

REPUTATION

EXAMPLE ("THE CHAIN STORE PARADOX")

CONSIDER AGAIN THE SITUATION DESCRIBED AT THE BEGINNING OF THE SECTION ON COMMITMENT, NAMELY, THE SITUATION IN WHICH NO COMMITMENT IS POSSIBLE AND THE ONLY "PERFECT" NASH EQUIL'BM IS THE ONE IN WHICH ENTRY OCCURS AND THE INCUMBENT ACQUIESCES.

SUPPOSE THE INCUMBENT COULD FORESEE, IF HE WERE TO SOMEHOW REPEL ENTRY, THAT HE WOULD BE PLAYING THIS SAME GAME REPEATEDLY, WITH PERHAPS MANY POTENTIAL ENTRANTS, IN THE FUTURE. THEN IT SEEMS AS IF IT MIGHT BE WORTHWHILE TO THE INCUMBENT TO ACTUALLY "CARRY OUT HIS THREAT" AND FIGHT IF THE ENTRANT CHOOSES TO ENTER, BECAUSE THIS WOULD ESTABLISH A REPUTATION FOR FIGHTING AND THUS DETER FUTURE POTENTIAL ENTRANTS —i.e., BY CHOOSING "SUPERGAME" STRATEGY OF "FIGHT IN RESPONSE TO ENTRY," THE INCUMBENT WILL INDUCE LITTLE OR NO ENTRY, SO THE LOSS FROM FIGHTING IS RARELY IF EVER ACTUALLY SUFFERED. LONG-RUN (AVERAGE) GAINS FROM FIGHTING SEEM TO JUSTIFY ITS SHORT-RUN LOSSES.

OTHER EXAMPLES:

(1) HONESTY, SELLING A GOOD PRODUCT, ETC. (BY A SELLER):

IN EACH INDIVIDUAL SALE, SELLER WOULD GAIN BY SELLING A "CHEAPER" PRODUCT (BUT NOT REVEALING ITS LOWER QUALITY), BUT LONG-RUN GAINS FROM HONESTY OR FULL DISCLOSURE OUTWEIGH ITS SHORT-RUN SACRIFICES.

(2) REPAYING A LOAN: AT THE LAST PERIOD, IT IS BETTER FOR THE BORROWER TO DEFAULT, THEREFORE FOR EACH POTENTIAL LENDER NOT TO LEND. EQUILIBRIUM IS THEREFORE FOR NO LENDER TO LEND AT ANY PERIOD.

"UNRAVELLING OF REPUTATIONAL EQUILIBRIUM:

SAME ARGUMENT — WITH FINITE (KNOWN)

HORIZON — AS IN THE PRISONERS' DILEMMA:

IN THE LAST PLAY, REPUTATION IS MEANINGLESS,
AND THEREFORE ENTRY WILL BE MET BY ACQUIESCENCE;

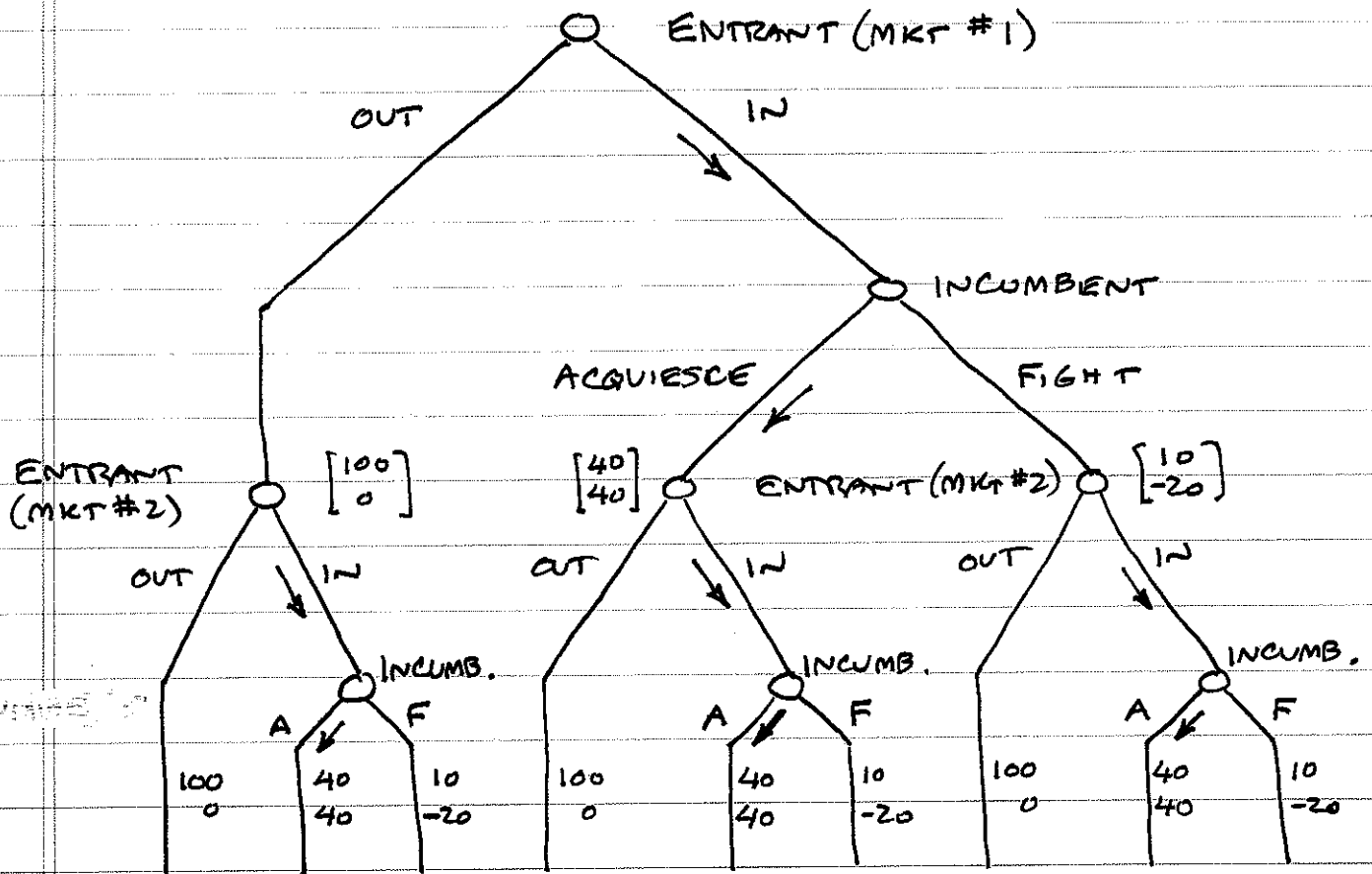
THUS, IN THE NEXT-TO-LAST PLAY REPUTATION-BUILDING
IS WORTHLESS, SO INCUMBENT WILL ACQUIESCE; ... ETC.

INCUMBENT THUS ALWAYS ACQUIESCES, BECAUSE
REPUTATION IS NEVER ACTUALLY WORTH ANYTHING.

THE CHAIN STORE PARADOX

(W/ TWO POTENTIAL ENTRANTS)

		ENTRANT	
		IN	OUT
INCUMBENT	FIGHT	10, -20	100, 0
	ACQUIESCE	40, 40	100, 0



INCUMBENT →	200	140	110	140	80	50	110	50	20
ENTRANT 1 →	0	0	0	40	40	40	-20	-20	-20
ENTRANT 2 →	0	40	-20	0	40	-20	0	40	-20

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BEST
OUTCOME
FOR
INCUMBENT