j_1) = 1$, $od_{D^W_{6,1}}(j_1) = 2$, hence $r_{D^W_{6,1}}(j_1) = 1/2$, while $NE^1_{D^W_{6,1}}(j_1) = \{j_1j_2, ij_1, j_6j_1\}$.

2.4 Network game

We are primarily interested in the network game under private information, but in order encompass public information as a benchmark we introduce the idea of a *radius of information.* Note first that a complete history of the game up to some period t will state, for every arc of the underlying network, whether the corresponding relationship is currently maintained, or when and by whom it was severed. The radius of information, denoted $\rho \in \{1, 2, ...\}$, is the length of paths (in the network) on which a player observes the history of play. For example, when $\rho = 1$ players only know the history of play on adjacent arcs (private information), while $\rho = \infty$ implies public information (where the entire history of play is common knowledge).

The relevant history of play on an arc ij at time t is summarized by $h^t_{ij} = (\mathfrak{s}, \mathfrak{t}, \mathfrak{p})^t_{ij} \in \{\mathcal{M}, \mathcal{S}\} \times \{0, 1, \ldots, t-1\} \times \{\{i\}, \{j\}, \{i,j\}\}$, where $\mathfrak{s} \in \{\mathcal{M}, \mathcal{S}\}$ denotes whether an arc is "maintained" or "severed" at the start of time t, $\mathfrak{t} \in \{0, 1, \ldots, t-1\}$ denotes when the arc was severed (if a severance has occurred; otherwise denote $\mathfrak{t} = \varnothing$), and $\mathfrak{p} \in \{\{i\}, \{j\}, \{i,j\}\}$ denotes which player severed the arc (if a severance has occurred, otherwise denote $\mathfrak{p} = \varnothing$). $h^{t,\rho}_i = \{h^t_{lk}|lk \in NE^{\rho}_D(i)\}$ is the *i-observable t-history*, i.e., the t-history of all arcs observed by player i. $h^t = \{h^t_{ij}\}_{ij \in A}$ is a complete *history* of the game at time t. Note that the time zero history is a collection of 3-tuples $(\mathcal{M}, \varnothing, \varnothing)^0_{ij}$, which summarizes the underlying network. Capital H's denote the corresponding collections (e.g., $H^t = \left\{\{h^t_{ij}\}_{ij \in A}\right\}$, the set of all possible t-histories on digraph D).

If ρ is small, players cannot distinguish between all histories. To formalize this, let $h^t \sim_{i,\rho} \hat{h}^t \iff h^{t,\rho}_i = \hat{h}^{t,\rho}_i$, where $\sim_{i,\rho}$ is an equivalence relation denoting the observational equivalence of two histories for player i. $\langle h^t \rangle_{i,\rho}$ denotes an equivalence class of t-histories from player i's perspective, i.e., $\hat{h}^t \in \langle h^t \rangle_{i,\rho} \iff \hat{h}^t \sim_{i,\rho} h^t$. $[H^t]_{i,\rho} = \left\{\langle h^t \rangle_{i,\rho}\right\}$ is the collection of all observational equivalence classes of t-histories from player i's perspective. Denote by $\langle h^{t,\rho}_i \rangle$ the set of complete t-histories that are observationally consistent with $h^{t,\rho}_i$, i.e., $\langle h^{t,\rho}_i \rangle = \{\hat{h}^t | \hat{h}^{t,\rho}_i = h^{t,\rho}_i\}$. We omit ρ when it is clear from the context.

We concentrate on equilibria in pure strategies. To define strategies formally, suppose ρ is given. Let $m_i^{t,\rho} : H_i^{t,\rho} \to \mathcal{A}(D)$ give, for any i-observable t-history, the set of arcs that are maintained within i's radius of information at time t; i.e., $m_i^{t,\rho}\left(h_i^{t,\rho}\right) = \left\{ij \in NE_D^{\rho}(i) \,|h_{ij}^t = (M,\varnothing,\varnothing)_{ij}^t\right\}$. Define an action function $s_{i,j}^t : H_i^{t,\rho} \to \{M,S\}$. A strategy of player i should state, for each i-observable t-history, which of any maintained arcs i intends to maintain into the next period. For this, let $s_i^t\left(h_i^{t,\rho}\right) = \left(s_{i,j}^t\left(h_i^{t,\rho}\right)\right)_{\underline{ij}\in m_i^{t,\rho}\left(h_i^{t,\rho}\right)}$. Then a *strategy of player* i is an infinite tuple, $s_i = (s_i^t)_{t\geq 0}$, and a *strategy profile* is a strategy for every player, $s = (s_i)_{i\in N}$. Denote the continuation of player i's strategy s_i after history $h_i^{t,\rho}$ by $s_i|_{h_i^{t,\rho}}$. Capital S's denote the corresponding collections (e.g., S_i is the set of all player i strategies). $\sigma_{ij}^t : S \to H_{ij}^{t+1}$ denotes the status of ij at time $t+1$ given strategy profile s. Analogously, $\sigma^t(s)$ is the status of the underlying network, and $\sigma(s)$ is the *path of play* of the infinite game under strategy s.

The payoffs of a player, i, in a given period, t, is the sum of payoffs across each of i's relationships realized in that period. On in-arcs this is 0 in relationships that were severed by either player prior to t, $(1-\underline{c})$ in relationships maintained in t by both players, $-\underline{c}$ in relationships unilaterally severed by the partner, and 1 on relationships unilaterally severed by i. Payoffs on out-arcs are determined likewise but with cost $\bar{c}$ for maintenance. The total period t payoff is the sum of payoffs from each bilateral relationship in t. Hence, the payoff realized by player i at time t under strategy profile s is:

$$\begin{aligned}\pi_i^t(s) \quad = \quad & (1-\bar{c})\left(\sum_{ij\in A} I_{(M,\varnothing,\varnothing)}\left(\sigma_{ij}^t(s)\right)\right) + (1-\underline{c})\left(\sum_{ji\in A} I_{(M,\varnothing,\varnothing)}\left(\sigma_{ji}^t(s)\right)\right) \\ & + \left(\sum_{ij\in A} I_{(S,t,i)}\left(\sigma_{ij}^t(s)\right) + \sum_{ji\in A} I_{(S,t,i)}\left(\sigma_{ji}^t(s)\right)\right) \\ & -\bar{c}\left(\sum_{ij\in A} I_{(S,t,j)}\left(\sigma_{ij}^t(s)\right)\right) - \underline{c}\left(\sum_{ji\in A} I_{(S,t,j)}\left(\sigma_{ji}^t(s)\right)\right), \qquad (1)\end{aligned}$$

where I is an indicator function that takes a value one according to which of the states $(M,\varnothing,\varnothing)$, (S,t,i), (S,t,j), $(S,t,\{i,j\})$ is chosen by the partners on a given active arc in period t, under s. The average continuation payoff to player i under strategy profile s at time t is $\pi_i^t(\delta,s) = (1-\delta)\sum_{\tau=t}^{\infty}\delta^{\tau-t}\pi_i^{\tau}(s)$, which exists because $\pi_i^{\tau}(s)$ is bounded and $\delta < 1$.[14]

[14] Note that the realized payoff of player i only depends on the status of arcs in his own network neighborhood. Private information therefore implies that players are able to condition play in the network game on exactly the relationships which are directly payoff relevant.

2.5 Equilibrium

As usual in dynamic games, Nash equilibria of the network game on a digraph D can be supported by non-credible threats off the path of play. To rule out such play we consider a refinement of Nash equilibrium that accounts for the dynamic structure of the game. Our focus is on network games under private information, so that t-histories are only partially observed by any one player. In equilibrium, players form beliefs about what happens in parts of the network they do not observe, and we impose Bayesian consistency on these beliefs.

To define beliefs when t-histories are only partially observed, denote by $\mu_i^t\left(\left\langle h_i^{t,\rho}\right\rangle\right)$ the probability distribution on $\left\langle h_i^{t,\rho}\right\rangle$, which represents player i's beliefs given the observation of t-history $h_i^{t,\rho}$. One component of this is denoted $\mu_i^t\left(h^t \middle| h_i^{t,\rho}\right)$ (note that $\mu_i^t\left(h^t \middle| h_i^{t,\rho}\right) = 0$ if $h_i^{t,\rho} \notin \langle h^{t,\rho}\rangle_{i,\rho}$). $\mu_i^t = \left(\mu_i^t\left(\left\langle h_i^{t,\rho}\right\rangle\right)\right)_{\left\langle h_i^{t,\rho}\right\rangle \in [H^t]_{i,\rho}}$ is a system of period t beliefs of player i (one set of beliefs for every history that player i could have observed at time t); $\mu^t = (\mu_i^t)_{i\in N}$ is a system of beliefs for each player at time t of the game; and $\mu_i = (\mu_i^t)_{t\geq 0}$ is a system of beliefs for player i. We call $\mu = (\mu_i)_{i\in N} = (\mu^t)_{t\geq 0}$ a *system of beliefs*. Finally, at time t the set of histories is finite and so the expected continuation payoff of player i under strategy s given i-observable t-history $h_i^{t,\rho}$ has been observed is given by an inner product,

$$R_i^t\left(s, \mu_i^t | h_i^{t,\rho}\right) = \mu_i^t\left(\left\langle h_i^{t,\rho}\right\rangle\right) \cdot \pi_i^t\left(\delta, \left(s_j|_{h_j^{t,\rho}}\right)_{j\in N(D)}\right) . \tag{2}$$

We say that a system of beliefs μ is *consistent* with a given strategy profile s if it is in the following set

$$\Psi(s) = \left\{\mu | \mu_i^t\left(\sigma^t(\hat{s}_i, s_{-i}) | h_i^t\right) = 1 \text{ if } \left\langle\sigma^t(\hat{s}_i, s_{-i})\right\rangle = h_i^t,\ \forall t \geq 0,\ \forall \hat{s}_i \in S_i,\ \forall i \in N\right\} . \tag{3}$$

This consistency condition is equivalent to the idea that players Bayesian update beliefs regarding t-histories from their beliefs about the strategy profile s at every information set reached with strictly positive probability under s. Given that s is a pure strategy profile, the condition $\mu \in \Psi(s)$ implies (1) if i has observed no deviations from the path of play defined by s, then i should put point mass on the path of play, and (2) if i deviates from s but observes no other deviations from the continuation path prescribed by s, then i should put point mass on the continuation path implied by s, given i's deviation from s. However, if i observes deviations from some player in $N - \{i\}$, then $\mu \in \Psi(s)$ imposes no restrictions on subsequent beliefs because these are all associated with probability zero events under s. We use this notion of consistency to define an appropriate equilibrium concept for the game.

Definition 1 (Perfect Bayesian Equilibrium) *A strategy profile s and system of beliefs μ are a perfect Bayesian equilibrium (PBE) if $\mu \in \Psi(s)$ and*

$$R_i^t\left(s, \mu_i^t | h_i^{t,\rho}\right) \geq R_i^t\left(\hat{s}_i, s_{-i}, \mu_i^t | h_i^{t,\rho}\right), \tag{4}$$

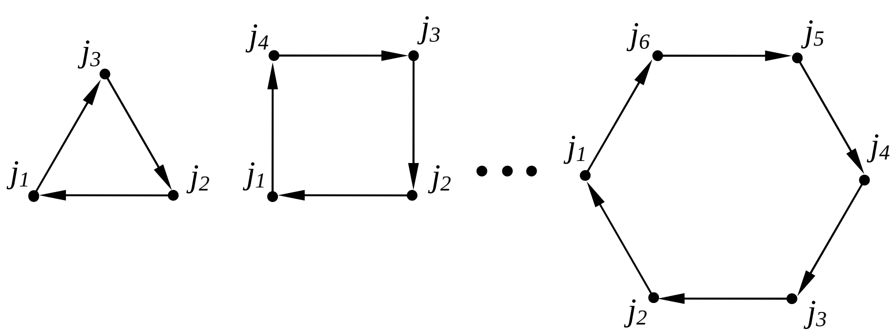
for all $h_i^{t,\rho} \in H_i^{t,\rho}$, $\hat{s}_i \in S_i$, *and* $i \in N(D)$.

Hence, a strategy profile s can be a PBE if and only if *there exists* a system of beliefs consistent with s, such that all players are maximizing expected continuation payoffs at every information set. Given that many of these information sets will be reached with zero probability under s, PBE is the weakest refinement that is consistent with Bayesian rationality and rules out non-credible threats in equilibrium. In the game at hand, PBE is a refinement of subgame perfect equilibrium and the two solution concepts coincide exactly when the network game has public information. We also consider a strong belief-free refinement of PBE in Section 6, to highlight network structures on which network enforcement is particularly robust, but we defer the definition of a belief-free equilibrium to that section.[15]

3 An Example

We first look at network enforcement on a particular subset of digraphs satisfying Assumption 1, namely the class of cycle networks of length n. We denote a typical member of this class $D_n^C = (\{j_1, ..., j_n\}, \{j_1 j_2, ..., j_n j_1\})$, and the initial members, D_3^C though D_6^C, are depicted in Figure 4. Note that D_3^C is the strong triangle network from Figures 1(b) and 2(a).

Figure 4: Cycle of length 3 (D_3^C) - Cycle of length 6 (D_6^C).



[15]We also consider sequential equilibrium in an extended version of this paper (Mihm et al., 2009). Sequential equilibrium refines on PBE by imposing more structure on beliefs, and is refined by belief-free equilibrium. The qualitative results on global network structure under PBE and belief-free equilibrium already go in the same direction, and so sequential equilibrium does not highlight many new insights here. Moreover, while we give some intuitive existence results for network enforcement in a sequential equilibrium, we also demonstrate by example a number of unappealing implications of sequential equilibrium that suggest why this is not a suitable solution concept for the game at hand.

Cycle networks are characterized by two properties: (1) there is only one component, and (2) each node has exactly one in- and one out-arc, i.e., each player in the network has one relationship where they incur cost $\underline{c}$ for maintenance, and one relationship where they incur cost $\bar{c}$. The observation that for $\delta < \bar{c}$ fully maintained digraphs must contain a cycle (see Section 2.2) has an immediate implication for cycle networks: No relationship in a cycle network, D_n^C, can be maintained in any period unless the whole network is fully maintained.[16] For a network game on a cycle network it therefore only remains to show when the whole network can be fully maintained in an equilibrium. This depends on the information structure of the game and we consider public and private information in turn.

3.1 Public network enforcement on cycle networks

To characterize the critical discount factor as of which the whole cycle network D_n^C can be fully maintained in an PBE under public information, we define the worst-punishment strategy of the network game. Let s^{pub} be the strategy profile where all players "maintain all arcs as long as no severance has been observed anywhere in the network, and sever all arcs immediately otherwise". Given this strategy profile, the optimal deviation for any one player is to sever both of their arcs in the network immediately. Hence, s^{pub} is a subgame perfect equilibrium in which a whole cycle network is fully maintained if and only if $\delta \geq (\bar{c}+\underline{c})/2 =: \delta^c_{pub}$. Since s^{pub} specifies the worst punishment, no other strategy profile could achieve full maintenance for $\delta < \delta^c_{pub}$. The critical discount factor as of which full maintenance can be achieved on network D_n^C under public information is simply the average of $\bar{c}$ and $\underline{c}$. If, for example, $\bar{c} = 0.9$ and $\underline{c} = 0.5$, any one relationship in D_n^C can be maintained if and only if $\delta \geq 0.9$, while the whole network can be maintained if and only if $\delta \geq 0.7$. Hence, full maintenance of D_n^C involves network enforcement when $\delta \in [0.5, 0.9)$. This is precisely the range identified in our discussion of the strong triangle network in Section 2.

Note that the critical discount factor δ^c_{pub} does not depend on n, the length of the cycle. However, while the assumption of public information becomes less plausible as the cycle size increases, it also becomes increasingly important for the enforcement mechanisms that utilize

[16]This follows from a simple backward induction argument: Suppose that some relationships in D_n^C are fully maintained, but the whole network is not. Then there exists some time period τ in which the maintained digraph does not contain a cycle, i.e., it has a source. A source will always sever their remaining relationship, but then the source's partner would become a source. Hence, in an equilibrium, the partner should anticipate severance and sever all remaining relationships in $\tau - 1$, and so on. As a result, unless the whole network is fully maintained, all relationships must be severed in period 0. This condition is unique to the class of cycle networks. In any other network, if the whole network is fully maintained it must contain some cycles, and at least one of those could also be maintained without maintenance of any other relationship in the network.

the network. In fact, while we do not impose that players use all the information regarding history of play, in every equilibrium in which a cycle network is fully maintained all players *must* be using all of this information. This again follows from a simple backward induction argument. For $\delta < \bar{c}$ maintenance of any relationship $j_k j_{k+1} \in D_n^C$ must be conditional on maintenance of $j_{k-1}j_k$, otherwise j_k has no incentive to maintain. By the same argument, maintenance of $j_{k-1}j_k$ must be conditional on maintenance of $j_{k-2}j_{k-1}$, and so on. But now suppose that any arc in the network is severed in some period τ, then the partner to that relationship must sever in $\tau + 1$, her partner should anticipate this and do likewise, and so on. It follows that if any relationship is severed in any period, all remaining relationships must be severed immediately in the following period. As a result, s^{pub} is, in fact, the unique equilibrium that can achieve full maintenance when $\delta < \bar{c}$ and information is public. But the assumption that players are be able to monitor the status of every relationship in a network becomes increasingly implausible as networks become large. For densely connected networks, such as the strong triangle, public information may be a reasonable approximation, but as cycles get larger constraints on monitoring limit the possibility of the kind of network enforcement mechanism that s^{pub} represents.

3.2 Private network enforcement on cycle networks

Again, we start by defining the worst-punishment strategy for the network game on a cycle under private information. Let s^{priv} be the strategy profile where all players "maintain all arcs as long as no severance has been observed *in their own network neighborhood*, and sever all arcs immediately otherwise". This strategy profile is similar to s^{pub} but explicitly takes account of the private monitoring constraint. The optimal deviation under private information is, however, quite different from the one under public information. For $\delta \in \Delta$, each player would like to sever out-arcs as soon as possible and maintain in-arcs as long as possible. Since severance by j_k of $j_k j_{k+1}$ is observed only by j_{k+1}, this implies that the optimal deviation from s^{priv} for j_k is to sever $j_k j_{k+1}$, but maintain $j_{k-1}j_k$ for the time being. According to s^{priv}, after $j_k j_{k+1}$ has been severed, severance will spread through the network as j_{k+1}, and then j_{k+2}, and so on, sever their out-arcs. Hence, the optimal deviation for j_k is to sever $j_k j_{k+1}$ in period τ and then sever $j_{k-1}j_k$ in $\tau + (n-2)$, the same period in which j_{k-2} will sever her relationship to j_{k-1}, and therefore the last period before j_{k-1} would anyway sever $j_{k-1}j_k$.[17]

[17]Note that this is not a one-shot deviation. The optimal one-shot deviation would be to sever both arcs immediately, but this is sub-optimal under private information, where the optimal deviation continues for $n-2$ periods. We therefore observe that the counterpart to the one-shot deviation principle does not apply in this game. That is not due to the dynamic structure because it is easy to verify that the same observation

Given the optimal deviation, we find that the critical discount factor under which full maintenance is incentive compatible for s^{priv} solves $(\bar{c} - \delta^c_{priv}) + (\delta^c_{priv})^{n-2}(\underline{c} - \delta^c_{priv}) = 0$. Clearly, this condition has a solution in Δ, i.e., $\delta^c_{priv} < \bar{c}$. But unlike under public information, δ^c_{priv} is strictly increasing in n, and converges to $\bar{c}$ as n goes to infinity. To give an idea about numerical significance, suppose that $\bar{c} = 0.9$ and $\underline{c} = 0.5$. Then Table 2 gives δ^c_{priv} for various values of n. We see from the example that, while for small n the difference between public and private is not large, as n becomes large the range of discount factors for which network enforcement via s^{priv} is significant diminishes quickly.

n	3	4	5	6	7	8	12	24
$\delta^c_{priv}(n)$	0.73	0.75	0.77	0.79	0.80	0.81	0.84	0.89

Table 2: Critical discount factor as a function of cycle length

Since s^{priv} is the worst punishment strategy available under private information, no other strategy profile could achieve full maintenance for $\delta < \delta^c_{priv}$. To get a characterization of the critical discount factor it therefore remains to show that there exists a system of beliefs under which s^{priv} is a PBE strategy profile. Let μ^{priv} be the belief system in which every player believes that the whole network is fully maintained if they have observed nothing to suggest the contrary, and that every relationship outside of their own neighborhood was severed in the last period otherwise. It is easily verified that $\mu^{priv} \in \Psi(s^{priv})$ and, for $\delta \geq \delta^c_{priv}$, the strategy profile s^{priv} is a mutual best response given μ^{priv} at every information set. Hence, (s^{priv}, μ^{priv}) is a PBE in which the whole cycle network D^C_n is fully maintained if and only if $\delta \geq \delta^c_{priv}(n)$. We therefore have necessary and sufficient conditions for the existence of a PBE with network enforcement, given in terms of the parameters of a bilateral relationship, $\bar{c}$ and $\underline{c}$, and the structural parameter of the network, n. Moreover, while we find that network enforcement does not require public information, we observe that as the cycle length increases network enforcement is relevant on an ever smaller range of discount factors.[18]

would hold if every relationship was an infinitely repeated Prisoner's Dilemma. Rather, the usual recursive structure breaks down because of the asymmetric information. Players can exploit private information when deviating from the equilibrium path, and the conditions that are sufficient to rule out one-shot deviations are therefore not sufficient for equilibrium.

[18]It is also worth noting how we have used the common knowledge assumption regarding the network in this argument. We need to assume that players have "knowledge" of the network structure and strategy profile in order to determine the incentive compatibility constraints of individuals in an equilibrium, just as common knowledge is required to determine incentive constraints in a standard two-player game. However, the strategy of any individual player makes no reference to any relationship outside of his neighborhood, and the belief system of an individual involves no specific beliefs about what happens on specific relationships

In the sequel we turn to network enforcement in the general class of networks satisfying Assumption 1. Results are stated generally, but even when it is not mentioned explicitly, it should be understood that $\delta \in \Delta$ in the discussion, i.e., we focus on the range of discount factors where network enforcement is both essential and easily identified.

4 Public Network Enforcement

We start with the case of public information. Under public information the network game is a dynamic game of perfect information. Players are able to condition maintenance of any bilateral relationship in their neighborhood on the status of any other bilateral relationship in the entire network.

Assumption 2 *The radius of information is* $\rho = \infty$.

4.1 Balancing roles as a measure of contribution

Recall that in the class of cycle networks public network enforcement did not depend on the specific structural properties of a network (i.e., the length of a cycle). This is no longer true when we leave the class of cycle networks, because nodes in a digraph D can now have different ratios (of out-arcs to in-arcs), and these are important when considering incentive compatibility constraints. For $\delta \in \Delta$ full maintenance of a given subdigraph $D' \subset D$ requires that players balance the incentive to sever less valuable relationships in D' against their desire to maintain more valuable relationships. If individuals are willing to balance relationships in their neighborhood, the network can act as an institution that pools asymmetries and relaxes overall incentive constraints. The *balancing role* occupied by player i is measured by i's ratio in D'. This ratio can be interpreted as i's contribution to full maintenance of D'. Players with a lower ratio benefit more from maintenance of the network, while players with higher ratios would benefit more from a deviation from maintenance. Hence, the opportunity cost of full maintenance is higher for players who are required to play a greater balancing role to support an equilibrium in which D' is fully maintained.

In Section 3 we found that for the class of cycle networks, full maintenance is only possible when every player makes the same contribution. In general, however, nodes can play quite different balancing roles in an equilibrium with network enforcement, and it is the maximal

outside of his neighborhood. Hence, we do not really require that players know the network in an objective sense, only that they act *as if* they know the network when we determine incentive constraints.

contribution made by any player that determines the incentive compatibility of full maintenance. Theorem 1 establishes this formally by relating equilibria in which a subdigraph D' is fully maintained for $\delta \in \Delta$, to a sufficient statistic of the digraph D', namely the maximum ratio of any node in N'. To state the theorem, we denote by Φ_{Pub} the function

$$\Phi_{Pub}(D) = \frac{r(D)\,\bar{c} + \underline{c}}{[r(D) + 1]}, \tag{5}$$

where $r(D) = \max_{i \in N} r_D(i)$ is the maximum ratio of any node in digraph D.[19] Φ_{Pub} is a weighted average of $\bar{c}$ and $\underline{c}$, and takes values in $[\underline{c}, \bar{c}]$ according to the maximum ratio of digraph D. In the special case of a cycle network, $r(D) = 1$ and we get the incentive constraint from Section 3.1. More generally, Φ_{Pub} determines whether the strategic indirect reciprocity that is required when $\delta \in \Delta$ is incentive compatible for all players in the network. To understand the theorem, it is important to note that Φ_{Pub} is not "monotone": If $D'' \subset D'$ are subdigraphs of D, $\Phi_{Pub}(D'')$ can be greater, less than or equal to $\Phi_{Pub}(D')$. The following theorem gives necessary and sufficient conditions for full maintenance of any subdigraph D' of a network D in terms of the relation between discount factor δ and $\Phi_{Pub}(D')$.

Theorem 1 *Suppose that the network game on a digraph D satisfies Assumptions* 1 *and* 2*.*

1. *If $\delta' \geq \Phi_{Pub}(D')$, then there exists a PBE, (s, μ), of the network game on D under which $D' \subset D$ is fully maintained for all $\delta \in [\delta', 1)$.*
2. *If subdigraph $D' \subset D$ is fully maintained in a PBE, (s, μ), of the network game on D, then there exists $D'' \supset D'$ such that D'' is fully maintained under s and $\delta \geq \Phi_{Pub}(D'')$.*

Proof. The proof is given in Mihm et al. 2009. ■

To interpret the content of the theorem, note that parameters $\bar{c}$ and $\underline{c}$ are defined purely in terms of the strategic interaction in an isolated bilateral relationship. Theorem 1 takes these as given and is concerned with two problems of the strategic interaction at the network level. *Problem 1* is to minimize δ such that a given subdigraph D' can be fully maintained in a PBE of the network game on $D \supset D'$. *Problem 2* is to maximize the subdigraph D' that can be fully maintained in a PBE of the network game on $D \supset D'$ for a given δ. Theorem 1 emphasizes the duality between *Problem 1* and *Problem 2* and, by exploiting this duality, identifies a simple network statistic, $r(.)$, that is necessary and sufficient to address both problems. The second condition of the theorem generalizes the insight from the cycle

[19] Note that $r_D(.)$ is a function on nodes for given digraph D (see Section 2.3), while $r(.)$ is an operator on the set of all possible digraphs.

examples (Section 3.1): For a given δ, a subdigraph D' may only be fully maintained in equilibrium if it is contained in a larger subdigraph $D'' \supset D$ that is itself fully maintained in equilibrium. That is the sense in which network interaction can be crucial. The theorem illustrates that it is the contribution that each player would be required to make towards full maintenance of a given subdigraph that alone determines the incentive constraints on public network enforcement. We return to the example of the wheel digraph to illustrate this point.

4.2 Public network enforcement on wheel networks

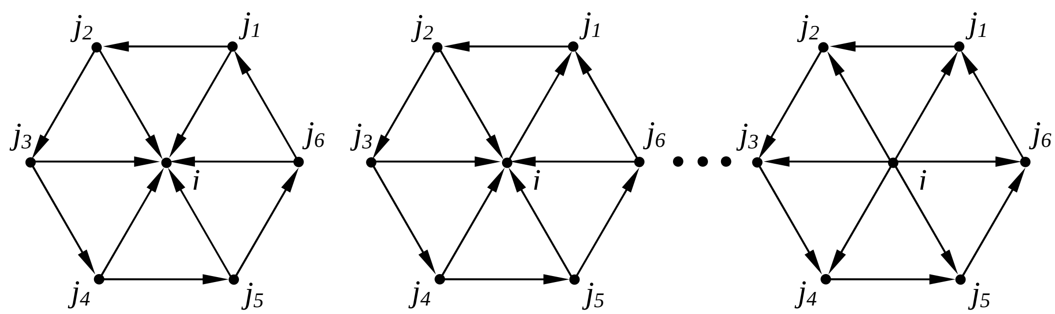


Figure 5: Wheel $D^W_{6,0}$ (far left) – Wheel $D^W_{6,6}$ (far right).

Figure 5 illustrates the first, second and last member of the class of wheel digraphs with periphery cycle of length 6. Consider digraph $D^W_{6,0}$ first. The whole digraph can be fully maintained in a SPE for $\delta \geq (2\bar{c} + \underline{c})/3$ ($= \Phi_{Pub}(D^W_{6,0})$). In an equilibrium with full maintenance of this network, player i makes no contribution. All other nodes in the network are required to play a balancing role. While every player in $N - \{i\}$ has the incentive to sever their relationship to i, they are not able to do so because deviations are publicly observed and, under an appropriate generalization of s^{pub} from Section 3.1, every deviation acts as a public coordination device. However, if full maintenance of $D^W_{6,0}$ is possible in an equilibrium, it follows immediately from Theorem 1 that the subdigraph in which only the cycle connecting the peripheral nodes is fully maintained must also be an equilibrium. In some sense, node i therefore appears to be a free-rider. The payoff of maintaining relationships to i does not compensate players on the periphery for foregoing the one-off severance payoff, and they are willing to do so only because they receive compensation from other players in the network (on each of their respective in-arcs).

Network $D^W_{6,1}$ is obtained from $D^W_{6,0}$ by replacing j_1i with ij_1. This increases the ratio of player i but does not change the maximum ratio in the digraph. Hence, the same range of δ's allows for full maintenance of $D^W_{6,1}$. Likewise $r(D^W_{6,2}) = r(D^W_{6,3}) = r(D^W_{6,4}) = r(D^W_{6,0})$, so that the critical discount factor is not altered. However, going from $D^W_{6,4}$ to $D^W_{6,5}$, player i's ratio increases above $r(D^W_{6,0})$ and the critical discount factor as of which $D^W_{6,5}$ can be fully maintained is $\delta^c = (5\bar{c} + \underline{c})/6 > \Phi_{Pub}(D^W_{6,0})$. Here, it is now the sponsor of the wheel who makes the greatest contribution to full maintenance, but i may still be willing to forgo deviation because of her one remaining in-arc. However, in $D^W_{6,6}$ player i is a source, and so there does not exist any $\delta \in \Delta$ for which $D^W_{6,6}$ can be fully maintained. The subdigraph $D^{W\prime}_{6,6} = D^C_6 \cup \{i\}$ can be fully maintained for $\delta > (\bar{c} + \underline{c})/2$ but full maintenance of the whole network $D^W_{6,6}$ is no longer an equilibrium outcome. While even player i would strictly prefer the outcome where the whole network is maintained to any outcome that is realized in equilibrium, full maintenance is not possible because other players in the network are aware that full maintenance is not incentive compatible for the sponsor.

4.3 Limits on network enforcement

The apparent discontinuity in going from $D^W_{6,5}$, where the whole digraph can be fully maintained for a range of δ's in Δ, to $D^W_{6,6}$, where half of the relationships in the network can not be maintained for any $\delta \in \Delta$, is somewhat misleading. In fact, if we consider the class of all wheel digraphs of the form $D^W_{n,m} = (\{i\} \cup \{j_k\}, \{ij_k | k \leq m\} \cup \{j_k i | m < k \leq n\} \cup \{j_k j_{k \oplus (n) 1} | k \leq n\})$ (where $n > 2$ and $m \leq n$) we have a convergence condition in the following sense: For any $\delta \in [(2\bar{c} + \underline{c})/3, \bar{c})$ there exist an n and an $\bar{m}$ such that for $m < \bar{m}$ the whole digraph can be fully maintained in a network game on $D^W_{n,m}$, and for $m > \bar{m}$ there does not exist a PBE in which the whole digraph is fully maintained in the network game on D^n_m. Corollary 1 establishes this result formally by highlighting that an absence of sources – already identified as a necessary condition for network enforcement in Section 2.2 – is, in fact, the only structural property that is required to get network enforcement on a digraph for some subset of discount factors in Δ.

Corollary 1 *Suppose that the network game on a digraph D satisfies Assumptions* 1 *and* 2*, and that $\delta \in \Delta$.*

1. *If $D' \subset D$ has no sources, then D' can be fully maintained in a SPE, s, of the network game on D for δ sufficiently large.*
2. *If subdigraph $D' \subset D$ is fully maintained in a SPE s of the network game on D, then there exists $D'' \supset D'$ such that D'' is fully maintained under s and has no sources.*

Proof. The proof is given in Mihm et al. 2009. ■

Theorem 1 and Corollary 1 highlight that balancing alone determines the incentive constraints on public network enforcement. This is a local incentive constraint and while it implies some constraints on global network structure (such as the existence of a cycle in the network), these come from the coordination on public signals rather than from strategic reasoning about the architecture of the network. Empirically and intuitively, the idea that network enforcement should be able to support full maintenace on arbitrarily large networks does not seem plausible. Most networks observed in empirical network studies are found to exhibit a small-worlds structure, with short distances between nodes. On such networks, public information may, in fact, be a reasonable approximation, but Theorem 1 and Corollary 1 suggest that it should also be possible to achieve the same kind of strategic indirect reciprocity observed in small-worlds, on arbitrarily large networks. As the examples of Section 3 illustrate, this often implies that players *must* condition on all information available. But in real networks such information is usually decidedly difficult to come by. We argue, therefore, that the extrapolation to large networks suggested by Theorem 1 and Corollary 1 is flawed because it does not account for monitoring constraints which seem, intuitively, to become increasingly important as the distance between nodes increases. The next section formalizes this intuition.

5 Private Information

We now give the analysis of network enforcement under private information. Under private information the network game is a dynamic game of imperfect information. Players are able to condition maintenance of any bilateral relationship in their neighborhood only on the status of other bilateral relationship in their network neighborhood.

Assumption 3 *The radius of information is* $\rho = 1$.

By restricting the information players can condition on, private information decreases the opportunities for network enforcement. However, decreasing the radius of information, ρ, is *not* an equilibrium refinement. We have demonstrated this already in the example of cycle networks in Section 3, where we observed that the equilibrium strategy profile s^{priv} – which can achieve full maintenance on a cycle network for some $\delta \in \Delta$ under private information – is not an equilibrium of the game under public information. We begin the analysis of private network enforcement with an example to highlight some of the constraints that arise when we require fully decentralized monitoring.

5.1 Gatekeeping, structural holes and transmission

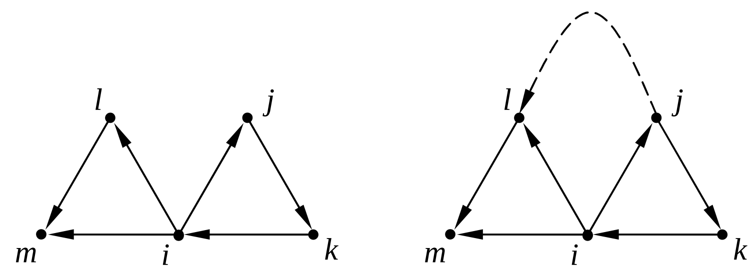


Figure 6: (a) Twin peak network D^{TP} (left), (b) Appended twin peak network D_n^{aTP} (right).

Figure 6(a) illustrates a "twin peak" network, D^{TP}. This network can be fully maintained under public information if and only if $\delta \geq (3\bar{c} + \underline{c})/4$, i.e., for a possibly large subset of discount factors in Δ. However, the twin peak network cannot be fully maintained under private information for $\delta \in \Delta$. Under private information, players j and k find out about the status of arcs in $\{il, im, lm\}$ only if player i reveals this through actions chosen on $\{ij, ik\}$. Hence, conditioning play on $\{ij, ki\}$ on $\{il, im\}$ (and vice versa) can never be part of an equilibrium because optimal deviations by player i will always treat these subdigraphs as separate. Player i therefore partions D^{TP} into two strategically indepedent subdigraphs: $(\{i, j, k\}, \{ij, jk, ki\})$ and $(\{i, l, m\}, \{il, im, lm\})$. The first of these is strong triangle from Sections 2.2 and 3.1, which can be fully maintained in a PBE on a range of discount factors in Δ. The second is D^{wT} from Section 2.2, which we know cannot be maintained for any $\delta < \bar{c}$. Hence, D^{TP} cannot be fully maintained by private network enforcement.

In D^{TP}, player i is said to be a *global gatekeeper*. Global gatekeepers lie on a unique path between two or more parts of a network and, under private information, control the flow of information between these parts of the network. A set of arcs is said to be an *arc-cut set* of a digraph if any path from a node not adjacent to an arc in the set, to a node adjacent to an arc in the set, must pass through a global gatekeeper. Hence, in the twin-peaks network, i is the only global gatekeeper, and $\{il, lm, im\}$ and $\{ij, jk, ki\}$ are the only non-trivial arc-cut sets. As the example indicates, a global gatekeeper will partition a network into its arc-cut sets and these will therefore always be part of strategically independent subdigraphs. A generalization of the notion of global gatekeeping can be used to interpret the additional incentive constraints that arise when we require private network enforcement.

Definition 2 (Local Gatekeeper) [20] *For digraph $D = (N, A)$, suppose that $\{\underline{ij}, \underline{ik}\} \subset N$. Node i is a local gatekeeper with respect to nodes j and k if i is on the (strictly) shortest,*

[20] Local gatekeepers are closely related to the concept of local bridges from the social network literature

undirected path between j *and* k*, i.e., if* $d_{G(D)}(j,k|\neg\{\underline{ij},\underline{ik}\}) =: n^i_D(j,k) > 2$*. In that case,* $n^i_D(j,k)$ *is called the order of* i *as a local gatekeeper between* j *and* k*.*[21]

To illustrate the relation between local and global gatekeepers, consider the appended twin-peaks network of Figure 6(b), D^{aTP}_n, obtained from D^{TP} by appending a path of length n connecting nodes j and l. Then i is a local gatekeeper of order n between j and l, and becomes a global gatekeeper as n goes to infinity. Our main result in this section demonstrates that it is not only player i's ratio that determines the incentive compatibility of private network enforcement, but also player i's position as a local gatekeeper between in- and out-arcs in i's neighborhood. This is because, for $\delta \in \Delta$, every maintained relationship in network D must be conditioned on the maintenance of other relationships in D. Suppose now that i severs arc $ij \in A(D)$ and that this represents a deviation from the path of play. By Assumption 1, player j is not in a position to punish i for the deviation directly. Moreover, under private information, i's deviation is not observed by any player other than j. Enforcing maintenance of ij therefore requires that j be willing and able to sever other relationships to communicate i's deviation to nodes that are in a position to punish i. We call this *transmission*, and how long transmission takes is vital for network enforcement under private information. The importance of gatekeeping has no counterpart when deviations from equilibrium are publicly observed precisely because transmission is not relevant. But when information is private, players can exploit the fact that the spread of severance through the network is constrained by the distance of paths along which severance must travel, and this means that the distance between nodes becomes important for private network enforcement.

As a result, private information has important implications for the role that nodes occupy in the network. While under public information a player's contribution to full maintenance of a network can be measured by their balancing role alone, under private information nodes can also perform a vital information transmission role to counteract the incentives other players have to exploit local gatekeeping positions. This is particularly relevant when the network has (or, rather, would otherwise have) "structural holes", i.e., when there are parts of the network which are sparsely connected or connected only by very long paths. Even nodes which make little contribution to network enforcement in terms of their balancing role can still be crucial for network enforcement if they occupy such structural holes, and transmit information between otherwise disparate parts of the network. Hence, what appear to be free-riders in the network under public information, can actually play a vital role in the decentralized monitoring that is essential for private network enforcement. We next

(see, e.g., Granovetter 1973).

[21] A local gatekeeper i is a global gatekeeper if there exists a partition of $NE_D(i) = NE^1 \cup NE^2$ such that $j \in NE^1$ and $k \in NE^2$ implies $n^i_D(j,k) = \infty$.

illustrate this point with an example.

5.2 Private network enforcement on wheel networks

The transmission role can be highlighted by comparing the cycle networks from Section 3 to the wheel networks analyzed under public information in Section 4. Note that each node in a cycle network of length n, D_n^C, is a local gatekeeper of order $n_D^{j_k}(j_{k-1}, j_{k+1}) = n - 1$, and recall that under private information the critical discount factor as of which D_n^C can be fully maintained in a PBE is a strictly increasing function of n. The critical δ as of which a typical wheel network in which the sponsor has ratio 0, $D_{n,0}^W$, can be fully maintained solves $(\bar{c}-\delta)+\delta(\bar{c}-\delta)+\delta^2(\underline{c}-\delta) = 0$. While the cycle subdigraph $D_n^C \subset D_{n,0}^W$ must be maintained in order for $D_{n,0}^W$ to be fully maintained, we observe that the critical discount factor for full maintenance of the wheel is independent of the structural parameter n (the length of the periphery cycle). This is because each node on the periphery of $D_{n,0}^W$ is a local gatekeeper of order 2, and these orders do not depend on n. Hence, both the ratio and gatekeeping order are constant in the class $D_{n,0}^W$ as we vary n. For $\bar{c} = 0.9$ and $\underline{c} = 0.5$, Figure 7 compares how the critical discount factor depends on n for cycle networks, D_n^C and wheel networks, $D_{n,0}^W$.

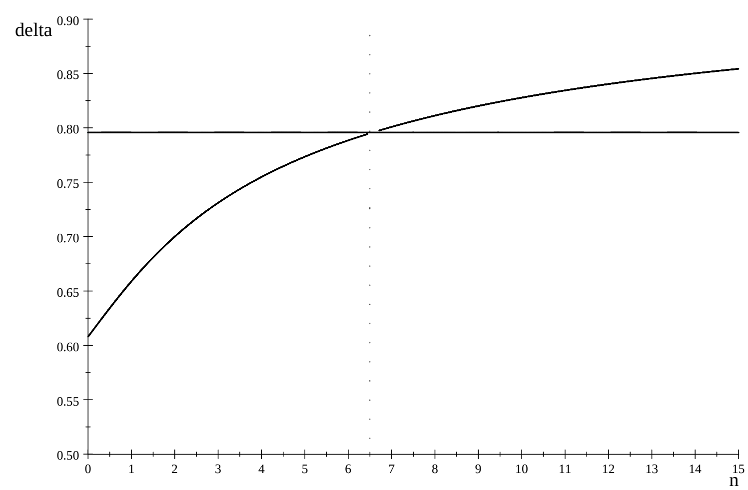


Figure 7: Critical δ as a function of n.

For $n \leq 6$ we observe that there is an open subset of Δ for which $D_{n,0}^W$ cannot be fully maintained, but D_n^C (which is a subdigraph of $D_{n,0}^W$) can be fully maintained in a PBE. But for $n \geq 7$ there is an open subset of Δ for which $D_{n,0}^W$ can be fully maintained in a PBE, but the subdigraph D_n^C cannot. The latter has no counterpart when $\rho = \infty$. But, under private information, despite the fact that node i makes no contribution to full maintenance in terms of a balancing role in $D^W_{7,0}$, node i does play a critical role in network enforcement. By reducing the local gatekeeping order of nodes on the periphery, node i allows information and punishment to spread more quickly through the wheel network. Such networks can be viewed as a stylized model of many information-sharing networks, which often appear to have this centralized structure. Moreover, it is common to find that the sponsor in such networks benefits disproportionately from the network interactions (as suggested here by the direction of the asymmetries in $D^W_{n,0}$). Under public information we are led to believe that the sponsor is free-riding because peripheral nodes can not coordinate severance. However, the analysis of private information highlights that the sponsor may play a vital role in private network enforcement.

5.3 Equilibrium analysis of private network enforcement

We now generalize the insights from the twin peak, cycle and wheel examples. Recall from Section 3 that under private information optimal deviations from a worst-punishment strategy such as s^{priv} do not generally involve a one-shot deviation. As a result, it is generally not possible to solve for a critical discount factor explicitly, but we can characterize the critical discount factor as of which any subset of relations in a digraph D can be fully maintained in terms of an implicit condition that highlights both the balancing and transmission roles observed in the wheel network example. To this end, let $N^+(D)$ denote the set of nodes in a digraph D which have at least one out-arc in D (i.e., $N^+(D) = \{i \in N(D) | od_D(i) > 0\}$), and for each $i \in N^+(D)$ let

$$\Upsilon^i_D\left(\alpha^i, \delta\right) = (\bar{c} - \delta) \sum_{ij \in NE_D(i)} \delta^{\alpha_{ij}} + (\underline{c} - \delta) \sum_{ji \in NE_D(i)} \delta^{\beta_{ji}(\alpha^i)}, \tag{6}$$

where $\alpha^i = (\alpha_{ij})_{ij \in NE_D(i)}$, $\alpha_{ij} \in \mathbf{N} \cup \{\infty\}$ for all $ij \in NE_D(i)$, and

$$\beta_{ji}(\alpha^i) = \min_{ik \in NE_D(i)} \left[\alpha_{ik} + d^{ik}_D\left(i, j | \neg\{ik\}\right) - 1\right]. \tag{7}$$

As a function of δ, $\Upsilon^i_D(\alpha^i, \delta)$ in (6) is defined in terms of parameters from the strategic interaction in a bilateral relationship, i.e., $\bar{c}$ and $\underline{c}$, properties of the network D, and an auxiliary variable α. Given δ, $(\bar{c} - \delta)$ is the net payoff to player i of severing an out-arc when his partner would otherwise have maintained that relationship. $(\underline{c} - \delta)$ is the net payoff to player i of severing an in-arc when his partner would otherwise have maintained that relationship. $\Upsilon^i_D(\alpha^i, \delta)$ can therefore be interpreted as a weighted average of the net benefit of maintaining in- and out arcs, with the number of terms determined by $od_D(i)$ and $id_D(i)$, and the weight on each term determined by α^i and (β_{ij}). The importance of transmission and local gatekeeping is identified by observing that (β_{ij}) in (7) is a function of the distance between out-arcs and in-arcs in player i's neighborhood.

The incentive constraints on full maintenance in a PBE are given by

$$\Phi_{PBE}(i, D, \delta) = \max_{\alpha^i} \Upsilon_D^i \left(\alpha^i, \delta\right) , \tag{8}$$

which can be interpreted as a weighted average of net benefits from severance (on in- and out-arcs) along an optimal severance program, given that all nodes in the network follow a specific worst punishment strategy that is very closely related to s^{priv} (see Appendix A for details).[22]

Theorem 2 *Suppose that the network game on a digraph D satisfies Assumptions* 1 *and* 3.

1. *If $\Phi_{PBE}(D', i, \delta') = 0$ for each $i \in N^+(D')$, then there exists a PBE (s, μ) of the network game on D under which D' is fully maintained for all $\delta \in [\delta', 1]$.*
2. *If subdigraph $D' \subset D$ is fully maintained in a PBE (s, μ) of the network game on D, then there exists $D'' \supset D'$ such that D'' is fully maintained under (s, μ) and $\Phi(D'', i, \delta) = 0$ for each $i \in N^+(D'')$.*

Proof. The proof is given in Mihm et al. 2009. ■

Theorem 2 re-emphasizes the duality between *Problem 1* and *Problem 2* observed in Section 4. Here both problems are solved by looking at a summary statistic, Φ_{PBE}, that is defined only in terms of the parameters $\bar{c}$ and $\underline{c}$, and structural properties of the network architecture. In particular, Φ_{PBE} highlights that the number of in- and out-arcs, as well as the distance between these, determine incentive compatibility constraints on private network enforcement. Heuristically, as the ratio of a player increases, the range of discount factors under which full maintenance is possible decreases. This is related to our findings under public information. The new aspect here is that the opportunity for network enforcement also diminishes as the distances between in- and out-arcs increase. As a result, we find that structural holes – places in the network where connections are not dense – can be a severe impediment to network enforcement. Hence, the importance of the transmission role for players that bridge such structural holes.

There is a large literature on the implications of "structural holes" in social and economic networks (see, e.g. Burt, 1992 and 2000). In the study of business organizations, for example, structural holes are often viewed as places in a network where the flow of information

[22]Note that the auxiliary variable α is no longer a part of Φ_{PBE}, which can be viewed as a constrained maximization problem where the relevant constraints have already been included via β's dependence on α.

is restricted by a lack of connectivity. This is hypothesized to reduce efficiency, suggesting that organizations should take efforts to close structural holes. However, it is also often assumed that local gatekeepers acquire benefits from their position bridging structural holes, and therefore resist organizational restructuring. In the context of the network game on a digraph D, Theorem 2 highlights that structural holes can indeed reduce efficiency because they reduce the opportunity for network enforcement mechanisms to counteract double coincidence of wants constraints. However, the equilibrium analysis also illustrates that this does not necessarily imply benefits for local gatekeepers in the network. In an equilibrium, partners of a local gatekeeper fully anticipate the gatekeeper's informational advantage and adjust their behavior accordingly. Hence, the local gatekeeper is never able to exploit the informational advantage of his position in the network.

Finally, it remains to show when $\Phi_{PBE}(D', i, \delta') = 0$ has a solution in Δ, where network enforcement is essential. In a manner analogous to Section 4, this is given by a simple limiting result if we interpret the relevant space correctly. First, as under public information, we need to realize that a source is the limit of a player with increasing ratio. In addition, under private information, we have to perform a similar exercise with respect to path lengths. In particular, we need to realize that global gatekeepers are the appropriately defined limit of local gatekeepers (as illustrated in the twin-peaks network). With these interpretations, the following corollary to Theorem 2 is immediate and gives a possibility result for private network enforcement.

Corollary 2 *Suppose that the network game on a digraph D satisfies Assumptions* 1 *and* 3*, and that $\delta \in \Delta$.*

1. *If the digraph $\left(\iota\left(\hat{A}\right), \hat{A}\right)$ has no sources for every arc-cut set $\hat{A} \subset A'$ of subdigraph $D' \subset D$, then D' can be fully maintained in a PBE of the network game on D for δ sufficiently large.*
2. *If subdigraph $D' \subset D$ is fully maintained in a PBE (s, μ) of the network game on D, then there exists $D'' \supset D'$ such that D'' is fully maintained under (s, μ), and $\left(\iota\left(\hat{A}\right), \hat{A}\right)$ has no sources for every arc-cut set $\hat{A} \subset A''$.*

Proof. The proof is given in Mihm et al. 2009. ■

5.4 The value of information and public monitoring institutions

The analysis of public and private network enforcement allows us to highlight the value of public monitoring institutions in a network environment. Assuming for the moment that cooperative equilibria can be selected, suppose that players in a network had the opportunity to pay some amount C to fund a public monitoring institution. How much would they be willing to pay? For any discount factor $\delta \in \Delta$ and network D, Theorems 1 and 2 give us the maximal subdigraph of D that can be maintained if, respectively, players do fund such an institution, compared to the maximal fully maintained subdigraph if they do not. Hence, for given values of $\underline{c}$ and $\bar{c}$, their willingness to pay, C, will be a function of the network D and the discount factor δ. We know already that public information increases the opportunity for network enforcement and hence $C(D, \delta)$ is non-negative. Moreover, Theorems 1 and 2 allow us to reduce the problem of calculating $C(D, \delta)$ to a straightforward computational exercise. For example, if $\bar{c} = 0.9$ and $\underline{c} = 0.5$, then for a cycle network of length $n = 7$ we get

$$C\left(D_7^C, \delta\right) = \begin{cases} 0 & \text{if } \delta \in (0, 0.7] \cup [0.8, 1) \\ 0.6 & \text{if } \delta \in (0.7, 0.8) \end{cases}, \tag{9}$$

because for $\delta \leq 0.7$ neither public nor private network enforcement can fully maintain the network, for $\delta \geq 0.8$ private network enforcement fully maintains the cycle, but for $\delta \in (0.7, 0.8)$ public information would allow players to maintain the whole network while private network enforcement fails. Hence, players may be willing to pay up to 60% of the benefit from a maintained relationship for a public monitoring institution that supports network enforcement in this network.

Institutions that appear to play a public monitoring role are observed in a number of network environments. The system of international trade relations is an example of a network environment in which trade is organized, essentially, via bilateral relationships, and in which in many dimensions the conduct of each partner is difficult for outsiders to the trade relationship to monitor. It is also difficult to demonstrate that each bilateral trade agreement really is mutually beneficial for the agents involved. In fact, one explicit justification given for multilateral agreements is that there is a sense that with some indirect reciprocity, free-trade is beneficial for all even if individual trade agreements are not necessarily beneficial for both parties. In this context, at least one function of the WTO is to monitor and report publicly on trade behavior (WTO, 2009). Of course, the WTO also plays other roles, e.g., by enforcing a multilateral agreement it helps to establish the right norm (free-trade) from the number that are available. But if we view international trade as a network of bilateral agreements, it is clear that the WTO also has an essential role to play in monitoring and coordinating responses to a deviation. Public monitoring institutions are also observed in collusion networks. An example is provided by the collusion case brought against the US airlines industry in the 1980's (see USA v. ATPC, 1992). Airlines colluded on prices by funding a public price board and then positing and implicitly trading forward prices on this board. One difficulty plaintiffs encountered in bringing a case against the airlines industry was that, in the absence of a theoretical framework in which to formulate and analyze strategic indirect reciprocity, they had to establish the mutual benefit of transactions on a bilateral level. Our model gives a framework for thinking about what indirect reciprocity would mean in such a context, and enables us to relate indirect reciprocity to incentives of individuals, (potentially observable) network structure and the monitoring institutions available.

To summarize the results of this section, we find that the analysis of PBE of the network game under private information is useful to demonstrate and delimit the possibilities of indirect reciprocity on a given network. In particular, we find that the distance between nodes in the network is important for incentive compatibility of network enforcement. As a result, we are able to make sense of the role certain individuals play by virtue of a central network position, and to assess the value of public monitoring institutions in network environments.

6 Belief-free Network Enforcement

In this section we want to consider a refinement of PBE that is useful for an alternative interpretation of the model, by which networks are formed partly under the anticipation of strategic indirect reciprocity. This alternative interpretation is closer to some of the existing literature in economics, which is concerned with incentives on network formation, and is also suggested by a number of applied literatures. For example, in the strategic management literature it is now in vogue to view network formation as a guided process, i.e., to view networks themselves, not just the firms that constitute a network, as the outcome of entrepreneurial design. This perspective is partly motivated by the striking regularities observed in network data, such as the small-worlds property, and by the observation of network institutions such indirect reciprocity. In this context, a closely related paper is Haag and Lagunoff (2006), who focus on a planner's problem in the design of real-world neighborhoods when there are strategic network interactions between inhabitants. Their modeling framework is close to ours and the tractability restrictions they impose in their equilibrium concept lead to conclusions that have the same flavor as the results derived in this section.

The preceding analysis already suggests a relation between indirect reciprocity and the small-worlds structures, but the dependence of perfect Bayesian equilibrium on particular belief systems is problematic if we want to view the network game as the second-stage in a network formation process. Under this interpretation of the model, the network is formed in some explicit network formation process between players in stage 0, with the understanding that the network game outlined in Section 2 will then be played on the resulting digraph. Anticipation of indirect reciprocity can influence the incentives in the formation process, but it does not seem reasonable that these institutions should then depend on particular belief systems. We introduce the notion of a belief-free equilibrium to address these concerns and identify network structures that allow for a more robust form of private network enforcement. Our main finding is a very stark small-worlds prediction.

6.1 Belief-free equilibrium

Recall that a strategy profile s is a PBE if there exists a system of beliefs $\mu \in \Psi(s)$ such that s is a mutual best response at every information set given the beliefs μ (see Section 2.5). In a *belief-free equilibrium* (BFE) we require that s be a mutual best response at every information set *for all* beliefs consistent with s (i.e., all beliefs μ in $\Psi(s)$).[23] This is a strong refinement that has the satisfying property that the equilibria we construct no longer depend on any particular system of beliefs. As a result, the equilibrium notion is better suited to an interpretation of the model in which the network is first formed under the anticipation of indirect reciprocity opportunities. In fact, the belief-free equilibrium concept is motivated, in part, by the literature on mechanism design (see, e.g., Bergemann and Morris 2007). [24]

To illustrate the concept of a BFE, consider the strong triangle network from Figure 4 in Section 3 again, and suppose that players follow the strategy profile s^{priv} from that section. It is easily verified that the continuation of s^{priv} after observing a severance is a best response regardless of which beliefs player any player in D_3^C entertains in $\Psi(s^{priv})$. Hence, whenever s^{priv} is a PBE it is, in fact, a belief-free equilibrium (BFE). However, consider going from D_3^C to D_4^C. The strategy profile s^{priv} cannot be a BFE of a cycle network of length 4 because we can identify two different belief systems consistent with s^{priv} in which the best response by a player in D_4^C following a deviation by one of their partners differ.[25] In fact, for $\delta < \bar{c}$ there

[23]Formally, a strategy s is a belief-free equilibrium (BFE) of a network game on D with radius of information ρ if for every $\mu \in \Psi(s)$

$$R_i^t\left(s, \mu_i^t | h_i^{t,\rho}\right) \geq R_i^t\left(\hat{s}_i, s_{-i}, \mu_i^t | h_i^{t,\rho}\right), \tag{10}$$

for all $h_i^{t,\rho} \in H_i^{t,\rho}$, $\hat{s}_i \in S_i$, $i \in N(D)$.

[24]The notion of belief-free equilibrium is also used in the literature on repeated games with imperfect private monitoring (see, e.g., Horner and Olszewski, 2006, and Ely et al. 2005). For a survey of the use of belief-free equilibrium concepts in game theory see Olszewski (2007).

[25]Suppose, for example, that j_2 severs the relationship j_1j_2. Player j_1 could believe that relationships j_2j_3 and j_3j_4 are severed or maintained. If both arcs are currently maintained, according to the continuation strategy j_2j_3 will be severed next period and j_3j_4 in the period after that. The arc j_4j_1 would therefore be severed three periods into the future and, if $\delta \in \Delta$, j_1's best response given these beliefs is to sever j_4j_1 in two periods. If, however, j_2j_3 and j_3j_4 have already been severed, player j_1 should sever the relationship

does not exist a BFE on any cycle network except the strong triangle. For $\bar{c} = 0.9$, $\underline{c} = 0.5$ the whole network D_3^C can be fully maintained in a BFE if and only if $\delta \geq 0.73$, but for $n > 3$ any relationship in D_n^C can be maintained if and only if $\delta \geq 0.9$. This is in contrast to our findings under PBE where the range of discount factors for which network enforcement is incentive compatible decreases quickly as n increases, but this range vanishes only as n goes to infinity. The reason there are no BFE in large cycles is an absence of "connectivity": In contrast to D_3^C there are players in D_n^C who are not connected to each other by a bilateral relationship when $n > 3$. This suggests that belief-free equilibria require that networks be tightly connected. The appropriate formalization of this idea is given by a notion of *triadic closure*.

Definition 3 (Triadic closure) *A digraph $D = (N, A)$ satisfies triadic closure if $\{lk, \underline{kj}\} \subset A$ implies $\underline{lj} \in A$.*

The terminology of triadic closure is borrowed from social network theory (see, e.g., Grannovetter, 1973). In sociology it expresses the idea that if two people share a common acquaintance it is likely that they will also know each other.[26] We show in Theorem 3 (below) that network enforcement is only possible in a belief-free equilibrium if two players with a common partner also have a bilateral relationship. In some sense, this provides a justification for triadic closure that – to our knowledge – has not yet been established formally. When individuals share acquaintances, they have access to very robust enforcement mechanisms that overcome private monitoring constraints because deviations in any one relationship can quickly be communicated to the whole community.

6.2 Belief-free network enforcement and triadic closure

To characterize belief-free network enforcement, we again define an appropriate weighting function, $\Phi_{BFE}(D)$, as follows,

$$\Phi_{BFE}(D) = \frac{-(r(D) - \underline{c}) + \sqrt{(r(D) - \underline{c})^2 + 4r(D)\bar{c}}}{2}. \tag{11}$$

Φ_{BFE} is a weighted average of $\bar{c}$ and $\underline{c}$ taking values in $[\underline{c}, \bar{c}]$ according to $r(D)$. While Φ_{Pub} was derived by considering the payoff from severing a set of arcs A that would otherwise be maintained in one period, Φ_{BFE} is derived by considering the payoff from severing all out-arcs in A in one period, and then severing all in-arcs in A one period thereafter.

to j_4 immediately. There are at least two systems of beliefs that are consistent with s^{priv}. The latter can support s^{priv} as a PBE for $\delta \in \Delta$. But s^{priv} cannot be a BFE since there exist j_1-observable histories under which player j_1's best responses are not the same under two distinct belief systems in $\Psi(s)$.

[26] Kossinets and Watts (2006) provide empirical evidence in support of triadic closure using e-mail data.

Theorem 3 *Suppose that the network game on a digraph D satisfies Assumptions* 1 *and* 3*.*

1. *If subdigraph $D' \subset D$ satisfies triadic closure and $\delta' \geq \Phi_{BFE}(D')$, then there exists a belief-free equilibrium s of the network game on D in which D' is fully maintained for all $\delta \in [\delta', 1)$.*
2. *If $D' \subset D$ is fully maintained in a belief-free equilibrium s of the network game on D, then there exists $D'' \supset D'$ such that D'' is fully maintained under s, D'' satisfies triadic closure and $\delta' \geq \Phi_{BFE}(D'')$.*

Proof. The proof is given in Mihm et al. 2009. ■

The duality between *Problem 1* and *Problem 2* also underlies Theorem 3. As under public information, the maximal ratio, $r(.)$, is a sufficient statistic. If D' satisfies triadic closure, coordination with respect to severance is enough to induce maintenance without the need to form beliefs about where deviations originated. On the other hand, if a network does not satisfy triadic closure, players who observe a deviation must form beliefs about who else in the network has already observed a deviation, and best responses depend on these beliefs. As in private and public network enforcement, belief-free network enforcement requires that players in the fully maintained network play a balancing role, and the incentive compatibility constraint given by Φ_{BFE} in Theorem 3 indicate that the balancing role may again be quite different across nodes. The information transmission role does not appear in Φ_{BFE}, but is in the restriction to networks satisfying triadic closure. In a BFE all players must be in a position to directly transmit information regarding a deviation from equilibrium to all players in the network who occupy a balancing role with respect to them, or who play a balancing role with respect to someone who plays a balancing role with respect to them, and so on. Transmission is then similar to a public signal except that there is a one period delay and transmission is via many private signals as opposed to a single public signal. Hence, on very densely connected networks, private network enforcement can operate in a similar way to public network enforcement, but while increasing the distance between nodes has no effect on public network enforcement, it rules out belief-free network enforcement altogether.[27]

[27] In the comparison between wheel and cycle digraphs in Section 5, we observed that sinks perform an important task: The sink in a typical wheel network $D^W_{n,0}$ bridges the "structural hole" that otherwise exists between nodes that are far apart in the network. However, sinks in a digraph satisfying triadic closure do not play the same role. In fact, the subdigraph in which all arcs connected to a sink are severed still satisfies triadic closure. Since the ratio of each node in the remaining subdigraph must be lower, existence of BFE in which the whole subdigraph is fully maintained implies existence of a BFE when relationships to any sink are severed.

As a corollary to Theorem 3, triadic closure and an absence of sources are both necessary and sufficient for full maintenance in a BFE for some $\delta \in \Delta$.

Corollary 3 *Suppose that the network game on a digraph D satisfies Assumptions* 1 *and* 3*, and that $\delta \in \Delta$.*

1. *If $D' \subset D$ has no sources and satisfies triadic closure, then there exists a belief-free equilibrium s of the network game on D in which D' is fully maintained for δ sufficiently large.*
2. *If subdigraph $D' \subset D$ is fully maintained in a belief-free equilibrium s of the network game on D, then there exists $D'' \supset D'$ such that D'' is fully maintained under s, has no sources and satisfies triadic closure.*

Proof. The proof is given in Mihm et al. 2009. ■

An important class of networks that satisfy triadic closure is the class of tournaments. A digraph D satisfying Assumption 1 is called a *tournament* if there is an arc connecting any two nodes in the network (i.e., $i, j \in N(D)$ implies $\underline{ij} \in A(D)$). While triadic closure is a local network property, in Mihm et al. (2009) we give a complete global characterization of networks satisfying triadic closure that is closely related to tournaments, and which we therefore call a quasi-tournament network structure. Basically, a digraph is a quasi-tournaments if it can be partitioned into strongly-connected tournaments, and these parts satisfy a global version of triadic closure (see Mihm et al., 2009, for details).

Tournaments (and quasi-tournaments) are common in economic environments. One example is the network of interconnections between large financial trading institutions, transacting in financial products such as commercial paper and credit default swaps.[28] The structure of interactions in this network is dense, with bilateral flows of transactions between firms that are only partially observed by outsiders, and which often imply highly asymmetric net obligations. Although the transactions are organized via formal markets, it has long been recognized that trust and informal enforcement between trading partners are crucial to the functioning of these markets (see, e.g. Mayer, 2008; or Allen and Babus, 2008, who also argue that tight networks may be important for monitoring in financial networks).[29] Theorem 3 demonstrates that tournament networks can serve as an institution to assist the market in pooling risk and asymmetries in a particularly robust sense. However, Theorem 3

[28] See Economides (1993) for a simple description of financial networks.

[29] Baker et al. (2004) also observe that in many R&D information-sharing networks the central core of companies that share the most information tends to be very tight, like a quasi-tournament, though they do not use that terminology.

also illustrates a sense in which belief-free network enforcement is fragile. The only strategy that constitutes a BFE on a tournament is "maintain as long as all observed arcs are maintained, and sever all remaining arcs immediately otherwise." While this provides a powerful inducement for others to maintain, it also highlights the potential for swift and crippling severance of cooperative ties if the prescribed path of play is ever left. Tournament networks support enforcement mechanisms that pool asymmetries even with very limited information, but do so by requiring large-scale coordination in punishments.

7 Conclusion

This paper analyzes enforcement mechanisms which foster cooperative behavior between individuals in a network. We show that strategic network externalities can be crucial to achieve efficient outcomes in a network of *a priori* independent relationships, and study constraints on such network effects coming from the structure of the underlying network and the monitoring capabilities across relationships. Intuitively, network effects arise when individuals understand that the way they behave in their own relationships influences the way their partners behave towards others in the network. If individuals believe that what goes around *can* come around, concerns about contagion become a powerful inducement to cooperate. Moreover, if individuals cooperate in some relationships only because of contagion concerns, they in turn become vehicles for further contagion if the incentive to cooperate is ever removed. As a result, social institutions can arise on the network and establish correlations between *a priori* independent bilateral relationships. Our model allows for a sharp characterization of such correlations in terms of equilibrium conditions of the dynamic network game. Specifically, we find that the network occupies a dual role. On the one hand, network institutions that utilize strategic interdependencies between network relations foster cooperation in long-term relationships. Hence, behavior observed in individual relationships that is difficult to rationalize when these are viewed as isolated entities makes sense when we account for the embeddedness in a network. On the other hand, network structure also imposes constraints on network enforcement mechanisms, and this leads to a clear connection between the incentives of individuals and the global network architecture.

Restrictions on monitoring are crucial to a good understanding of the interconnection between network structure and individual incentives. On networks exhibiting a small-worlds structure we find that network enforcement can be effective, even when monitoring is fully decentralized. However, under private information strategic indirect reciprocity is constrained by the inability of individuals to monitor that informal agreements in distant relationships are being upheld. As a result, we find that network enforcement is only effective on networks exhibiting a small-worlds structure. The conclusion that strategic indirect reciprocity requires small-worlds is further underscored by looking at belief-free network enforcement. Here we find that networks must exhibit a form of triadic closure, which implies a very stark small-worlds prediction. While the perfect Bayesian and belief-free analysis are motivated in part by different interpretations of the model, they lead to qualitatively similar conclusions on global network structure. In particular, the conclusions we reach for private and belief-free network enforcement are much closer than our findings under public information. In all three cases we observe the incentive constraints that arise due to a balancing role that individuals must play in network enforcement. However, unlike under public information, the analysis of private information also highlights the information transmission role in network enforcement, and this leads to the small-worlds structure. As a result, our model suggests an institutional rationale for this pervasive structure of social and economic interactions.

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