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Competitive Burnout: Theory and Experimental Evidence*

J. Atsu Amegashie

C. Bram Cadsby

Yang Song

Department of Economics

University of Guelph

Guelph, Ontario

Canada N1G 2W1

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Send correspondence to: Bram Cadsby, University of Guelph, Department of Economics, Guelph, Ontario, Canada, N1G 2W1. Fax: 519-763-8497. Email: bcadsby@uoguelph.ca.

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Abstract

We examine equilibrium selection in a two-stage sequential elimination contest in which contestants compete for a single prize. This game has a continuum of equilibria, only one of which satisfies the Coalition-Proof Nash Equilibrium (CPNE) refinement. That equilibrium involves "burning out" by using all of one's resources in the first stage. It is Pareto-dominated by many other equilibria. We find that CPNE predicts well when four people compete, but not when eight people compete for two second-stage spots. Using a cognitive hierarchy (CH) framework, we show that when the number of players and the mean number of thinking steps are large, the CH prediction involves burning out. This provides a partial explanation of our results. We also develop a formal argument as to why CPNE logic is more compelling with more players. We conclude that more competition leads to higher bids, and that burning out is indeed a competitive phenonemon.

Keywords: all-pay auction, burning out, cognitive hierarchy, coalition-proof Nash equilibrium, contests, experiment, step thinking.

Introduction

Contests are an important fact and pervasive aspect of economic life. A contest is a game in which players compete over a prize by making irreversible outlays. Election campaigns, rent-seeking games, R & D races, competition for monopolies, litigation, wars, and sports are all examples of contests.

A common feature of contests is that they involve multiple stages where the set of contestants is narrowed in successive stages of the contest until a winner is finally chosen. Another feature of contests is that the players may be constrained in terms of how much effort or outlay they can expend (e.g., Che and Gale, 1997; 1998; Gavious et al., 2002). In a sequential elimination contest with such a constraint, it may be rational for contestants to expend *all* their efforts in earlier stages, thus burning out and having nothing left to offer in subsequent stages. Amegashie (2004) shows that under certain conditions burning out in this manner may be equilibrium-consistent rational behavior even though the ultimate prize is won only if a contestant is successful in all stages including the final one.

However, in this setting the burning-out equilibrium is not the only equilibrium. There are also equilibria in which the players do not burn out. Indeed, there is a continuum of equilibria, many of which are Pareto-rankable. The presence of multiple Pareto-rankable equilibria suggests that it is desirable for the players to coordinate on Pareto-dominant equilibria. Since the burning-out equilibrium is always Pareto-dominated by many other equilibria, it is never Pareto optimal to burn out.

Similar kinds of coordination problems are common in many economic contexts. A frequently-cited example is the case of team production. If low effort on the part of one worker reduces the marginal products of other team members, it may not be optimal for a particular worker to exert high effort when the efforts of another are low. In this case, the team may be stuck in a low-effort equilibrium even though all team members would be better off in a high-effort equilibrium.

Economists and game theorists have proposed solutions to equilibrium selection in such games. Some of these include focal points (Schelling, 1960), belief-learning (Camerer and Ho, 1999), and Pareto dominance (Harsanyi and Selten, 1988). A growing area of research examines coordination games experimentally in order to shed light on the issue of equilibrium selection (e.g., Van Huyck et al., 1990, 1991; Camerer and Knez, 1994; Van Huyck et al., 2001; Anderson et al., 2001; Berninghaus et al., 2002).[1] Generally, this literature finds that smaller groups reach more efficient equilibria than larger groups, especially when play is repeated with a fixed group of participants.

This paper contributes to this line of research by examining equilibrium selection in a two-stage sequential elimination contest in which a group of contestants competes to win a single prize. Only a subset of the participants survives the first stage. In the second stage, the survivors compete once more, with the winner taking home the prize. Like the weak-link team-production coordination game described above, the sequential elimination game has a continuum of Nash equilibria. In contrast to the weak-link coordination game, which has a continuum of Pareto-rankable equilibria, many but not necessarily all of the equilibria in the sequential elimination game are Pareto-rankable. A more significant contrast between the two games is that the main point of a sequential elimination contest is not cooperation to produce a high return for the group, but competition to win a single valuable prize. Thus, in the sequential elimination game, the equilibrium selected through some process of coordination by group members affects the earnings of the group as a whole even as its members compete for the ultimate prize. Is cooperation to maximize group welfare possible in such a competitive context?

A refinement of Nash equilibrium, in particular the Coaliton-Proof Nash Equilibrium (CPNE) concept (Bernheim et al., 1987), suggests that the answer to this question is no. Garratt et al. (in press) find that CPNE has considerable predictive power when it exists in a game of coalition government formation. Gillette et al. (2003; 2004), however, find only limited support for the predictive power of CPNE when compared to that of an equilibrium that is strictly

[1] Chapter 7 of Camerer (2003) provides an excellent summary of this literature.

preferred by all agents. The unique CPNE in our game involves the exertion of maximum effort to the point of complete burnout during the first stage of the game, leaving no resources to utilize during the second stage. From the perspective of the competing participants, the burning-out CPNE is Pareto-dominated by many other equilibria in the game. Since the CPNE refinement is Pareto-dominated by many other equilibria, this is a challenging context in which to assess the predictive power of the refinement.

The burning-out equilibrium is somewhat puzzling because of its counter-intuitive prediction that active contestants expend *all* their energies or resources in stage one, get burned-out, and thus have nothing left to offer in stage two. Recently, Parco et al. (in press) and Amaldoss and Rapoport (2005) both ran experiments based on an interesting, but rather different two-stage game.[2] In their game, no equilibrium predicts burning out. However, they nonetheless found that their contestants overspent in stage one relative to the equilibrium prediction. In our framework, it is consistent with equilibrium behavior for contestants to go much further and use up all of their resources in the first stage of a two-stage contest. Under what circumstances will we observe the behavior predicted by such an equilibrium, despite its inefficiency and seemingly myopic nature?

Our experimental results show little evidence of cooperation to maximize group welfare. Furthermore, they indicate that the predicted burning-out result is more likely to emerge when there are more rather than fewer players. This contrasts with the CPNE prediction of burning-out regardless of the number of players. We examine this puzzle using a cognitive hierarchy (CH) model, recently developed by Camerer et al. (2004). In that model, players engage in differing numbers of thinking steps, while overconfidently believing that other players engage in fewer thinking steps. We show that when the number of players and the mean number of thinking steps

[2] The main differences between the model examined by both Parco et al (in press) and Amaldoss and Rapoport (2005) compared with the model tested here are: (a) they do not use an all-pay auction; (b) they use identical contestants, while our contestants have different valuations; (c) their players compete with only a subset of the contestants in stage one, meeting the other winners of the stage one contests in stage two, while ours meet all the contestants in stage one, playing the subset of players who are successful at stage one in stage two; (d) their game has neither a burnout equilibrium nor an equilibrium at which each player bids zero in stage one; and (e) their game does not have multiple equilibria.

are both sufficiently large, the CH prediction involves burning out by using all of one's resources in the first stage.

We estimate the mean number of thinking steps based on the experimental data from the first two periods of each session of our eight-period experimental game. We find that it is very close to 0 in the initial period for both four-player and eight-player treatments. In the eight-player case, it is substantially higher in the second period. After the first two periods, the CH model is less relevant because players learn about the behavior and beliefs of others as they experience more periods of play. Indeed, the predictions of the CH model are often inconsistent with the results of later periods.

In the later periods, CPNE is not a good predictor of behavior when four people compete for two second-stage spots, but it does predict well when eight people compete for the two available spots. We provide an analysis of this result, arguing that the logic of CPNE is more likely to affect equilibrium selection when the number of players is large since there is more chance that two or more players will deviate from a lower to a higher bid.

In the next section, we describe and analyze the two-stage sequential elimination game. Section 3 presents the experimental design and section 4 discusses the results. Section 5 uses the cognitive hierarchy model of Camerer et al. (2004) to examine the relationship between the level of bids and the number of players in the early periods of the game. Section 6 presents a formal discussion based on CPNE of why burning-out occurs when there are eight players, but not when there are four players. Section 7 concludes the paper.

2. A Two-Stage Sequential Elimination Game

In Amegashie (2004), the following game is presented. Consider $N \geq 3$ risk-neutral agents contesting for a prize with valuations commonly known to be $V_1 \geq V_2 \geq \ldots V_{N-1} \geq V_N > 0$, where V_i is the valuation of the i-th contestant, i = 1, 2, …, N-1, N. The contest is divided into two stages. In the first stage, the F contestants with the highest bids or effort levels are chosen to compete in a second stage from which the ultimate winner is chosen, where $2 \leq F < N$. Ties are broken randomly in each stage. Formally, the contest success function in stage one is:

$$P_{1i} = \begin{cases} 1 \quad \text{if } e_i \text{ is one of the top F effort levels and is not tied with anyone,} \\ (F-g)/(r+1) \quad \text{if g contestents bid higher than the i-th contestant and this contestant ties with r} \\ \text{other contestants where } g+r+1 > F \text{ and } 0 \le g \le F, \end{cases}$$

where P_{1i} = the probability of advancing from stage one to stage two and e_i = the effort level of player i. In stage two, the contestant with the highest bid wins. Note that the contest in each stage is an all-pay auction.[3]

Following Che and Gale (1997; 1998) and Gavious et al. (2002), suppose all contestants face a common budgetary or effort constraint or cap, B > 0. These papers give examples of caps in contests: caps on campaign contributions, salary caps in US professional sports[4], and caps on how fast Formula 1 racing cars can move. Also, a cap on effort arises because human beings naturally have a limit on how much effort they can expend.

Suppose B can be allocated between the two stages. Let e_i and x_i be the bid or effort levels of the i-th contestant in stages 1 and 2 respectively, where $e_i + x_i \le B$. We assume that e_i and x_i also represent the cost of expending effort, i.e. the cost function of effort is linear. In each stage, the contestants move simultaneously.

Let $P_{1i}(\tilde{e}) = P_{1i}(e_1, e_2, ..., e_N)$ and $P_{2i}(\tilde{x}) = P_{2i}(x_1, x_2, ..., x_F)$ be the success probabilities of the i-th contestant in stages 1 and 2 respectively. Denote the equilibrium success probabilities by $P_{1i}^*(\tilde{e}^*)$ and $P_{2i}^*(\tilde{x}^*)$ for the i-th contestant.

In stage two, the equilibrium expected payoff of the i-th contestant, conditional on making it to that stage, is $\Pi_{2i}^* = P_{2i}^*(\tilde{x}^*)V_i - x_i^*$. Focusing on a subgame perfect Nash equilibrium and applying backward induction, the equilibrium payoff to the i-th contestant in stage one is $\Pi_{1i}^* = P_{1i}^*(\tilde{e}^*)\Pi_{2i}^* - e_i^*$.

The solution to this game is summarized in the following proposition:

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[3] See Baye et. al. (1996) and Clark and Riis (1998) for analyses of all-pay auctions.
[4] As noted by Gavious et al. (2002), in the year 2000, NFL teams faced a salary cap of $62,172,000. This was a cap on the aggregate amount they could spend on their top 51 salaried players.

Proposition 1: *Consider a two-stage contest where the contest in each stage is an all-pay auction and the contestants have valuations commonly known to be* $V_1 \geq V_2 \geq \ldots V_{N-1} \geq V_N$*. If* $F \geq 2$ *contestants are chosen in the first stage to compete in the second stage and all the contestants face a common budget (effort) constraint, B, which can be allocated between the two stages, then a given equilibrium effort allocation (e*, B-e*) between the two stages induces a corresponding equilibrium number of active contestants, K, such that* $\Pi_i^* = (F/K)[(1/F)V_i - (B-e^*)] - e^* \geq 0$ *for* $e^* \in [0, B]$*, i = 1, 2, …, K-1, K and* $\Pi_i^* = (F/(K+1))[(1/F)V_i - (B-e^*)] - e^* < 0$ *for* $e^* \in [0, B]$*, i = K+1, K+2,…, N-1, N and* $F < K \leq N$*. In any equilibrium, the active contestants i = 1, 2, …, K-1, K bid e* in stage one and B-e* in stage two, while the rest bid zero in each stage.*[5]

Proof: In any equilibrium the expected payoff for the i-th active player is $\Pi_i^* = (F/K)[(1/F)V_i - (B-e^*)] - e^* \geq 0$, i = 1, 2, …, K-1, K. If $F \geq 3$, a player who deviates from this equilibrium by bidding marginally more than e* in stage one guarantees entry to stage two, but will then lose in stage two with certainty since he/she will be joined by, at least two players who, having bid e* in stage one, have bigger caps in stage two. There exists a pure-strategy equilibrium in the stage-two subgame in which the players with the bigger cap in stage two will bid their cap. This will yield an expected payoff lower than the equilibrium expected payoff for the player who deviated. If F = 2, a player who deviates by bidding marginally more than e* in stage one guarantees entry to stage two, but will be joined by a player who bid e* in stage one and hence has a bigger cap in stage two. In this case, there is no equilibrium in pure-strategies in the stage-two subgame. However, in any mixed-strategy equilibrium in stage two, the player with the smaller cap will get a zero expected payoff, [6] which is less than the expected payoff in the symmetric equilibrium in which everyone bids e* in stage one. Hence, it is not profitable for any player to deviate by bidding more than e* if F = 2. A player who bids less than e* in stage

[5] Equilibria may also exist in which a player with a lower valuation is active (i.e., bids a positive amount in at least one of the stages) while a player with a higher valuation bids nothing in either stage. The existence of such an equilibrium requires that the difference in valuations between these two players be sufficiently small. We do not focus on such equilibria. Note also that we assume that if a player is indifferent between participating in the contest and staying out, he will participate.

[6] See appendix A for a proof of this result, adapted with slight modifications from Amegashie (2004).

one will lose with certainty in that stage, yielding an expected payoff lower than the equilibrium expected payoff. Hence there is no profitable deviation from the equilibrium stated in the proposition for an active player. The players i = K +1,…, N-1, N, have no incentive to participate if $[F/(K+1)][(1/F)V_i – (B-e^*)] – e^* < 0$ for $e^* \in [0, B]$.**Q.E.D.**

According to proposition 1, different values of e* may induce different numbers of active contestants, K. If K and e* vary simultaneously, a Pareto ranking of the different equilibria is not straightforward. For the sake of exposition, we initially investigate the Pareto ranking of equilibria that share a common number of active participants, K. For a given K, all such equilibria can be ranked by noting that $\delta \Pi_i^* / \delta e^* = F/K – 1 < 0$. Hence the equilibrium with the lowest e* gives the highest expected payoff and the equilibrium with the highest e* gives the lowest expected payoff for i = 1, 2,…, K-1, K. This of course implies that the burning-out equilibrium in which e* = B, the highest possible e*, is Pareto-dominated by all other equilibria with the same number of active participants, K, since each of those equilibria has an e* < B.

As indicated above, a general Pareto ranking of the different equilibria is less straightforward when comparing equilibria with different K's. When equilibria with different K's exist, the burning-out equilibrium may not be Pareto-dominated by all other equilibria. To see this, consider a burning-out equilibrium with K_1 active contestants and N-K_1 passive contestants. Then there can be no equilibrium with less than K_1 contestants. The reason is that any contestant in the burning-out equilibrium that has K_1 contestants will want to participate actively in any hypothetical equilibrium with less than K_1 contestants, given our assumption that a player who is indifferent between participating in the contest and staying out will participate. It follows that only K_1 contestants can sustain a burning-out equilibrium. The remaining equilibria are those with K_1 or more players. Hence the burning-out equilibrium has the lowest number of players. It is possible that some players are better off in the burning-out equilibrium than in some other equilibrium with more active players and hence less chance of winning the prize. We construct an example in Appendix B1 showing that the burning-out equilibrium can weakly Pareto-dominate another equilibrium with a larger number of active participants. However, there will always be many equilibria, including all of those with the same number of participants as the burning-out equilibrium, that will Pareto-dominate burning out. For the parameters used in our experimental treatments, all equilibria Pareto-dominate burning out.

If we apply the Coalition-Proof Nash Equilibrium (CPNE) refinement,[7] which allows for joint deviations, the burning-out equilibrium, in which e* = B, is the only surviving pure-strategy equilibrium. To see this, consider an equilibrium in which all the contestants in stage one bid e* < B. Suppose a group of M contestants deviate by bidding marginally more than e* in stage one.[8] If M = F ≥ 2, then they are all guaranteed entry to stage two. Their payoff will be $\Pi_i^d = (1/F)V_i - B > 0$. It is easy to show that $\Pi_i^d > \Pi_i^*$ as long as $(1/F)V_i - (B-e^*) > 0$ which is true for all active players. Note that such a deviation by the M = F players is immune to further deviations by sub-coalitions of this deviating group, since each coalition member's probability of success in stage one is already at a maximum (i.e., 1). Hence, there exists a profitable joint deviation from any equilibrium where e* < B.[9] Neither a single nor joint deviation is feasible at e* = B. Thus, e* = B is the unique pure-strategy CPNE. This leads to the following proposition:

Proposition 2: *Consider a two-stage contest where the contest in each stage is an all-pay auction and the contestants have valuations commonly known to be $V_1 \geq V_2 \geq \ldots V_{N-1} \geq V_N$. If F ≥ 2 contestants are chosen in the first stage to compete in the second stage and all the contestants face a common budget (effort) constraint, B, which can be allocated between the two stages, then there exists a continuum of symmetric pure-strategy Nash equilibria in which each active contestant bids $e^* \in [0, B]$ in stage one and B – e* in stage two but e* = B is the only coalition-proof Nash equilibrium*.

We experimentally investigate the following issues. First, how does the value of the prize

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[7] See Bernheim et. al (1987) for a discussion of CPNE.

[8] In the experiment, only integer bids were permitted. Thus, in our experimental context, a bid marginally more than e* may be interpreted as a bid of e* + 1.

[9] Notice that a deviation by M > F players to bid more than e* is not immune to further deviations by a sub-coalition of F players. A deviation is also not profitable for M < F players because they will be joined by, at least, one player who has a bigger cap in stage two. In any case, to show that any equilibrium with e* < B is not CPNE, we only need to show that there exists a coalition size which can deviate profitably.

affect the effort or bid level? Given K active contestants bidding $e = e^*$ with $e^* \in [0, B]$, a risk neutral player i should bid e^* in stage one and $B-e^*$ in stage two if $(F/(K+1))[(1/F)V_i - (B-e^*)] - e^* \geq 0$ and should bid zero in both stages if $(F/(K+1))[(1/F)V_i - (B-e^*)] - e^* < 0$. Actual players need not be risk-neutral. Nonetheless, for each player there should be a critical valuation level consistent with his/her level of risk aversion that would induce a bid of e* rather than zero.

Second, do we observe Pareto-preferred equilibria, or do we find the burning out predicted by the CPNE refinement, despite the fact that this unique CPNE is Pareto-dominated by other pure-strategy Nash equilibria? Under what if any circumstances will players allocate all their efforts to stage one when there is another stage ahead? Will there be a process of convergence to the burning-out CPNE over the rounds of a finite repeated game?

Third, will the feedback received between rounds make a difference to the convergence process? Whether or not winning bids are announced at the end of each stage makes no difference to Nash equilibrium predictions. Nash equilibria are based on consistent beliefs, beliefs that are simply confirmed with announcements of winning bids. However, a number of recent papers have suggested that the type of feedback provided between periods of play can significantly affect bids in first-price sealed bid auctions despite having no effect on Nash predictions (e.g., Neugebauer and Selten, 2003; Ockenfels and Selten, 2005). In particular, Neugebauer and Selten (2003) found that bids were significantly higher when winning bids were revealed to participants than when they were told only whether they had won the auction or not.[10] They attributed this result to an asymmetry that arises when only winning bids are revealed. Losers receive a clear signal about how much more they should have bid to win the auction. However, winners do not receive an analogous signal about how much less they could have bid without losing the auction. Neugebauer and Selten (2003) argue that this asymmetric revelation of winning bids pushes bids upward over repeated rounds of play. Similarly, we

[10] In contrast, Dufwenberg and Gneezy (2002) found that when the entire vector of bids was annouced, this feedback affected behavior in the lab. However, announcing only the winning bid did not affect behavior relative to announcing nothing between periods of play.

hypothesize that announcing successful bids might promote higher stage-one bids as our two-stage all-pay auction unfolds, leading to faster convergence to the burning-out CPNE.

Fourth, how does the number of players affect the equilibrium. Earlier experimental studies of coordination games have shown that coordination on Pareto-superior outcomes is harder to sustain with more players. For example, Camerer and Knez (1994) argue that coordination on Pareto-superior outcomes in their minimum-effort coordination game was difficult to sustain for more than two players because forming beliefs about the behavior of other players becomes more complex with larger numbers. While two players only have to worry about each other's beliefs, the introduction of additional players forces everyone to think about the beliefs that each player has about the others in order to predict behavior. In the above analysis the uniqueness of the burning-out CPNE is independent of the number of players. However, the predictive power of the burning-out CPNE may depend on the number of players, since the higher the number of players, the more likely it is that some coalition of $F \geq 2$ players will deviate from a non burning-out equilibrium, as discussed more formally in our theoretical analysis of the results in section 6.

3. Experimental Design

We ran twelve sessions with participants who were undergraduate students at the University of Guelph. They were recruited in the University Centre. A thirteenth session was run using economics professors at the University of Guelph. Participants received a \$3.00 Canadian show-up fee. The rest of their earnings depended on their performance in the game. Average earnings were \$13.20 Canadian, equal to about \$10.00 US, inclusive of the show-up fee. The sessions lasted about one hour.

Upon entering the room, participants were asked to take a seat and were assigned a player number. Written instructions were distributed.[11] The instructions were then read aloud while participants followed along on their own copies. The experiment lasted for eight periods, each of

[11] A copy of the instructions is attached as Appendix C.

which was divided into two stages. At the beginning of each period, each participant was asked to draw an envelope containing an information slip from a box held by the experimenter. The randomly selected information slip told each participant his/her potential prize value. There were four different prize values. Participants were also told the prize values assigned to the other players. The potential prize values determined the monetary payoff of each participant if he/she won the prize at the end of stage two. The information slip also indicated that each participant had an endowment of 50 tokens, some or all of which could be used to place bids in stages one and two. Each token was worth two cents Canadian. Any tokens that were not used in either stage could be cashed in at the end of the game.

In stage one, participants were given the opportunity to bid any integer amount of tokens between zero and their budgetary caps of 50. After writing their bids in the designated space on their information slips, participants raised their hands and the experimenter collected the slips. Participants understood that once bids were placed, the amount bid would not be returned, regardless of whether or not they won the prize. The two participants with the highest bids were then privately informed that they would move on to stage two. Ties were broken randomly by a draw. Other participants were informed privately that they would not be moving on. Their earnings for the period were 50 tokens minus their stage-one bids.

The two participants who reached stage two were then given the opportunity to bid any amount of tokens from zero up to whatever number of tokens remained after their stage-one bids by writing the desired amount in the designated space on their information slips. The participants who had not reached stage two were asked to write zero in the designated space so that it would not be obvious which two players were still in the game. The person who placed the highest stage-two bid was then privately informed that he/she had won the prize, which was worth the amount that had been indicated on his/her information slip. As in stage one, a random draw was used to determine the final winner if both participants bid the same amount.

At the end of each period, the information slips were returned to each participant, indicating his/her earnings for the period. Earnings were equal to the 50-token endowment plus the payoff from playing the game. Thus, the earnings of the final winner consisted of the 50-token endowment, minus the tokens bid in stages one and two, plus the prize value drawn at the beginning of the period. The earnings of the other participants consisted of the 50-token endowment, minus the bid or bids placed during the period.

At the beginning of a new period, each participant drew a new information slip at random containing a new prize value. Tokens from earlier periods could not be used in the new period. Each participant began each period with exactly 50 tokens.

We ran four treatments, which are summarized in Table 1.

Treatment 1 - Four persons, no announcement of winning bids: In the first treatment, four persons participated in the game. Participants were informed at the end of stage one whether or not they would advance to stage two. However, they were not given any information about the level of the successful bids. Similarly, at the end of stage two, continuing participants were informed whether or not they had won the prize. However, they were not told the level of the winning bid.

Treatment 2 - Four persons, announcement of winning bids: Once again in treatment 2, four persons participated in the game. However, in this treatment, the two stage-one bids of those moving on to stage two were publicly announced after stage one and the stage-two bid of the final winner was publicly announced after stage two.

Treatment 3 - Eight persons, no announcement of winning bids: In treatment 3, eight persons participated in the game. As in treatment 1, successful wins were not announced.

Treatment 4 - Eight persons, announcement of winning bids: In treatment 4, eight persons participated in the game. As in treatment 2, successful bids were announced.

In treatments 1 and 2, the prize values assigned randomly to the four participants were set at 100, 170, 230 and 300 tokens. Consider a risk-neutral participant who believed the other three participants would also behave as if they were risk-neutral. If such a participant drew the possibility of winning the 100-token prize, proposition 1 indicates that he/she would bid zero in both stages for all non-zero equilibria since $(F/K+1)[(1/F)V_i - (B\text{-}e^*)] - e^* < 0$, for $e^* \in (0, B]$ in this case. If $e^* = 0$, then $(F/K+1)[(1/F)V_i – (B-e^*)] – e^* = 0$. Given the assumption that a player who is indifferent between participating in the contest and staying out will participate, the risk-neutral player with a valuation of 100 tokens would bid zero in stage one and B = 50 in stage two. However, if such a risk-neutral participant drew the possibility of winning one of the other three prizes, proposition 1 indicates that he/she would bid $0 \leq e^* \leq B$ in equilibrium in stage one and $x^* = B – e^*$ in stage two since $(F/K+1)[(1/F)V_i – (B-e^*)] – e^* > 0$ in these cases. The available equilibria for the two treatments with four participants are summarized in the top half of Table 2. In appendix B2 we show that the burning-out CPNE in which K = 3 and $e^* = B = 50$ is the worst equilibrium in the sense that it is Pareto-dominated by all of the other Nash equilibria in the four-player case. We also demonstrate that $e^* = 1$ and K = 3 is the Pareto-optimal equilibrium in this case.

In treatments 3 and 4, the prize values were doubled relative to treatments 1 and 2 in order to hold expected earnings constant across the four- and eight-person treatments. The prize values were accordingly set at 200, 340, 460 and 600 tokens. Each of these prize values was randomly assigned to two of the eight participants. Employing the same reasoning as above, risk neutrality implies a bid of zero for those drawing the 200-token prize in stages one and two when $20 < e^* \leq B$. When $16.667 < e^* \leq 20$, the equilibrium calls for one of the players with the 200-token valuation to bid e* in stage one and B – e* in stage two, while the other bids zero in both stages. Both of the players with the 200-token valuations will bid e* in stage one and B – e* in stage two in any equilibrium in which $0 \leq e^* \leq 16.667$. Those drawing any of the other prize values will place a bid of $0 \leq e^* \leq B$ in equilibrium in stage one and $x^* = B – e^*$ in stage two. The available equilibria for the two treatments with eight participants are summarized in the bottom half of Table 2. In appendix B3, we show that the burning-out CPNE in which K = 6 and $e^* = B = 50$ is the worst equilibrium in the sense that it is dominated by all other equilibria in the eight-player case. In appendix B4, we demonstrate that there are two Pareto-optimal Nash equilibria that are not themselves Pareto-rankable in the eight-person case: K = 8, $e^* = 0$ and K = 6, $e^* = 21$.

Three sessions of each treatment were run using undergraduate student participants and were analyzed in a two-by-two factorial design framework. One session of treatment 2 was run using economics professors. As discussed above, we hypothesized that both announcements of the winning bids and larger numbers of players might facilitate convergence to the burning-out CPNE. In the case of announcements, we conjectured that if everyone learned how much those moving on to stage two had bid in stage one, it might encourage attempts to bid even higher. In the case of eight-person versus four-person competitions, we reasoned that more competitors would increase the likelihood of coalition formation and defection, pushing bids higher.

4. Results

We focus our analysis on the stage-one bids. The CPNE refinement calls for all participants for whom the prize value is sufficiently large to burn out by bidding their entire 50-token endowment in the first stage. Participants for whom the prize value is not large enough to justify bidding withdraw from the contest by bidding zero. Of course, any outcome in which all active participants bid a common amount in stage one is consistent with a Nash equilibrium. The CPNE is Pareto inferior to all of the other pure-strategy Nash equilibria in both the four- and eight-person treatments.

Figures 1 to 5 present representative results from five of the 13 experimental sessions, one from each of the student treatments as well as the one session with economics professors as participants. The bars in the figures indicate the bids placed by the individual participants in the first stage of each period. The bars are ordered by prize value from lowest to highest in each period. The participant numbers appear beneath the figure. Asterisks indicate bids of zero.

Table 3 reports the mean bids and bid standard deviations for active players in the final period of each session.[12] The Pareto-optimal equilibria ($e^* = 1$, $K = 3$ in the four-person treatments; $e^* = 0$, $K = 8$ or $e^* = 21$, $K = 6$ in the eight-person treatments) were not achieved in

[12] We defined active players as those bidding more than one. There were three instances of players bidding one in the last period of a session. None of these three players bid zero in any of the other periods. Thus, it is possible that they did not understand that they were permitted to bid zero, and thus bid one rather than zero when they did not want to compete for the prize.

any of the experimental sessions. The economics professors playing the four-person announcement treatment, illustrated in Figure 3, came closest, converging to a bid of about e* = 20, K=3, which was nonetheless still a whopping 19 tokens above the Pareto-optimal equilibrium bid for the four-person case

Mean active bids in the final period of the eight-person sessions were all within 3.5 tokens of the CPNE burning-out equililbrium. Standard deviations were less than one in all but one eight-person session. While eight-person sessions converged to a bid very close to the CPNE, four-person sessions did not. Mean bids were dramatically lower in all but one four-person session. Standard deviations of active bids were greater than one in four of the six four-person student sessions, indicating less convergence to one of the Nash equilibria.

The figures also indicate that some participants placed a bid of zero. However, only in the case of the economics professors did the bidding behavior suggest reasonably consistent risk neutrality. In every period with the exception of period 2, the economics professor who drew the lowest prize value of 100 bid zero. In both periods 2 and 8, the professor who drew the second-lowest prize value of 170 also placed a zero bid, showing some risk aversion. In the student sessions, some participants who drew low prize values bid positive amounts, while some who drew higher prize values bid zero. Thus, there is evidence of both risk-averse and risk-loving behavior.

If participants had different attitudes toward risk, the prize value required to produce a level of expected earnings high enough to warrant a positive bid at a given e* would differ from person to person. However, one would nonetheless expect the overall probability of a positive bid to be higher, the higher the prize value drawn. In fact, those drawing the lowest prize bid zero 30% of the time, those drawing the second lowest prize bid zero 15% of the time, those drawing the second highest prize bid zero 6% of the time, and those drawing the highest prize bid zero just 4% of the time. These observations indeed suggest a positive relationship between the probability of a positive bid and the prize value drawn. To examine this issue more formally, we employ a three-level hierarchical logit model and estimate it using the data from the twelve student sessions.[13] The binary dependent variable is equal to one if a positive bid is placed and zero if a zero bid is placed. We hypothesize that the probability of a positive bid will be positively related to the prize value drawn, while controlling for the period of play, possible treatment effects, and random effects related to both individual participants and particular sessions.

Level 1 is a logit model, defined for each individual participant ‘i’ in every session ‘s’over the eight periods of play ‘t’:

$$\log[P_{tis}/(1-P_{tis})] = \pi_{0is} + \pi_{1is}(PER_t) + \pi_{2is}(NV_{tis}), \qquad (1)$$

where P_{tis} is the probability of a positive bid in period ‘t’ for individual ‘i’ in session ‘s’, PER_t is the period number minus eight in period ‘t’, NV_{tis} is the normalized prize value in period ‘t’ for individual ‘i’ in session ‘s’, and the π’s are individual–level coefficients. Subtracting eight from the period number allows the effect of treatment variables that may interact with the period of play to be tested during the last period of the game when convergence to an equilibrium is most likely to have occurred. The prize value is normalized to correspond with the expected earnings it represents by dividing prize values by the number of participants in the session, either four or eight.

The level-2 model takes account of possible individual-specific random effects on the level-1 coefficients:

$$\pi_{0is} = \beta_{00s} + \eta_{0is}$$
$$\pi_{1is} = \beta_{10s} + \eta_{1is} \qquad (2)$$
$$\pi_{2is} = \beta_{20s} + \eta_{2is},$$

where the β’s are session-level coefficients and the η’s represent individual-specific random effects.

The level-3 model takes account of possible session-specific treatment and random effects

[13] Raudenbush and Bryk (2002), and Snijders and Bosker (1999) both provide excellent discussions of hierarchical linear and logit models (also called mixed models or random-effects models) incorporating both fixed and random effects.

on the level-2 coefficients:

$$\beta_{00s} = \gamma_{000} + \gamma_{001}(NA_s) + \gamma_{002}(8P_s) + \mu_{00s}$$
$$\beta_{10s} = \gamma_{100} + \gamma_{101}(NA_s) + \gamma_{102}(8P_s) + \mu_{10s} \quad (3)$$
$$\beta_{20s} = \gamma_{200} + \gamma_{201}(NA_s) + \gamma_{202}(8P_s) + \mu_{20s},$$

where the γ's are level-3 coefficients and the μ's represent possible session-specific random effects. The treatment dummy variable NA_s is equal to 0 for sessions in which the winning bids are announced and 1 if they are not announced. The treatment dummy variable $8P_s$ is equal to 0 for the four-person treatments and 1 for the eight-person treatments. Combining the three sets of equations, we estimate:

$$\log[P_{tis}/(1-P_{tis})] = \gamma_{000} + \gamma_{001}(NA_s) + \gamma_{002}(8P_s) + \gamma_{100}(PER_t) + \gamma_{101}(PER_t \times NA_s) + \gamma_{102}(PER_t \times 8P_s) + \gamma_{200}(NV_{tis}) + \gamma_{201}(NV_{tis} \times NA_s) + \gamma_{202}(NV_{tis} \times 8P_s) + \eta_{0is} + \eta_{1is}(PER_t) + \eta_{2is}(NV_{tis}) + \mu_{00s} + \mu_{10s}(PER_t) + \mu_{20s}(NV_{tis}). \quad (4)$$

Table 4 reports the results. The prize value is positively related to the probability of a positive bid as hypothesized, rejecting the null hypothesis with a two-tailed p-value of 0.076, which corresponds to a one-tailed p-value of 0.038. We can thus reject the null in the direction of the hypothesized positive relationship. Neither the period variable nor either of the treatment variables or their interactions is significantly related to the probability of a positive bid. Thus, the positive relationship between prize value and the probability of a positive bid appears to be invariant to both the period in which the prize is drawn and the four treatments. If we drop all of the insignificant variables, maintaining only NV and the individual-specific and session-specific random effects, the two-tailed p-value on NV falls to 0.001, strongly supporting the hypothesized relationship.[14]

We are primarily interested in how close participants came to the burning-out CPNE in the various treatments. The CPNE is consistent with some participants bidding zero in stage one if

[14] If the data from the professor treatment is added to the estimation of equation 4, the two-tailed p-value becomes 0.019 and all the other variables remain insignificant. When the insignificant variables are dropped the two-tailed p-value becomes 0.000.

they determine that the expected gains from bidding are not worth the cost. Of course, if everyone bid zero in stage one, they would be playing a different Nash equilibrium. Nothing close to this ever happened in any period of any session. In the CPNE, while some participants may bid zero, many others burn out by bidding their entire 50-token endowment in stage one of the game. Since a bid of either zero or 50 is consistent with the burning-out CPNE, we define EQDIST = Min(50-Bid, Bid-0) as the dependent variable in a three-level hierarchical linear model.

The level-1 model is defined over time 't' for each individual participant 'i' in each session 's' to account for convergence over the course of the game as:

$$EQDIST_{tis} = \pi_{0is} + \pi_{1is}(PER_t) + \varepsilon_{tis}, \quad (5)$$

where ε_{tis} is an observation-specific disturbance term. The level-2 model takes into account the possibility of individual-level random effects:

$$\pi_{0is} = \beta_{00s} + \eta_{0is}$$

$$\pi_{1is} = \beta_{10s} + \eta_{1is}, \quad (6)$$

The level-3 model introduces the session-specific treatment effects, which are now our primary focus of interest, as well as session-specific random effects:

$$\beta_{00s} = \gamma_{000} + \gamma_{001}(NA_s) + \gamma_{002}(8P_s) + \mu_{00s}$$

$$\beta_{10s} = \gamma_{100} + \gamma_{101}(NA_s) + \gamma_{102}(8P_s) + \mu_{10s}. \quad (7)$$

Initially, we included interaction effects between NA, the no-announcement dummy, and 8P, the eight-person dummy at level 3. These effects were very far from significance and therefore dropped from the model. Combining equations (5), (6), and (7), we estimate:

$$EQDIST_{tis} = \gamma_{000} + \gamma_{001}(NA_s) + \gamma_{002}(8P_s) + \gamma_{100}(PER_t) + \gamma_{101}(PER_t \times NA_s) +$$
$$\gamma_{102}(PER_t \times 8P_s) + \eta_{0is} + \eta_{1is}(PER_t) + \mu_{00s} + \mu_{10s}(PER_t) + \varepsilon_{tis}. \quad (8)$$

Table 5 outlines the results. It is important to remember that there are eight periods in the game and that PER is defined as the period number minus eight. Thus, the estimated intercept and coefficients on both NA and 8P are calculated with respect to the last period. The intercept is equal to about 14.5 and highly significant (p = 0.000), indicating that in the last period of the four-person sessions with announcements, bids were about 14.5 tokens away from the burning-out CPNE. NA is insignificant, implying that whether or not there was an announcement made no difference to the distance from the burning-out CPNE in the last period. The insignificance of the interaction between PER and NA indicates that whether or not there was an announcement did not affect the speed of convergence to the CPNE either.

This result is in hindsight not particularly surprising. For example, suppose it is announced that the winning bids in stage one were 39 and 40. Then in the next period of play, we might expect the losers to bid very close to 39 and 40. The winners might maintain their bids or even reduce them. However, there is no compelling reason why announcements should induce the players to bid close to B = 50 in the next period. Notice that in a one-stage auction, the losers might bid more than 40 in the next period, if they were informed that the winning bid was 40 in the previous period. In our game, this would be a very risky strategy, since bidding too high in stage one could leave one with too few resources to win the prize in stage two.

In contrast, 8P is negative and highly significant ($p = 0.000$), indicating that more players push participants significantly closer to the CPNE. The sum of $\gamma_{000} + \gamma_{002}$, which represents an estimate of the distance from the CPNE in the last period of the eight-person sessions, is insignificant, indicating that bids were very close to the burning-out CPNE in the eight-person case.

The coefficient on PER is not significant, implying that in the four-person games, there is no significant movement towards or away from the CPNE. However, the interaction between PER and 8P is negative and highly significant ($p=0.009$), indicating that in the eight-person sessions the period-to-period movement towards the CPNE was significantly higher than in the four-person case. The sum of $\gamma_{100} + \gamma_{102}$, which represents that movement, is significant ($p = 0.001$) and equal to about –1.41, indicating that from period to period, bids moved about 1.41 tokens closer to the burning-out CPNE in the eight-person case.

How did participants behave in stage two? Table 6 summarizes stage-two bids in the student sessions. In all of the pure-strategy Nash equilibria, both participants who reach stage two after bidding identical amounts as required by all the pure-strategy equilibria in stage one, should bid all of their remaining endowments in the second stage. In 16 out of the 17 cases in which the announcement indicated that the two players entering stage two were tied in stage one, both players did in fact bid all of their remaining endowments in stage two as predicted. The professors did so in four out of four tied cases.

There were cases, however, in which the announcement revealed that the two participants entering stage two bid different amounts in stage one, despite the fact that such behavior is not part of a pure-strategy Nash equilibrium. Since in these cases the participants in the stage-two subgame have unequal caps, there is no pure-strategy equilibrium for the subgame, but only an equilibrium in mixed strategies (Che and Gale, 1997). While we did not set out to test the mixed-strategy equilibria of the one-stage all-pay auction in Che and Gale (1997),[15] we nevertheless wish to make a few comments on the stage-two experimental evidence. The mixed-strategy equilibrium in Che and Gale (1997) has the property that when two players face different caps, the player with the larger cap puts a positive mass on the smaller cap and distributes the remainder uniformly on $(0, B_2)$, where B_2 is the smaller cap. The other player puts a positive mass on zero and distributes the remainder uniformly on $(0, B_2)$. An immediate implication is that it is not part of a mixed-strategy equilibrium for both players to bid their caps in stage two, given that they are different. However, we found that of the 15 instances in which the announced winning stage-one bids differed by one token, both players bid the rest of their endowments nine out of 15 times. Out of the 16 instances in which the announced winning stage-one bids differed by more than one token, both players bid the rest of their endowments five out of 16 times. These results seem inconsistent with the mixed-strategy equilibrium in the stage-two subgame.

In the treatments where the successful bids were not announced, a participant moving on to stage two would only know his own stage-one bid and whether there had been zero, one, or two random draws. Since such draws were used only in the event of a tie for one or both of the two

[15] Rapoport and Amaldoss (2004) experimentally test a mixed-strategy equilibrium in a discrete all-pay auction.

winning positions, the following inferences could be drawn. If there were two draws, three or more players must have been tied, requiring two draws to choose the two players who would advance to stage two. Thus, in this case, the two advancing players could determine that they must have bid identical amounts in stage one and thus have identical caps in stage two. This is of course consistent with all of the pure-strategy equilibria of the game, each of which requires the advancing players to bid the rest of their endowments in stage two. This actually occurred in six out of the eight cases in which there were two draws. Behavior in the lab when there were fewer than two draws is summarized in the last two rows of Table 6. Note that stage-two behavior in this treatment cannot generally be tested based on the mixed-strategy equilibrium in Che and Gale (1997). This is because the size of a player's cap in stage two remains private information when there are no announcements, while in Che and Gale (1997), a player's cap is common knowledge. With no knowledge of the other person's cap, both players bid their caps in 28 out of the 40 such cases.

5. A cognitive hierarchy (CH) analysis[16]

In this section, we analyze the outcome of our game using a recently developed model of decision-making by boundedly rational agents due to Camerer et al. (2004). The model, which is based on a cognitive hierarchy, relaxes one key assumption of Nash equilibrium: the mutual consistency of beliefs, which requires that beliefs be true in equilibrium. Consistency of beliefs is unlikely in complex games where players do not have sufficient time, ability, or incentive to move beyond boundedly-rational beliefs. The model in Camerer et al (2004) is an extension of models in Nagel (1995), Stahl and Wilson (1995), Ho et al.(1998), and Costa-Gomes et al. (2001). We shall use the CH model to show how the number of players can affect bids in stage one, and compare its predictions to the data from our experiment, concentrating on the earlier periods in which consistency of beliefs is least likely to pertain.

[16] We thank an associate editor for suggesting this line of research.

5.1 Analysis

As in Camerer et al (2004), we assume that players think in steps. This captures the empirical fact that human beings have limited thinking capacities (e.g., Stahl, 1998). Also, as shown by Camerer et al. (2004), this idea explains some experimental data very well.

Suppose all players solve the game in k steps, where k = 0, 1, …, J. If k = 0, then a player does no thinking and hence does not behave strategically. As in Camerer et al. (2004), we assume that such players make their decisions by randomizing uniformly on some support. In our case, we assume that in stage one, such players randomize uniformly on [0, b], where $0 < b < B$.[17] Each player who does k steps of thinking assumes that all other players do less than k steps of thinking. Hence each player is overconfident, and thinks that he/she is smarter than everyone else.[18]

As in Camerer et al. (2002; 2004), we assume that the actual distribution of thinking steps follows a Poisson distribution with a mean number, τ, of thinking steps. However, we do not use the Camerer et al. (2002; 2004) assumption that a k-step thinker believes that other players do 0 to k-1 steps of thinking according to a normalized Poisson distribution. Instead, we follow Nagel (1995), Stahl and Wilson (1995), and Ho et al. (1998) by assuming that a k-step thinker believes that all other players do exactly k-1 steps of thinking.[19] Players hold false beliefs. However, best response functions are correct, given these false beliefs. In quantal response equilibrium models developed by McKelvey and Palfrey (1995), beliefs are correct but best responses are not necessarily correct.

Consider a 0-step thinker in stage one. He will randomize uniformly on [0, b]. Now

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[17]Shortly, the need for $b < B$ will be obvious.

[18] Camerer et al. (2004) make a number of arguments in support of this overconfidence assumption. See also Binmore (1988) and Selten (1998).

[19] Using the normalized Poisson distribution of beliefs in Camerer et al. (2002; 2004) produces results identical to the ones derived here with a minor exception noted in footnote 24. The analysis under this assumption is available at http://www.uoguelph.ca/~jamegash/CH_normalized_poisson.pdf, or from the authors upon request. Camerer et al. (2002, fn 13) note that the k-1 assumption used here is "… easy to work with theoretically because the sequence of predicted choices can be computed by working up the hierarchy without using any information about the true distribution …" We adopt it because it leads to empirically indistinguishable predictions, and enormously simplifies the exposition.

consider a 1-step thinker who believes that all other players are 0-step thinkers. Then when he bids e in stage one his probability of successfully moving on to stage two, given F = 2, is

$$\rho_1 = \left(\frac{e}{b}\right)^{N-1} + (N-1)\frac{b-e}{b}\left(\frac{e}{b}\right)^{N-2}$$

. The first term is the probability that each of the other N-1 players bid less than e, and the second term is the probability that, out of

N-1 players, N-2 players bid less than e and one player bids more than e.[20] Clearly, it could be argued that there is more than one step of thinking in computing the probability above. So while we refer to this as 1-step thinking, we do so only in the sense that a higher-step thinker goes through more thinking steps than a 1-step thinker, or that a 1-step thinker best responds to the 0-step thinkers. Indeed, a 1-step thinker does even more strategic thinking by looking ahead to the outcome of the game in stage two. We assume that a 1-step thinker believes that his opponent, if he makes it to stage two, is a 0-step thinker who randomizes uniformly on the support $[0, \hat{B}]$,[21] where $\hat{B} = B - e$ is his opponent's cap in stage two. To find $\hat{B}$ as stage one commences, a 1-step thinker must compute the conditional density function that his eventual opponent in stage two will have emerged as the winner from the (N-2) other 0-step thinkers by bidding $\tilde{e}$. This is the density of $\tilde{e}$, conditional on success in stage one. Denote this conditional density by $f(\tilde{e}|s)$, where "s" denotes "success in stage one". This conditional density function is the density function of the largest order statistic of the (N-1) random variables. This gives $f(\tilde{e}|s) = (N-1)\tilde{e}^{N-2} / b^{N-1}$.

Recall that a 1-step thinker believes that his opponent, if he makes it to stage two, is a 0-step thinker who randomizes uniformly on the support $[0, B-\tilde{e}]$. From the standpoint of stage one, a 1-step thinker computes his success probability when he bids x in stage two as $\rho_2(\tilde{e}) = x / (B-\tilde{e})$. Since a player who is burnt out in stage two cannot randomize over any support, the only belief by a 1-step thinker and higher-step thinkers consistent with the belief that 0-step thinkers

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[20] Note that a uniform distribution has no mass points, so the probability of a tie is zero.

[21] This is consistent with Camerer et al (2004, p. 892) that "… extending the model to extensive-form games is easy by assuming that 0-step thinkers randomize independently at each information set, and higher-level types choose best responses at information sets using backward induction."

randomize in both stages is b < B. In what follows, we set b = 49.99. Hence the expected payoff of a 1-step thinker in stage two with valuation V_i is

$$\Pi_{2i} = V_i \int_0^b \rho_2(\tilde{e}) f(\tilde{e}|s) d\tilde{e} - x = x\left(\frac{V_i(N-1)}{b^{N-1}} \int_0^{49.99} \frac{\tilde{e}^{N-2}}{50-\tilde{e}} d\tilde{e} - 1 \right). \quad (9)^{22}$$

By setting $N \in \{4,8\}$ and b = 49.99, we use the math software, Maple V, to compute the integral in (9). We find that the term in brackets is positive, given the values of $V_i \geq 100$ and $N \in \{4,8\}$ used in our experiments and b = 49.99. Hence the optimal bid for a 1-step thinker in stage two is $\hat{x} = B - e$. This gives

$$\hat{\Pi}_{2i} = (B-e)\left(\frac{V_i(N-1)}{b^{N-1}} \int_0^{49.99} \frac{\tilde{e}^{N-2}}{B-\tilde{e}} d\tilde{e} - 1 \right). \quad (10)$$

Therefore, in stage one, a 1-step thinker chooses e to maximize $\Pi_1 = \rho_1 \hat{\Pi}_2 - e$. Let the optimal value be $\hat{e} = \hat{e}(N, V_i)$. In our analysis, we find that $0 < \hat{e} < B$ (i.e., an interior solution) and is increasing in N and V_i. We obtain these results for B = 50, $V_i \geq 100$ and $N \in \{4,8\}$. We check that second-order conditions for a local maximum hold.[23] We also look at graphical plots of Π_1, where e ranges over the interval [0, B]. We find that $\hat{e}$ is a unique global maximum. Since, we allow only integer values in our experiments, we ask the reader to think of $\hat{e}$ as an integer. The results are summarized in Table 7.

Given $f(\tilde{e}|s) = (N-1)\tilde{e}^{N-2} / b^{N-1}$, the expected highest bid among the (N-1) randomizers in stage one, from the standpoint of a 1-step thinker, is $E(\tilde{e}|s) = [(N-1)/N]b$. Notice that $E(\tilde{e}|s) \rightarrow b$ as $N \rightarrow \infty$. Also, the expected second-highest bid among the (N-1) randomizers can be shown to be $\hat{E}(\tilde{e}|s) = [(N-2)/N]b$. Again, $\hat{E}(\tilde{e}|s) \rightarrow b$ as $N \rightarrow \infty$. Hence, when N is large, a 1-step thinker requires a bid very close to b in stage one to be successful. Therefore, $\hat{e}(N, V) \rightarrow b$ as $N \rightarrow \infty$. Since b = 49.99 $\approx$ B, it follows that the players almost burn out when N is very large.

We summarize our analysis in the following proposition:

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[22] For notational convenience, we suppress the i subscripts on the bids.

[23] There are three solutions to the first-order condition for an interior solution. Only one solution satisfies the second-order condition for a local maximum. Of the two remaining solutions, one solution is a minimum and the other solution violates the budget constraint (i.e., e > B).

Proposition 3: *Consider a two–stage contest in which the contest in each stage is an all-pay auction where the i-th contestant has valuation, V_i, contestants have a common budget constraint, B, and behave according to the cognitive hierarchy (CH) step model of thinking , i = 1, 2, …, N. Then (i) there exists a pure-strategy CH outcome in which a player with valuation V_i bids $\hat{e} = \hat{e}(N, V_i) \leq B$ in stage one and $\hat{x} = B - \hat{e}$ in stage two , where $\hat{e}$ is increasing in N and V_i, and (ii)* $\hat{e}(N, V_i) \rightarrow B$ as $N \rightarrow \infty$.

We wish to emphasize that the predicted CH bid $\hat{e}$ is increasing in the number of players, N, as indicated in Table 7. This is not the case in all-pay auctions with non-boundedly rational players (Baye et al, 1996; Che and Gale, 1997). This result is however consistent with Anderson et al. (1998) who, using a quantal response equilibrium model in which players choose best response functions stochastically, show that aggregate expenditure is increasing in the number of players in a one-stage all-pay auction. Moldovanu and Sela (2001; in press) also obtain a similar result in an all-pay auction where a player's ability is private information and is assumed by his opponents to be a random variable that is drawn from some distribution. It is interesting to note that the number of players has no effect on individual or aggregate bids in all-pay auctions with complete information, mutually consistent beliefs, and unboundedly rational players. This suggests that some exogenous randomness either in the bidding behavior of the players as in the present paper and Anderson et al. (1998), or in some player-specific parameter (e.g., ability or valuation) as in Moldovanu and Sela (2001; in press) is required to obtain a relationship between the number of players and bids in all-pay auctions. Similarly, using the CH model, Camerer et al. (2004) also find a group size effect in the predicted outcome of the "stag hunt" game consistent with experimental evidence, while Nash equilibrium makes no such prediction.

We shall now consider thinking steps beyond step 1. Consider a 2-step thinker. Note that a 2-step thinker knows that a 1-step thinker bids $\hat{e}$ in stage one and $B-\hat{e}$ in stage two. In general, as indicated above, $\hat{e}$ increases with V_i, and should thus differ among 1-step thinkers with different valuations. However, as indicated in Table 7, the predicted differences are so small as to be inconsequential in our experiments where only integer bids were permitted. When N = 4, $\hat{e}$

rounds off to 29 for all valuations, while for N = 8, it rounds off to 40 for all valuations. We will use $\hat{e}$ to refer to these predicted integer bids for 1-step thinkers in what follows. Since a 2-step thinker believes that all other players are 1-step thinkers, his optimal response is also to bid $\hat{e}$ in stage one and B-$\hat{e}$ in stage two.[24] Similarly, all higher-step thinkers will bid $\hat{e}$ in stage one. Given a Poisson distribution of thinking types, the probability mass function of k-step thinkers is $g_k = \tau^k \exp(-\tau) / k!$. Restricting bids to integer amounts and given the Poisson CH model, we predict that a proportion, $g_0 = 1/\exp(\tau)$, of the players will randomize on [0, 49] and the rest will bid $\hat{e}$.

An important observation is that our claim that players almost burn out when N is sufficiently large holds when a sufficiently high proportion of the players are non-0-step thinkers. That is, τ must be sufficiently high. It is the 1-step and higher-step thinkers who burn out when N is sufficiently high, while 0-step thinkers choose their bids randomly.

Note that the normalized Poisson belief assumption in Camerer et al. (2004) is equivalent to the "k-1" assumption as $\tau \to \infty$. An interesting theoretical result is that as $\tau \to \infty$, the prediction of the Poisson CH model in Camerer et al. (2004) will converge to one of the Nash equilibria. This is because as $\tau \to \infty$, k-step thinkers act as if *almost* all other thinkers are one step below them (see Camerer et al, 2004, p. 868). Hence a 2-step thinker will act as if he will meet a 1-step thinker with certainty in stage two. Therefore, he bids $\hat{e}$. Similarly, a 3-step thinker will bid $\hat{e}$, since he expects to meet a 2-step thinker in stage two with a probability close to one and so on. Thus, almost everyone bids $\hat{e}$. This convergence to Nash equilibrium when τ is very large is obtained in Camerer et al. (2004) as a general result in games where a Nash equilibrium is reached by finitely many iterated deletions of weakly dominant strategies. It is interesting to note that we obtained this result although the Nash equilibria in our game are not reached by iterated deletions of weakly dominant strategies.

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[24] If τ is sufficiently high, for example $\tau \geq 0.4$ for N = 8 we can show that, using the normalized Poisson distribution of beliefs in Camerer et al. (2004), a 2-step thinker will bid $\hat{e} + 1$ and all other higher-step thinker will bid likewise. The proof is available at http://www.uoguelph.ca/~jamegash/CH_normalized_poisson.pdf.

5.2 Estimation and Model Comparison

Since our game has a multiplicity of strategies available to the players, estimating τ to fit the data by maximum likelihood would be inefficient (Camerer et al, 2002, pp 23 – 26). Therefore, we follow Camerer et al. (2002; 2004) in choosing τ such that the predicted mean bid is close to the actual mean bid in the data. For N = 8, the predicted mean is $\bar{e}_8 = 24.5\exp(-\tau) + 40(1-\exp(-\tau))$. For N = 4, the predicted mean is $\bar{e}_4 = 24.5\exp(-\tau) + 29(1-\exp(-\tau))$.

To fit the data, we focus our analysis on the first two periods of each treatment. This allows us to abstract from possible learning effects that may take place as players receive feedback between periods. Note that our CH analysis does not take account of learning. The development of a dynamic CH-learning model is beyond the scope of this paper. We will however show that many of the results from the later periods are inconsistent with the predictions of the simple CH model, suggesting that it is less relevant as more learning about the behavior and hence the beliefs of other participants takes place.

The τ estimates for the first period are presented in Table 8. In two out of ten cases in our sample, the mean bid was greater than $\hat{e}$. However, as τ approaches infinity, the mean bid predicted by the CH model approaches $\hat{e}$ from below. Since there is no τ that predicts the observed mean bids in these cases, we did not provide a τ estimate.[25] In 10 out of 12 cases, the estimated $\tau \in (0,1)$.[26] These results imply that the mean number of thinking steps in period one was very low. Most players were apparently 0-step thinkers. This is not surprising in a dynamic game like ours where the players have to figure out the equilibrium via backward induction.[27] The average of the sample means for N = 4 and N= 8 were 25.04 and 24.77 respectively. This is not surprising because most of the players were randomizing in this period, and hence the

[25] If τ were really close to infinite in these cases, implying belief consistency, we would expect the standard deviations of the bids to be close to zero. However, they were not. Two similar cases arise in period two. In the N=8 case (session 11), the standard deviation is quite low and the distribution of bids appears very close to a Nash equilibrium.
[26] We do not fit the CH model to the professor treatment because we believe the Nash equilibrium is more applicable to the behavior of the professors. They were not randomizing. Zero bids were almost all associated with low prize values, and non-zero bids were almost all close to 20.
[27] See Johnson et al. (2002).

average bid should be very close to 24.5 regardless of sample size. Camerer et al. (2004) also obtained very low estimates of τ in beauty contest games. As in Camerer et al. (2004, table II), the predicted standard deviations were not very far away from the actual standard deviations, although the τ's were not chosen to match the standard deviations.

The τ estimates for the second period are presented in Table 9. The average of sample means for N = 4 is 24.54, while it is 33.52 for N = 8. In four of six cases, the estimated τ for N = 4 is 0. In four out of six cases, the estimated τ for N = 8 is at least 0.60. It would seem that greater competition when N = 8 than when N = 4 motivates players to think harder, resulting in a more sophisticated understanding of the beliefs and expected behavior in the former case after one period of play. The higher level of τ , together with the higher $\hat{e}$ in the eight-person treatments, lifts the bids in these treatments above those in the four-person treatments.

In subsequent periods, as indicated in the statistical results reported earlier, active bids moved progressively higher in the eight-person treatments relative to the four-person treatments. Although this may be partially explained by both higher τ's and a higher $\hat{e}$ in the eight-person treatments, the CH model cannot fully explain the mean bid levels that result. From period three through period eight, the mean bid for active players[28] was greater than $\hat{e} = 40$ in the eight-person treatments fully 94.4% of the time, validating our decision not to apply the CH model and estimate τ in the these periods. For the four-person treatments the corresponding percentage of mean active bids above $\hat{e} = 29$ was 61.1%. Some players bid zero or one in these latter periods. As previously discussed, such bids were significantly more common when low valuations were drawn. Thus, they likely represent situations were the expected payoff was not high enough to compensate for the risk of bidding as opposed to randomly-chosen bids by 0-step thinkers.

Standard deviations of active bids generally fell as the game progressed, particularly in the eight-person treatments as exemplified in the multi-period results displayed in figures 1 to 5 and

[28] As explained in footnote 12, we defined active players as those bidding more than one. If active players are defined more stringently as those who bid more than zero, the percentage of mean bids above $\hat{e}$ becomes 88.9% in the eight-person treatments and remains at 61.1% in the four-person treatments.

the final period mean bids and standard deviations for active players reported in Table 3. In five of the six eight-person cases, the standard deviation was less than one. In two of the three eight-person sessions with announcements, all active players burned out by bidding exactly 50. Thus, in many of our samples, randomizing behavior seems much reduced and convergence towards a Nash equilibrium with consistency of beliefs seems to be occurring by the end of the game. Although the CH model predicts burning out as the number of players becomes very large, it does not do so for N = 8, where $\hat{e}$ is predicted to be 40. However, the basic idea that more players imply a higher probability that at least two players might randomly choose a high bid is very likely an important motivation for strategic thinkers, with some perhaps limited understanding of this likelihood, choosing higher bids in the eight-person than in the four-person treatments.

6. Burning-out in the eight-player treatment: a formal CPNE explanation

As argued above, we believe that the CH model is applicable to period one and perhaps period two of each treatment, but has less applicability in later periods. Since burning out in the lab was observed in later periods, we shall examine the difference in behavior for N = 8 and N = 4 by returning to the CPNE model. We do so in this section.

The effect of the number of players on the likelihood of burning out does not support the CPNE predictions, since these equilibria are independent of the number of players. In this section, we shall show how the number of players might affect the equilibria which are non-CPNE, and why burning out is more likely to occur with eight players than with four players as players converge toward Nash outcomes.

Consider any Nash equilibrium that is not a CPNE. These are the non-burning out equilibria. Suppose p is a player's subjective probability that an opponent in stage one

will deviate to a higher bid.[29] We assume that a player holds this subjective belief at any

[29] Notice that it does not make sense to deviate to a lower bid.

non-burning-out equilibrium. Let d be the number of deviators. Then, of the N-1 other players, the probability that d players will deviate is $\text{prob}(d) = \frac{(N-1)!}{d!(N-1-d)!} p^d (1-p)^{N-1-d}$. If $d \geq 2$, the probability that a non-deviating player will advance to stage two is zero, given F = 2. If d < 2, the probability that a non-deviating player will advance to stage two is (F-d)/(N-d) = (2-d)/(N-d). Therefore, the probability that a non-deviating player will advance to stage two is $\text{prob}(adv) = \sum_{d=0}^{1} \frac{2-d}{N-d} \frac{(N-1)!}{d!(N-1-d)!} p^d (1-p)^{N-1-d}$. Now suppose that each player believes that there is a 50-50 chance that a randomly chosen opponent will deviate. That is, p = 0.5. Then $\text{prob}(adv | N = 4, p = 0.5) = 0.1875$ and $\text{prob}(adv | N = 8, p = 0.5) = 0.00977$. So, when N = 8, a player has a very small chance (i.e., 0.977%) of advancing to the next stage if he does not deviate to a higher bid. In contrast, when N = 4, a player has a much higher chance (i.e., 18.75%) of advancing if he does not deviate to a higher bid. Note that these probabilities are the same at any non-burning out equilibrium and are independent of a player's valuation. Since these probabilities are the same at any non-burning-out equilibrium and a player does not know by how much others have increased their bids by deviating, it is reasonable that if a player decides to deviate, he should deviate to the burning-out equilibrium. Since, if a player does not deviate, the probability of advancing when N = 8 is almost 1/20 of the probability of advancing when N = 4,[30] it is reasonable to argue that a player is much more likely to deviate from any non-burning out equilibrium, when N = 8 than when N = 4. The intuition is simple. The higher is N, the higher is the probability that two or more of the other players will deviate to a higher bid. With only two slots and eight contestants, a player feels that he has to bid more to get to stage two when he has to beat six out of seven other players rather than two out of three players. This urge to bid more may stem from a player's belief that deviations to higher bids are more likely with more players than with fewer players.

[30] This ratio is even smaller than 1/20 for 0.5 < p < 1. Indeed, holding N fixed at 4 and 8, we find that the probability of advancing is decreasing in p. Note that if one were to assume that p = p(N) where p is an increasing function of N, this will strengthen our result since p(8) > p(4).

7. Conclusion

We have examined a two-stage sequential elimination game with a continuum of equilibria in the first stage. Many of these equilibria can be ranked according to the Pareto criterion. A set of such rankable equilibria resembles the continuum of Pareto-rankable equilibria in the weak-link coordination game. In that game, groups of two and to a lesser extent three are better able than larger groups to maintain a Pareto-dominant equilibrium over a series of periods in which the game is repeated in a partner protocol. Our game differs from such weak-link games in that the main point is not to cooperate, but to win the prize. In addition, in our game but not in weak-link games, the Coalition-Proof Nash Equilibrium refinement rules out all equilibria but the one in which everyone who chooses to bid burns out by bidding all of their resources in stage one. In all of our treatments, this is the least efficient pure-strategy equilibrium in the sense that it is Pareto-dominated by all of the other equilibria.

Our first finding is that some players withdraw from the game by bidding zero, while others bid substantial amounts. This is reminiscent of a laboratory result that emerged unexpectedly in Muller and Schotter's (2003) recent experimental examination of a model developed by Moldovanu and Sela (2001) in which players had different costs of effort. Although Moldovanu and Sela's theoretical model predicted that the amount of effort exerted should be a continuous inverse function of cost, the laboratory results indicated a discontinuity: higher-cost players generally gave up, expending little effort, while lower-cost players generally tried hard, exerting a lot of effort. In the Amegashie (2004) model, the cost of effort is identical for all players, but prize valuations can differ.[31] The specific version of the Amegashie model adopted in this paper predicts that players with lower valuations will withdraw from the contest by bidding zero, while players with higher valuations will compete for the prize by bidding

[31] However, as shown by Baye et. al (1996) and Clark and Riis (1998), a contest where the players have different valuations but a common cost of effort is analytically equivalent to a contest where the players have common valuations but different costs of effort.

positive amounts in the first stage of a two-stage game, a prediction that is corroborated by the data.

Our second finding is that a Pareto-dominant equilibrium is never attained in any of our sessions. In addition, our experimental results show that bids are higher with more players and that burning out, which is Pareto-dominated by all other equilibria in our treatments, is more likely to occur with more than with fewer players. This somewhat parallels a recent experimental finding in Amaldoss and Rapoport (2005), where in a quite different context, bids are higher when there are more players and hence more competition in the first stage of a two-stage game. However, in Amaldoss and Rapoport (2005), such behavior is not consistent with any equilibrium, and first-stage bids are higher than predicted by Nash both with smaller and larger numbers of players in the first stage. The puzzle in Amaldoss and Rapoport (2005) is that bids are higher than predicted in both of their treatments. In contrast, our puzzle is that bids are lower than predicted by CPNE in our four-person treatment. Amaldoss and Rapoport (2005) propose that people get non-pecuniary utility, increasing with the number of competing players, from winning an auction, and show that this can explain much of the behavior they observe. In our framework, such an explanation would require unrealistically high levels of such utility to explain the differences in our four-person and eight-person results.

Using a recent cognitive hierarchy (CH) model developed by Camerer et al. (2004), which is based on steps of thinking by players, we show that when both the number of players and the mean number of thinking steps are large, the CH prediction involves burning out by using all of one's resources in the first stage. For the four-person treatments, it predicts that strategic players, for whom the number of thinking steps is greater than zero, will bid $\hat{e} = 29$. For the eight-person treatments, the corresponding number is $\hat{e} = 40$. Thus, it does not predict burning out in either of our treatments. We estimate the mean number of thinking steps to fit our experimental data and find that it is very close to 0 in the initial period but substantially higher in the second period for the eight-person treatments. It thus provides some support for the higher mean bids observed in the eight-person treatments in the second period. However, the CH model does not predict well in subsequent periods as players learn about each other's behavior and beliefs, and as many bids rise above the level predicted by CH, especially in the eight-person case where players burn out. Nonetheless, the idea emanating from the CH analysis that more players competing for the same number of spots means a higher probability of randomizers choosing very high bids, which in turn causes the bids of strategic players to be higher, is likely a driving force behind our burning-out results. In addition, our results suggest that with more competition for spots, people learn more quickly to think in a more sophisticated manner. Camerer (2004) argues that high stakes encourage more sophisticated thinking. Apparently, more competition does as well.

The CPNE is not a good predictor of behavior when four people compete for two second-stage spots, but it does predict well when eight people compete for the two available spots. Allowing for joint deviations, we provide a formal analysis and intuition as to why the CPNE is likely to have more predictive power in the eight-person case. With more players, there is a higher probability that two will deviate to a higher bid, leading to the breakdown of any equilibrium that is not coalition-proof, and convergence towards the unique CPNE burning-out equilibrium.

More competing players imply: a higher probability that two randomly-chosen high bids will be placed by 0-step thinkers; more strategic-thinking motivated by more competition leading to higher τ's; and a higher probability that two competitors might deviate to a higher bid. All of these factors suggest that more competition leads to higher bids, and that burning out is indeed a competitive phenonemon as observed in the laboratory.

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Table 1
Summary of Treatments

	4-person group	8-person group
Without announcement (eight periods)	3 sessions with students	3 sessions with students
With announcement (eight periods)	3 sessions with students 1 session with economics professors (excluded from statistical analysis)	3 sessions with students

Table 2
Summary of the Complete Set of Nash Equilibria

Total Number of players, N	Number of active players, K	Symmetric bids of active players in stage one	Identity of non-active players
4	4	$e^* = 0$	None
4	3	$0 < e^* \leq 50$	Player 4
8	8	$0 \leq e^* \leq 16.667$	None
8	7	$16.667 < e^* \leq 20$	Player 7 or 8 but not both
8	6	$20 < e^* \leq 50$	Players 7 and 8

The stage-two bid $x^* = B – e^*$ for all active players.

Table 3
Period Eight Mean Bids and Standard Deviations in Various Samples

Sample	Winning Bids Announced	Sample Size	Mean Active Bid in Period Eight	Active Bid Std Dev in Period Eight
1	No	4	32.00	2.00
2	No	4	27.75	16.52
3	No	4	32.33	1.53
4	Yes	4	25.25	0.50
5	Yes	4	45.67	0.58
6	Yes	4	35.50	5.26
7	No	8	48.83	0.41
8	No	8	46.71	2.69
9	No	8	48.57	0.52
10	Yes	8	50.00	0.00
11	Yes	8	50.00	0.00
12	Yes	8	48.38	0.92
Econ. Profs	Yes	4	20.00	0.00

Table 4
Positive versus Zero Bid Results

Repeated Measures Three-level Hierarchical Logit Model with Random Effects on Intercept, Period and Normalized Valuation, using Full PQL (Penalized Quasi-Likelihood) Estimation.

Equation estimated: $\log[P_{tis}/(1-P_{tis})] = \gamma_{000} + \gamma_{001}(NA_s) + \gamma_{002}(8P_s) + \gamma_{100}(PER_t) + \gamma_{101}(PER_t \times NA_s) + \gamma_{102}(PER_t \times 8P_s) + \gamma_{200}(NV_{tis}) + \gamma_{201}(NV_{tis} \times NA_s) + \gamma_{202}(NV_{tis} \times 8P_s) + \eta_{0is} + \eta_{1is}(PER_t) + \eta_{2is}(NV_{tis}) + \mu_{00s} + \mu_{10s}(PER_t) + \mu_{20s}(NV_{tis})$

Independent Variables	*Estimate*	*t value*	*Pr > |t|*
Intercept	0.004332	0.004	0.997
No Announcement (NA)	-0.635910	-0.516	0.618
8 Participants (8P)	-0.980644	-0.762	0.465
Adjusted Period (PER)	0.008298	0.059	0.954
NA × PER	0.045866	0.331	0.748
8P × PER	-0.191543	-1.272	0.236
Normalized Valuation (NV)	0.052823	1.999	0.076
NA × NV	0.037350	1.262	0.239
8P × NV	-0.009759	-0.320	0.756

Table 5
Distance from Burning-out CPNE Results

Repeated Measures Three-level Hierarchical Linear Model with Random Effect on Intercept and Adjusted Period using Full Maximum Likelihood.

Equation estimated: $EQDIST_{tis} = \gamma_{000} + \gamma_{001}(NA_s) + \gamma_{002}(8P_s) + \gamma_{100}(PER_t) + \gamma_{101}(PER_t \times NA_s) + \gamma_{102}(PER_t \times 8P_s) + \eta_{0is} + \eta_{1is}(PER_t) + \mu_{00s} + \mu_{10s}(PER_t) + \varepsilon_{tis}$

Independent Variables	*Estimate*	*t value*	*Pr > |t|*
Intercept [γ_{000}]	14.544341	6.053	0.000
No Announcement (NA) [γ_{001}]	0.425206	0.155	0.881
8 Participants (8P) [γ_{002}]	-15.001736	-5.464	0.000
Adjusted Period (PER) [γ_{100}]	-0.159603	-0.474	0.646
PER×NA [γ_{101}]	-0.227421	-0.615	0.553
PER×8P [γ_{102}]	-1.254216	-3.347	0.009
Other Hypothesis Tests			
$\gamma_{000} + \gamma_{002}$	-0.457395	-0.195	0.850
$\gamma_{100} + \gamma_{102}$	-1.413819	-4.577	0.001

Table 6
Summary of Stage-Two Behavior in Student Sessions

Announce-ment	*Stage One Winning Bids*	*Both spend rest of Endowment*	*One spends rest of Endowment*	*None spend rest of Endowment*	*Total*
Yes	Tie	16	1	0	17
Yes	Difference = 1	9	5	1	15
Yes	Difference >1	5	8	3	16
No	Two chosen randomly	6	1	1	8
No	One chosen randomly	5	1	0	6
No	No random draw	23	9	2	34

Table 7
Values for $\hat{e}$, given B = 50, N = 4 or 8, and various values of V

V	$\hat{e}$ (N= 4)	$\hat{e}$ (N = 8)
100	28.5562	39.5947
120	28.6188	39.6166
150	28.6808	39.6382
170	28.7097	39.6484
200	28.7422	39.6597
230	28.7661	39.6681
270	28.7896	39.6764
300	28.8031	39.6811
400	28.8333	39.6918
500	28.8514	39.6981
600	28.8634	39.7024

Table 8
Period One Data and CH Estimates of τ in Various Samples

Sample	Winning bids announced	Sample size	Sample mean in period one	Sample Std Dev Period one	**Estimated τ**	Predicted mean from CH model	CH Std Dev
1	No	4	24.75	11.5	**0.06**	24.75	13.79
2	No	4	33.50	5.80	**N/A**	**N/A**	N/A
3	No	4	26.50	14.34	**0.59**	26.50	10.78
4	Yes	4	20.50	4.20	**0.00**	24.50	14.14
5	Yes	4	33.25	7.89	**N/A**	N/A	N/A
6	Yes	4	11.75	6.24	**0.00**	24.50	14.14
7	No	8	32.25	13.19	**0.69**	32.25	12.65
8	No	8	25.13	13.53	**0.04**	25.13	14.18
9	No	8	26.63	4.37	**0.15**	26.63	14.17
10	Yes	8	15.75	16.45	**0.00**	24.50	14.14
11	Yes	8	28.00	17.70	**0.26**	28.00	14.02
12	Yes	8	20.88	14.53	**0.00**	24.50	14.14

The predicted variances = $(1/\exp(\tau))(\sigma_0^2 + (\bar{e}_0)^2) + (1-1/\exp(\tau))(\sigma_1^2 + (\hat{e})^2) - (\bar{e})^2$, where σ_0^2 = $(49\text{-}0)^2/12$ is the variance of the bid of a 0-step thinker, $\sigma_1^2 = 0$ is the variance of the bids of all higher-step thinkers, $\bar{e}_0$ is the predicted mean bid of 0-step thinkers, and $\bar{e}$ is the predicted mean bid for all players. N/A indicates that the mean bid fell above $\hat{e}$, which is inconsistent with any τ.

Table 9
Period Two Data and CH Estimates of τ in Various Samples

Sample	Winning Bids Announced	Sample Size	Sample Mean in Period Two	Sample Std Dev Period Two	**Estimated τ**	Predicted Mean from CH Model	CH Std Dev
1	No	4	20.00	13.88	**0.00**	24.50	14.14
2	No	4	27.75	13.55	**1.28**	27.75	7.72
3	No	4	21.00	14.31	**0.00**	24.50	14.14
4	Yes	4	22.75	1.89	**0.00**	24.50	14.14
5	Yes	4	36.00	4.69	**N/A**	N/A	N/A
6	Yes	4	19.75	3.40	**0.00**	24.50	14.14
7	No	8	34.88	18.15	**1.12**	34.88	10.92
8	No	8	31.50	14.8	**0.60**	31.50	13.01
9	No	8	32.00	13.46	**0.66**	32.00	12.77
10	Yes	8	21.13	19.35	**0.00**	24.50	14.14
11	Yes	8	47.63	1.41	**N/A**	N/A	N/A
12	Yes	8	33.88	14.44	**0.93**	33.88	11.68

See the notes to Table 8

Figure 1
Four Persons Without Announcement

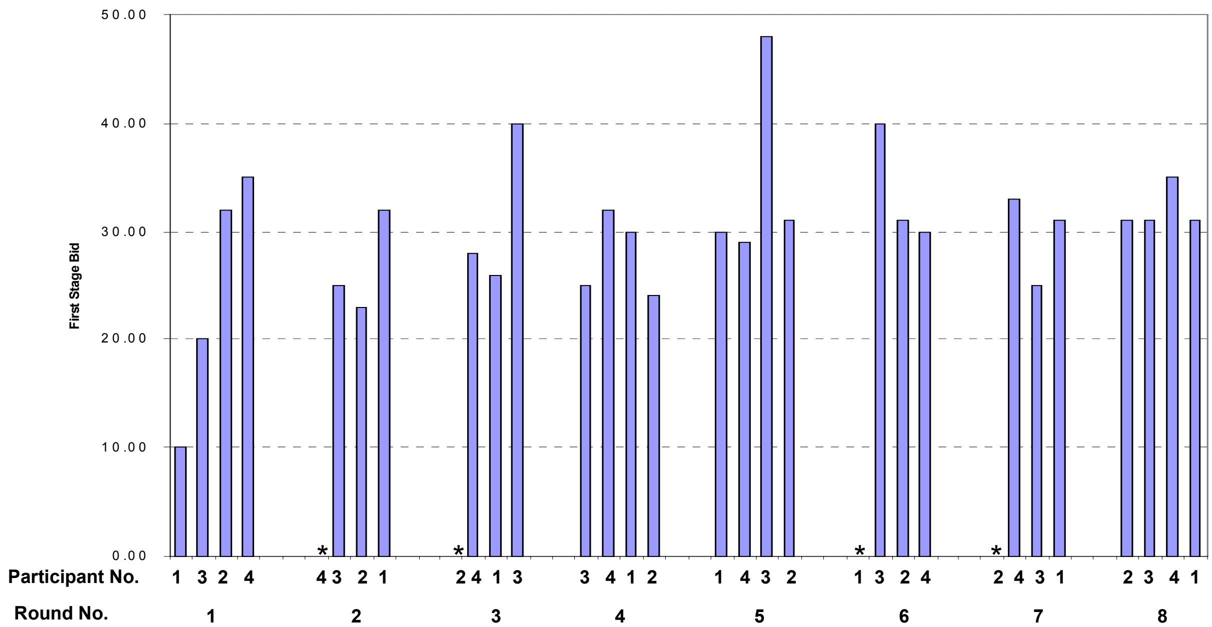


Figure 2
Four Persons with Announcement

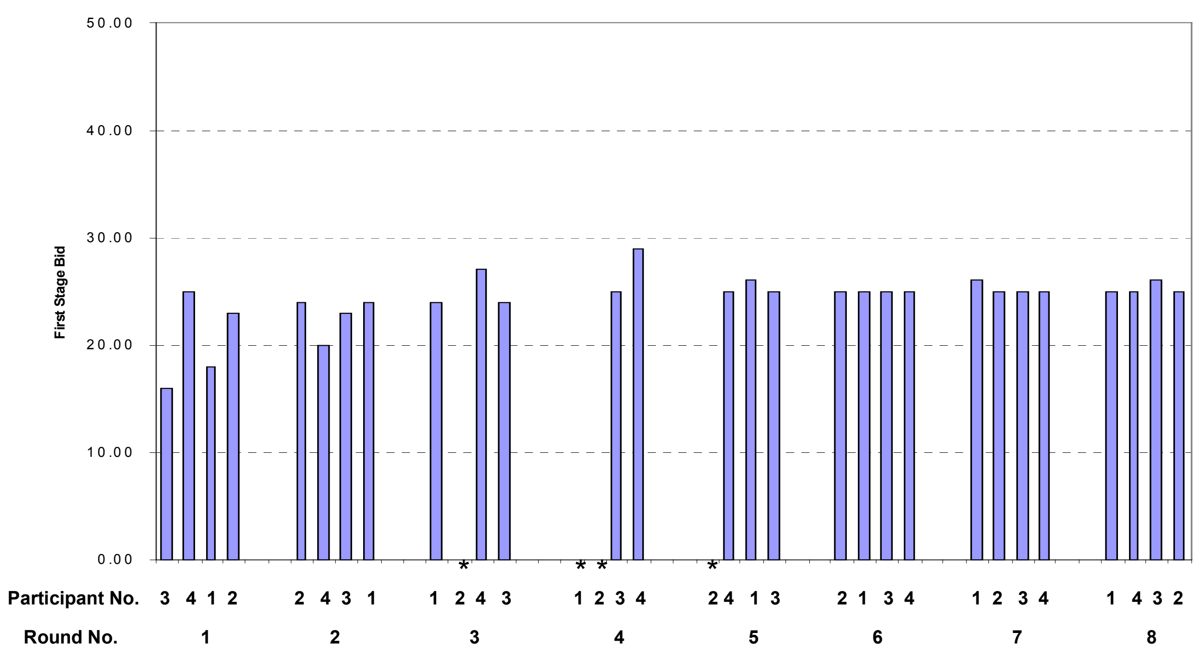


Figure 3
Four Professors with Annoucement

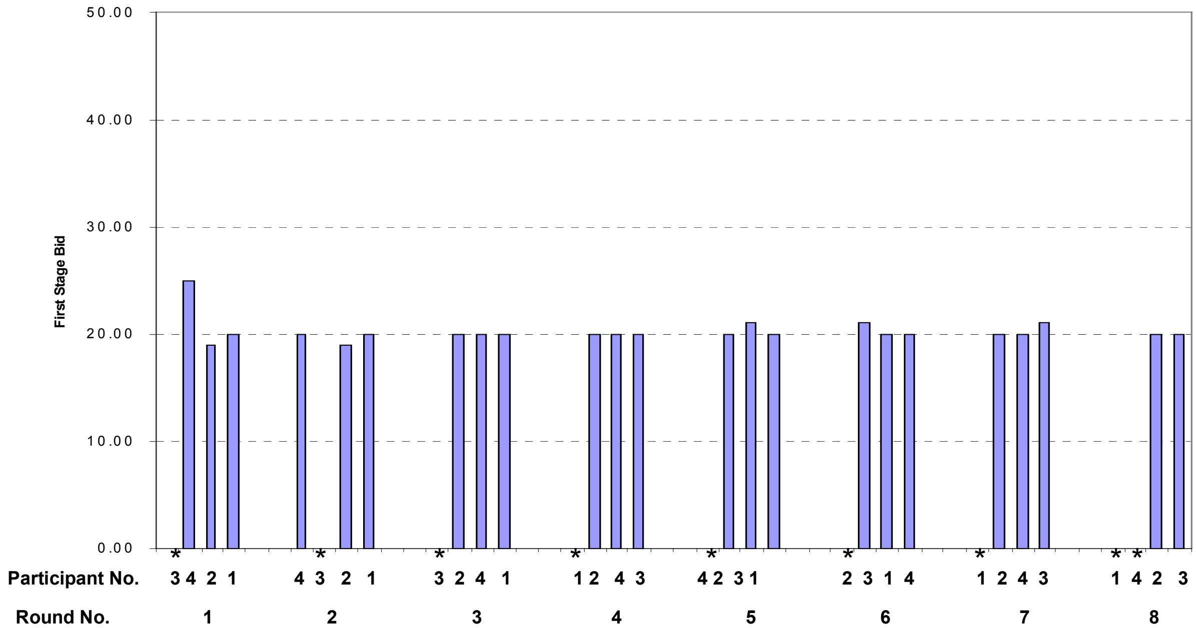


Figure 4
Eight Persons without Annoucement

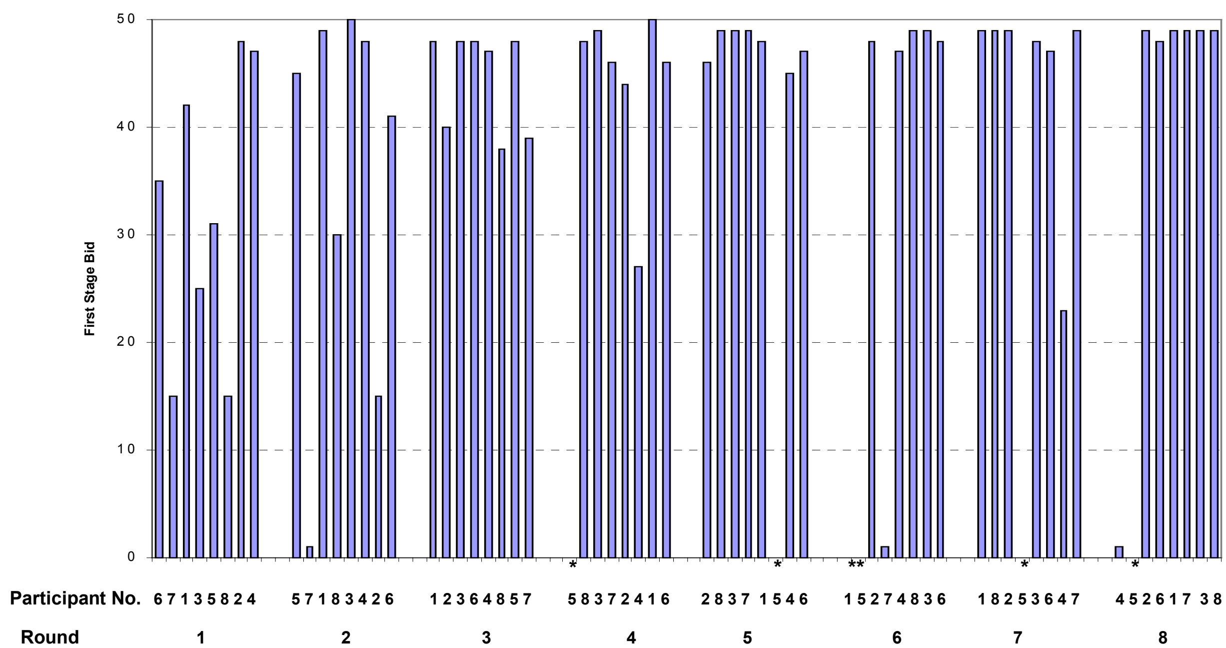
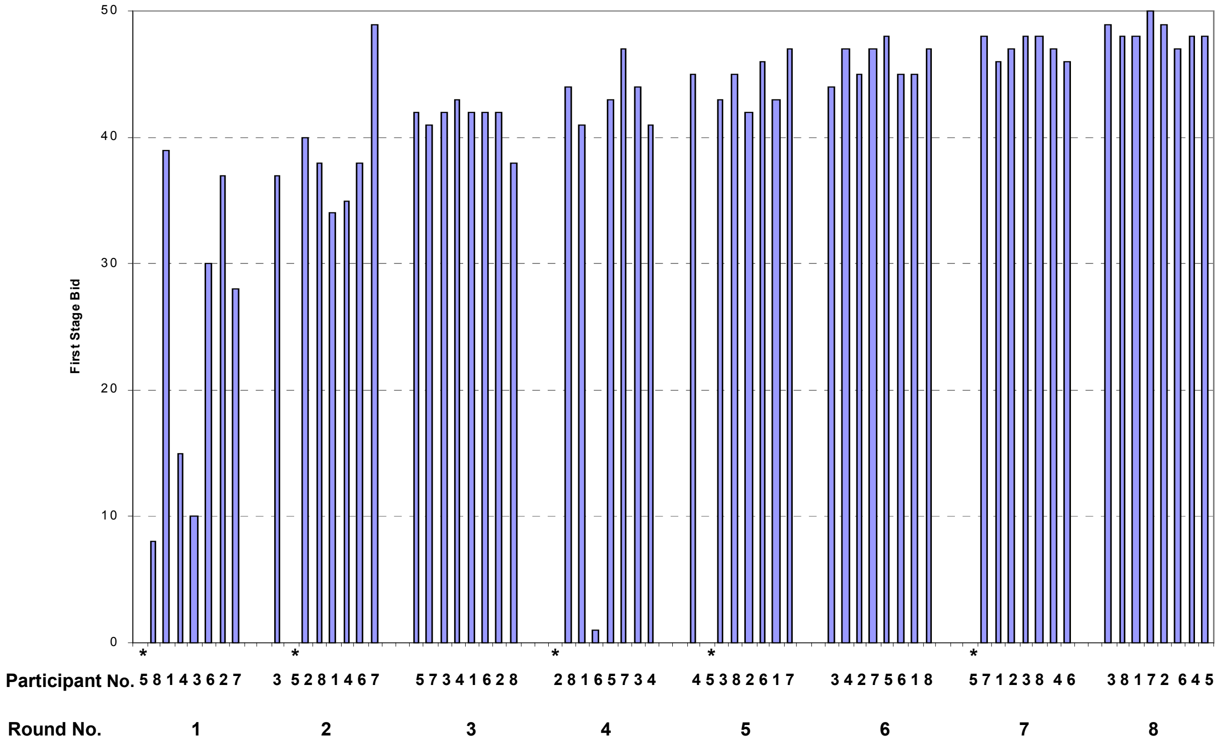


Figure 5
Eight Persons with Announcement



Appendix A: Proof that in an all-pay auction with two players who have different caps, the player with the smaller cap gets a zero expected surplus if the cap is sufficiently small

Consider stage two of the game (an all-pay auction) where there are two active players with different caps. For the sake of argument, suppose the players are 1 and 2, with valuations V_1 and V_2 and caps B_1 and B_2, where $B_2 < B_1 \leq B$ and $V_1 > V_2 > B_2$. Note that $V_2 > B_2$ since $(1/F)V_i - B > 0$, for all active players. We follow the proof in Che and Gale (1997), although in their model the players have different caps but the same valuations.

If $B_2 = 0$, then the only equilibrium is in pure strategies in which player 2 bids zero and player 1 bids a small but positive amount.

Now suppose $B_2 > 0$. First, there is no equilibrium in pure strategies. The proof is straightforward, so it is omitted. There is an equilibrium in mixed strategies (Che and Gale, 1997). Second, no player has a mass point at any bid $x \in (0, B_2)$ in stage two. Without loss of generality, suppose the contrary that player 1 has a mass point at

$x \in (0, B_2)$, say at x_1. Then the probability that player 2 wins rises discontinuously as a function of his bid at x_1. Hence there is some $\varepsilon > 0$ such that player 2 will bid on the interval $[x_1 - \varepsilon, x_1]$ with zero probability. But then player 1 is better off bidding $x_1 - \varepsilon$ instead of x_1 since his probability of winning is the same. This contradicts the hypothesis that putting a mass point at $x \in (0, B_2)$ is an equilibrium strategy. Third, only one player can receive a strictly positive expected surplus. Suppose instead that both players receive positive expected surpluses. Then both players must have the same infimum bid. If not, the player with the strictly lower infimum would lose with probability one when he bids below the other player's infimum bid, so his expected surplus cannot be strictly positive, since every bid in the support of his equilibrium mixed strategy must yield the same expected surplus. If both players have the same infimum bid, $\underline{x} > 0$, then in order for each of them to win with positive probability when bidding $\underline{x}$, they must both have mass points at $\underline{x}$. But this is not possible since no player puts a positive mass at $x \in (0, B_2)$ and B_2 cannot be either player's lowest bid since there is no pure-strategy equilibrium. Hence, only one player can have a strictly positive expected surplus. Finally, the player with the bigger cap (i.e., player 1) gets a positive expected surplus and therefore player 2's expected surplus is zero. To see this, note that player 1 can guarantee himself a positive expected surplus by submitting a bid above B_2. Since there exists a bid that guarantees player 1 a positive expected surplus, this player cannot make a zero expected surplus in a mixed-strategy equilibrium. Hence player 2 (i.e., the player with the smaller cap) gets a zero expected surplus. **QED.**

Appendix B

B1: An example to show that a burning-out equilibrium can weakly Pareto-dominate a non-burning-out equilibrium with higher K.

Consider N players with valuations, $V_1 = 600$, $V_2 = 600$, $V_3 = 460$, $V_4 = 460$, $V_5 = 340$, $V_6 = 340$, $V_i = 100$ for i = 7, 8, …, N. The cap is B = 50 and F = 2.

Then K= 6 and e* = B is an equilibrium because $(1/6)V_i – B > 0$ for i = 1, 2,, …, 6. If players 7 to N bid B = 50 they will each get a negative payoff. However, K = N, e* = 0 is also an equilibrium because $(2/N)(V_i/2 – 50) \geq 0$ for i = 1, 2, …, N. The players indexed 7 to N are neither better off nor worse off in this equilibrium than in the six-player burning-out equilibrium, since expected payoffs equal zero in both cases. For the burning-out equilibrium to Pareto-dominate K = N, e* = 0, we require $(2/N)(V_i/2 – 50) \geq (1/6)V_i – 50$, or equivalently, if $N \geq 6(V_i – 100)/(V_i – 300)$ for i = 1, 2,, …, 6 with strict inequality for at least one i. Given the players' valuations above, this is true if $N \geq 36$. **QED**.

B2: (i) Proof that K = 3 and e* = B = 50 is dominated by all other pure-strategy equililbria in the four-player case, and (ii) Proof that e* = 1 and K = 3 dominates all other pure-strategy equilibra in the four-player case

There are four players with valuations $V_1 = 300$, $V_2 = 230$, $V_3 = 170$, and $V_4 = 100$. The cap is B = 50 and F = 2.

Part (i): First, K = 3 and e* = B = 50 is an equilibrium because $(1/3)V_i – B > 0$ for i = 1, 2, 3. If player 4 bids B = 50 given K = 3, his payoff is negative because 100/4 – 50 < 0. Given K = 3, we know from the discussion in the text that all other equilibria for which K = 3 (i.e., 0 < e* < 50) Pareto-dominate K = 3, e* = B = 50.

Note that there is no equilibrium with K < 3 players since any player who participated in the three-player burning-out equilibrium would also participate in any hypothetical equilibrium having less than three players. Hence we only need to compare the equilibria with K = 4 to the three-player burning-out equilibrium.

For K = 4 to be an equilibrium, we require that $(2/4)[(1/2)V_i – (50\text{-}e^*)] – e^* \geq 0$ for i = 1, 2, 3, 4. This holds so long as $e^* \leq (1/2)V_i – 50$ or, substituting the lowest valuation for V_i, $e^* \leq 0$. Hence, the only equilibrium is e* = 0 given K = 4. Note that player 4 gets a zero expected payoff whether K = 3 or K = 4. Now the equilibrium in which K = 4 and e* = 0 Pareto-dominates the three-player burning-out equilibrium if $(2/4)[(1/2)V_i – 50] \geq (1/3)V_i – 50$, with strict inequality for at least one i, i = 1, 2, 3. This holds if $V_i \leq 300$ with strict inequality for $V_i < 300$. Hence players 2 and 3 are better off in the equilibrium with K = 4 and e* = 0 and players 1 and 4 are no worse off. Hence K = 3, e* = B is the worst equilibrium. **QED**.

Part (ii): First, recall that player 4 gets a zero expected payoff whether K = 3 or 4. Given K = 3, the equilibrium which gives the highest payoff is the equilibrium with the lowest effort, e*, in stage one. Since we only allow integer bids in our experiments, the lowest such bid in stage one consistent with K=3 is e* = 1. Hence to show that K = 3, e* = 1 is the best equilibrium, we need to compare this equilibrium to K = 4, e* = 0. To do this, we need to show that $(2/3)[(1/2)V_i – (50 – 1)] – 1 \geq (2/4)[(1/2)V_i – 50]$, for i = 1, 2, 3, with strict inequality for, at least, one i. This holds if $V_i \geq 104$, with strict inequality for at least one i. This is true, given $V_1 = 300$, $V_2 = 230$, and $V_3 = 170$. **QED**.

B3: Proof that K = 6 and e* = B = 50 is Pareto-dominated by all other pure-strategy equilibria in the eight-player case.

There are eight players with valuations, $V_1 = 600$, $V_2 = 600$, $V_3 = 460$, $V_4 = 460$, $V_5 =$

340, V_6 = 340, V_7 = 200, and V_8 = 200. The cap is B = 50 and F = 2.

First, K= 6 and e* = B, is an equilibrium because $(1/6)V_i - B > 0$ for i = 1, 2,, …, 6. If either player 7 or player 8 bids B = 50, he/she will each get a negative expected payoff. Given K = 6, we know from the text that all other equilibria (i.e., $0 \leq e^* < 50$), if they exist, Pareto-dominate K = 6, e* = B = 50.

Note that there is no equilibrium with K < 6 players since any player who participated in the six-player burning-out equilibrium would also participate in any hypothetical equilibrium having less than six players. Hence we only need to compare the equilibria with K = 7 and K = 8 to the six-player burning-out equilibrium.

We now need to show that in any equilibrium with K = 7 or K = 8, players 7 and 8 get an expected payoff greater than or equal to zero and players 1 to 6 get expected payoffs greater than or equal to $(1/6)V_i - B$ with strict inequality for at least one player. Since players 7 and 8 get a zero payoff in the six-player equilibrium and cannot be forced to choose a negative expected payoff in any other possible equilibrium, we focus primarily on players 1 to 6 unless otherwise indicated.

Any equilibrium with K = 7, 8 Pareto dominates the six-player burning-out equilibrium if $(F/K)[(1/F)V_i - (B-e^*)] - e^* \geq (1/6)V_i - B$, with strict inequality for at least one i, i = 1, 2, 3,…, 6. Solving for e*, gives

$$e^* \leq B + V_i\left(\frac{1-K/6}{K-F}\right), \qquad \text{(B3-1)}$$

i = 1, 2,…,5, 6.

If (B3-1) holds for $V_1 = V_2 = 600$, then it holds for lower V_i with strict inequality. Substituting K = 8, V_i = 600, F = 2, and B = 50 into (B3-1) gives $e^* \leq 16.667$ as the required condition. Now for K = 8 to be an equilibrium, we require that $(F/K)[(1/F)V_i - (B-e^*)] - e^* \geq 0$ for i = 7 and 8. This will also be true as long as $e^* \leq 16.667$. It follows that when an equilibrium exists for K = 8, it satisfies the inequality in (B3-1) and thus Pareto-dominates the six-player burning-out equilibrium.

We now compare equilibria with K = 7 to the six-player burning-out equilibrium.

Substituting K = 7, $V_i = 600$, F = 2, and B = 50 into (B3-1) gives $e^* \leq 30$ as the required condition for Pareto dominance. For K = 7 to be an equilibrium, we require that $(F/K)[(1/F)V_i - (B-e^*)] - e^* \geq 0$ for either i = 7 or 8 and $[F/(K+1)][(1/F)V_i - (B-e^*)] - e^* < 0$ for either i = 7 or 8. Substituting into these two expressions yields $16.667 < e^* \leq 20$. It follows that if players 1 to 7 bid $e^* \in (16.667, 20]$, then player 8 will stay out of the contest.[32] Hence equilibria with K = 7 exist for $e^* \in (16.667, 20]$.[33] Since $e^* \in (16.667, 20]$ satisfies $e^* \leq 30$, it follows that when an equilibrium exists for K = 7, it satisfies the inequality in (B3-1) and thus Pareto-dominates the six-player burning-out equilibrium.

We have therefore proven that any pure-strategy equilibrium Pareto-dominates the six-player burning-out equilibrium. **QED**.

B4: Proof that (K = 8, e* = 0) and (K = 6, e* = 21) are the only pure-strategy equilibria that are not Pareto-dominated

Recall that equilibria with K = 7 exist for $e^* \in (16.667, 20]$. Hence the best equilibrium when K = 7 has $e^* \approx 16.667$. However, since in our experiments, we allow only integer bids, the best equilibrium for K = 7 is at e* = 17. Call this equilibrium (K =7, e* = 17).

When K = 8, the best equilibrium has e* = 0. Call this (K = 8, e* = 0). To find the best equilibrium for K = 6, we need to find the lowest value of e* for which K = 6 is an equilibrium. When K = 6, then players 7 and 8 will stay out of the contest if

$(2/7)[200/2 - (50 - e^*)] - e^* < 0$. This gives $e^* > 20$. Hence the best equilibrium for K = 6 is at e* = 21, given that we allow only integer bids in our experiments. Call this (K = 6, e* = 21).

[32] By symmetry, the roles of players 7 and 8 are interchangeable.

[33] For K = 7, there is no equilibrium in which the players with valuations $V_i = 200$, are active players but one of the other players is not. As shown above, for player 7 or 8 to be an active player for K = 7, we require that $e^* \leq 20$. Then for one of the other players to be non-active, we require that $(F/(K+1))[(1/F)V_i - (B-e^*)] - e^* < 0$ or $(2/8)[(V_i/2 - (50 - e^*)] - e^* < 0$. This gives $e^* > 40$ for $V_i = 340$. Since $e^* \leq 20$ and $e^* > 40$ cannot simultaneously hold, it follows that there is no equilibrium with K = 7 where the players with $V_i = 340$ are non-active and the players with $V_i = 200$ are active. There is also no such equilibrium with K < 7. A similar argument holds for the players with $V_i = 460$, 600.

First, let's compare (K = 8, e* = 0) and (K = 7, e* = 17). The payoff of a player with valuation, V_i, when K = 8 and e* = 0, is $\prod_{8i} = (1/8)V_i - 12.5$. The payoff of a player with valuation, V_i, when K = 7 and e* = 17, is $\prod_{7i} = (1/7)(V_i - 185)$. Therefore, $\prod_{8i} - \prod_{7i} = 13.92857143 - 0.0178571429V_i > 0$ for $V_i \in [200, 600]$. Hence, (K = 8, e* = 0) Pareto-dominates (K = 7, e* = 17).

We now compare (K = 8, e* = 0) and (K = 6, e* = 21). The payoff of a player with valuation, V_i, when K = 6 and e* = 21, is $\prod_{6i} = (1/6)V_i - 92/3$. Therefore,

$\prod_{8i} - \prod_{6i} = 18.66667 - 0.04167V_i$. Now $\prod_{8i} - \prod_{6i} > 0$ for $V_i = 340$ but $\prod_{8i} - \prod_{6i} < 0$ for $V_i = 460$ and 600. Hence, (K = 8, e* = 0) and (K = 6, e* = 21) cannot be ranked according to the Pareto criterion. **QED**.

Appendix C: Experimental Instructions

This is an experiment in the economics of decision making. The Social Sciences and Humanities Research Council of Canada has provided funds for this research. The instructions are simple and if you follow them carefully, you may make money in this experiment. This money along with a $3.00 participation fee will be paid to you by cheque at the end of the session.

The session will last for eight periods and each period consists of two stages. You will be playing with three other persons. Your total earnings will depend on your decisions together with the decisions of the other players and your luck during the sessions. You should not communicate with anyone else in the room during the session.

The game uses a fictional currency called tokens. All game transactions are denominated in this fictional currency. Your information slip contains the rate that allows you to convert the tokens that you earn in the experiment into Canadian dollars. The total amount of money you earn in all of the rounds will determine your dollar payoff at the end of the game.

At the beginning of each period, you will be asked to draw an information slip from a box held by the experimenter. On each slip you should enter the date, your assigned player number, and the period number.

At the end of stage two, one of the four persons will be awarded a monetary prize. The value of the prize for you and for the other members of your group will be specified on your information slip. Your prize value may differ from the prize value for the other members of your group. Each information slip will also indicate that you have 50 tokens that you may either keep or use in order to bid for the prize.

In stage one of each period, you will be given the opportunity to bid any amount of money from zero up to 50 tokens. You are not allowed to bid more than 50 tokens. Enter the value of your bid in the designated space on the information slip. Once you make your decision, please raise your hand and your information slip will be collected by the experimenters. The person who places the highest bid and the person who places the second-highest bid will move on to stage two. The other two players will earn 50 tokens minus their bids in that period. If two players choose the same bid and it is the highest bid, they will both move on to stage two. If more than two players choose the same bid, and it is the highest bid, a random draw will be used to determine which two will move on to stage two. Finally, if one player places the highest bid and two or more players place the same bid and it is the second-highest bid, a random draw will be used to determine which one of the latter will move on to stage two.

If you reach stage two, you will be given the opportunity to bid any amount of money from zero up to whatever amount of money remains after your stage-1 bid. The person who places the highest bid will receive the prize. Its value will be as specified on that person's information slip. If both players choose the same bid, a random draw will be used to determine which of the two will receive the prize.

If you receive the prize, your total earnings will simply be 50 tokens, minus the tokens you bid in both stages, plus the prize value you drew at the beginning of the game. If you do not receive the prize, your total earnings for each period will just be 50 tokens, minus your bid or bids in the period.

At the end of each period, the amount you have earned in tokens will be indicated by the experimenter on your information slip, which will then be returned to you. Please note that you will have 50 tokens allocated to you at the beginning of each period. You may not use your earnings from an earlier period to make bids in a later period.

At the end of the session, you will be called up one at a time and paid by cheque the total amount that you earned for all periods in the sessions. All slips used in the session should be returned at that time.