

Assortative Matching with Externalities and Farsighted Agents

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Abstract

We consider a one-to-one assortative matching problem in which matched pairs compete for a prize. With such externalities, the standard solution concept, pairwise stable matching, may not exist. In this paper, we consider farsighted agents and analyze the largest consistent set (LCS) of Chwe (1994). Despite the assortative structure of the problem, LCS tend to be large with the standard effectiveness functions: LCS can be the set of all matchings, including an empty matching with no matched pair. By modifying the effectiveness function motivated by Knuth (1976), LCS becomes a singleton of the positive assortative matching. Our results suggest that the choice of effectiveness function can significantly impact the solution in a matching problem with externalities.

Keywords: group contest, pairwise stable matching, assortative matching, farsightedness, largest consistent set, effectiveness function

JEL Classification Numbers: C7, D71, D72.

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1 Introduction

There is a large literature on two-sided matching problems after a celebrated paper by Gale and Shapley (1962). The structures and the properties of its central solution concept, pairwise stable matching, have been investigated extensively. At the same time, relatively little attention has been paid to matching problems with externalities, despite their ubiquity in many matching markets in the real world. For instance, matched pairs compete after a matching is formed. In this case,

Consider the following example. Suppose that there are three male and three female skaters with high, medium, and low ability. It is natural to predict a positive assortative matching as an outcome of this example. Is it pairwise stable under the above effectiveness function? Consider a deviation by the high ability male and the medium ability female skaters from the assortative matching. Then, according to the effectiveness function, their former partners, the high ability female and the medium ability male, cannot participate in the pairs competition, since they become singles. This means that there are only two pairs in the competition, and the deviating pair gets a high winning probability against the low ability pair. Thus, in the presence of externalities, there may not be a pairwise stable matching under the standard effectiveness function.

When the high ability male and the medium ability female agents deviate, they do not expect any reaction from their former partners. Since single agents cannot participate in the pairs contest, it is beneficial to match with any available partner. Given the two singles dumped by their partners are available to form a pair, it is probably not reasonable for the deviating pair to expect their deviation to decrease the number of pairs. Thus, it is natural to investigate whether or not agents'

1.1 Literature Review

There are three branches of literature related to our paper. The first branch is the matching problem with externalities.⁵ Recently, a number of papers have been written in this field. Sasaki and Toda (1996) was the first to analyze a one-to-one matching problem with externalities. They considered a set of admissible matchings which can be realized after a pair is formed (or deviates), and defined pairwise stable matching, assuming that deviating pairs expect the worst case scenario. They showed that the admissible set needs to be the set of all matchings to ensure the existence of a stable matching, and proved that there always exists a Pareto-efficient stable matching. Hafalir (2007) imposed certain rationality constraints on players' expecting which set of matchings might be realized by forming a pair, and showed the existence of stable matching under pessimism as in Sasaki and Toda (1996). Chen (2019) considered a specific example of Cournot oligopoly game played by joint ventures, assuming that each pair has unique expectation on the realization of a matching if it is formed. With this list of expectations for each possible pair, each player chooses his/her partner and Chen defined a stable matching as the outcome of this game. Chen identified conditions under which positively and negatively assortative matchings are stable. Mumcu and Saglam (2010) introduced outside options, and Fisher and Hafalir (2016) and Chade and Eeckhout (2020) avoided the impacts of pairwise deviations through externalities by imposing a behavioral assumption and by considering a continuum of atomless agents, respectively. Bando (2012, 2014) and Pycia and Yenmez (2021) considered one-to-many and many-to-many matchings, and analyzed the standard stability concept and its existence by imposing assumptions on agents' preferences.

Second is the field of farsighted stability. Mauleon, Vannetelbosch, and Vergote (2011), Herings, Mauleon, and Vannetelbosch (2020), and Kimya (2021) considered farsighted agents in one-to-one matching problems without externalities. The first two papers showed that every farsighted

⁵More generally, there is a large literature of theory of coalition formation with externalities, starting from Hart and Kurz (1983). For surveys from various aspects, see Bloch (1997), Ray (2008), and Ray and Vohra (2014).

stable set is a singleton set of a stable matching under coalitional and pairwise effectiveness functions, respectively. Kimya (2021) showed that the largest maximal farsighted set in the spirit of Dutta and Vartiainen (2020) coincides with LCS by Chwe (1994) in this domain with coalitional deviations.⁶ We consider farsighted agents in the pairs competition model with externalities in this paper, and show that the choice of effectiveness function matters, providing an example where LCS, under the standard effectiveness function, is the set of all matchings, including a fully unmatched matching.

Third, our paper belongs to the literature of assortative matching. Becker (1973) introduced the assortative model of marriages. Banerjee, Konishi, and Sönmez (2001) extended Becker's assortative matching problem to hedonic coalition formation problems without externalities by defining a top coalition property. This property guarantees the existence and uniqueness of the core.⁷ Diamantoudi and Xue (2003) proved that under the top coalition property, LCS coincides with a singleton core under the standard effectiveness function in coalition formation problems. Mauleon, Vannetelbosch, and Vergote (2011) derived the same result in the context of one-to-one matching. Although our model has the same assortative structure, the results are quite different with externalities.

2 The Model

We first define our one-to-one matching problem with externalities, and introduce basic terminologies in the next subsection, then we move on to introduce (figure skating) pairs competition problem.

⁶Dutta and Vartiainen (2020) introduced history dependence to the rational expectations farsighted stability in Dutta and Vohra (2017) to assure nonemptiness of solutions for all finite problems.

⁷See Bogomolnaia and Jackson (2002) and Leo et al. (2021) as well.

2.1 One-to-One Matching Problems with Externalities

Let $M = \{m_1, \dots, m_n\}$ and $W = \{w_1, \dots, w_n\}$ be the sets of male and female agents with $|M| = |W| = n$. Let $\mu : M \cup W \rightarrow M \cup W$ be a one-to-one matching: $\mu(x) = x$ for all $x \in M \cup W$ such that if $\mu(m) \in M$ then $\mu(m) \in W$, and if $\mu(w) \in W$ then $\mu(w) \in M$. The set of all matchings is denoted by \mathcal{M} . Each agent $x \in M \cup W$ has a complete, transitive, and reflexive preference relation R_x which is a binary relation over $M \cup W$. Let the associated strict preference relation be $P_x = (R_x \text{ and } \neq)$, and associated indifference relationship be $I_x = (R_x \text{ and } \sim)$. A matching μ is fully matched if $\mu(x) \neq x$ for all $x \in M \cup W$. Denote a set of all fully matched matchings by \mathcal{M}^* . A matching μ is a fully unmatched matching if $\mu(x) = x$ for all $x \in M \cup W$.

We define an effectiveness function which describes the resulting matching induced by a deviation from the original matching. The following effectiveness function is standard in the literature of matching theory and coalition formation (Roth and Vande Vate, 1990; Diamantoudi and Xue, 2003; Herings, Mauleon, and Vannetelboch, 2020).

Definition 1. A matching μ' is induced from μ by a pair $(m; w) \in M \times W$, denoted by

$\mu' = \mu(m; w)$, if it holds

- (i) $\mu(m) \in W$ and $\mu(w) = m$;
- (ii) $\mu(m) \in M \Rightarrow (\mu'(m)) = \mu(m)$ and $\mu(w) \in W \Rightarrow (\mu'(w)) = \mu(w)$;
- (iii) for all $x \in M \cup W \setminus \{m; w\}$, $\mu'(x) = \mu(x)$;

In words, the effectiveness function states that when a pair of agents deviates from a matching, the resulting matching is identical to the original matching except that (1) deviators are matched, and (2) their previous partners are single. Similarly, we can define the effectiveness function for a deviation by an agent.

Definition 2. A matching μ is induced from μ_0 by an agent $x \in M \cup W$, denoted by $\mu \succsim_x \mu_0$, if it holds

$$(i) \quad \mu(x) \in X \text{ and } \mu(x) = x; x$$

pair i 's winning probability is given by

$$= \frac{Y}{\sum_{j=1}^n Y_j} \quad (1)$$

The effort cost function is common and linear for every agent x : $c(e_x) = e_x$. Therefore, the expected payoffs of agent x in pair i is

$$U_x = e_x + a_x(\cdot);$$

where $a_x(\cdot)$ is agent x 's payoff from the partner's ability, and $\epsilon > 0$ is sufficiently small. This is introduced to break ties when there is only one pair in the competition: agent x in the pair prefers a high ability partner even though he/she wins with probability one without making effort. Thus, in the pairs competition problem, for every agent x , preference P_x satisfies

(i) for all

$n(i)$ is the number of matched pairs under μ ;

$A(i) = a_i + a_{x(i)}$ is the productivity of pair $i \in N$.

Pair i 's equilibrium winning probability is calculated as¹⁰

$$= 1 - \frac{(n(i) - 1) \frac{1}{a_{i(x)}}}{\sum_{j \in N(i)} \frac{1}{a_{j(x)}}}$$

Member x of pair i 's equilibrium payoff under μ when $(x) \in \mu$ can be explicitly solved as¹¹

$$U_x = \underbrace{1 - \frac{(n(i) - 1) \frac{1}{a_{i(x)}}}{\sum_{j \in N(i)} \frac{1}{a_{j(x)}}}}_{\text{winning probability}} \underbrace{1 - \frac{(n(i) - 1) \frac{1}{a_{i(x)}}}{\sum_{j \in N(i)} \frac{1}{a_{j(x)}}} \frac{a}{A(i)}}_{\text{net benefits by taking effort dis utility into account}} + a_{x(i)}$$

Since agent x cannot control a , we can write U_x as:

$$U_x = V(A(i); E(i)) + a_{x(i)}$$

where $E(i)$ is an aggregated externalities index under μ

$$E(i) = \frac{\sum_{j \in N(i)} \frac{1}{a_{j(x)}}}{n(i) - 1}$$

Note that when agent x gets a higher ability partner, payoff U_x increases due to increases in both $A(i)$ and $E(i)$.

It is important to mention two properties of the aggregated externality index $E(i)$. First, $E(i)$ tends to decrease in the number of matched pair $n(i)$. This is because assuming that the average value of $\frac{1}{a_{j(x)}}$, $\frac{1}{a_{i(x)}}$ stays constant, $\frac{1}{a_{j(x)}}$ decreases as $n(i)$ goes up. This externality causes an important difference between the standard matching problem and the one without externalities. The following example mentioned in the introduction illustrates that.

¹⁰For the detailed derivations, see Imamura, Konishi, and Pan (2021); Konishi, Pan, and Simeonov (2021).

¹¹We can show that if $\sum_{j=1}^n \frac{1}{A_j} > (n-1) \frac{1}{A_i}$ for all $i = 1, \dots, n$, then every pair gets a positive winning probability, see Imamura, Konishi, Pan (2021); Konishi, Pan, and Simeonov (2021) for the details. This condition is satisfied for any $n \geq 2$ if $\sum_{j=1}^n \frac{1}{A_j} > \frac{1}{A_i}$

Example 1. (Imamura, Konishi, and Pan, 2021) Consider a pairs competition problem with $M = \{m_1, m_2, m_3\}$ and $W = \{w_1, w_2, w_3\}$. Let $a_{11} = a_{12} = 1$, $a_{21} = a_{22} = 0.9$, and $a_{31} = a_{32} = 0.7$. Set $\beta = \frac{1}{2}$, then we have $Y = (a_{1i}^{\frac{1}{2}} e^{\frac{1}{2}x_i} + a_{2i}^{\frac{1}{2}} e^{\frac{1}{2}x_i})^2$ and $A = a_{1i} + a_{2i}$. For simplicity set $\gamma = 0$.¹² We calculate m_1 's payoffs under the positive assortative matching μ and matching μ' with $\mu = (m_1, w_1), (m_2, w_2), (m_3, w_3)$.

(i) $\mu = f(m_1; w_1); (m_2; w_2); (m_3; w_3)g$:

$$U_1(\mu) = 1 - \frac{2 \cdot \frac{1}{2}}{\frac{1}{2} + \frac{1}{18} + \frac{1}{14}} = 1 - \frac{2 \cdot \frac{1}{2}}{\frac{1}{2} + \frac{1}{18} + \frac{1}{14}} = \frac{1}{2} = 0.31209$$

(ii) $\mu' = f(m_1; w_2); (m_3; w_3)g$:

$$U_1(\mu') = 1 - \frac{\frac{1}{19}}{\frac{1}{19} + \frac{1}{14}} = 1 - \frac{\frac{1}{19}}{\frac{1}{19} + \frac{1}{14}} = \frac{1}{1.9} = 0.44720$$

Thus, m_1 is better off by dumping his superior partner for an inferior partner. For any other fully matched matching $\mu \in M$, a similar deviation blocks μ . In addition, for any matching

Lemma 1. (Imamura, Konishi, and Pan, 2021) Let $\mu, \mu' \in M$ with $\mu' < \mu$ (thus $a_{i, \mu'} > a_{i, \mu}$), and $(m, m') \in W$ with $a(m, \mu) < a(m', \mu)$. Let μ'' be such that $\mu''(m) = \mu(m)$ and $\mu''(m') = \mu(m')$ with $\mu''(x) = \mu(x)$ for all other x by swapping the partners among these two pairs. Then, $E(\mu'') > E(\mu)$ holds.

One important implication of Lemma 1 is that higher ability agents m and m' are better off by the above assortative swapping, since the abilities of their partners improve. We use these properties to analyze LCS in the next section.

3 The Results

3.1 LCS under the Standard Effectiveness Function

In this section, we consider farsighted agents and analyze the largest consistent set (LCS) introduced by Chwe (1994). We begin by providing a few concepts to define LCS.

Definition 3. A matching μ is indirectly dominated by μ' if there is a finite sequence of distinct matchings μ_0, \dots, μ_L with $\mu_0 = \mu$ and $\mu_L = \mu'$ such that for every $l \in \{0, \dots, L-1\}$, $\mu_{l+1} \succ \mu_l$ holds for some $S \subseteq M \cup W \cup M \cup W$ such that $\mu_{l+1} \succ \mu_l$ for $x \in S$. We denote this indirect domination by $\mu \prec \mu'$.

Definition 4. A set of matchings $CS(M) \subseteq M$ is consistent if for all $\mu \in CS(M)$, all μ' induced by deviation $\mu \prec \mu'$ for some $S \subseteq M \cup W \cup M \cup W$, there exist $\mu'' \in CS(M)$ such that $\mu \prec \mu''$, and $x \in S$ with $\mu''(x) = \mu(x)$.

Definition 5. A set of matchings $LCS(M) \subseteq M$ is the largest consistent set if it is consistent and contains all consistent set $C(M) \subseteq LCS(M)$.

Denote the positive assortative matching by μ^* , where $\mu^*(m) = w$ for all $k = 1, \dots, n$. In pairs competition problems, μ^* satisfies the following property.

Lemma 2. (1) For all $M \in \mathcal{M}$ with $\mu \in \mathcal{M}$, P_1 and P_1 hold, and (2) for all $k = 2, \dots, n-1$, and all $M \in \mathcal{M}$ such that (i) $\mu_j = w$ for all $j = 1, \dots, k-1$, and (ii) $\mu_k \notin w$, if $\mu \in \mathcal{M}$ then P_k and P_k hold.

Proof. Suppose that $M \in \mathcal{M}$ and $\mu \in \mathcal{M}$. Then, there is k such that $\mu_k \notin w$. Let the smallest of such k , and name it k . Then, $\mu_j = w$ holds for all $j = 1, \dots, k-1$, and $a_{x(k)} < a_k$ and $a_{x(k)} < a_k$. Consider a deviation by assortative swapping $\Rightarrow_{(k, k)}$. Since $M \in \mathcal{M}$, M holds. By Lemma 1, we have P_k and P_k , and P_j and P_j for all $j = 1, \dots, k-1$. Now, suppose that $\mu \in \mathcal{M}$. By the same argument, there is the smallest $k' > k$ with $\mu_{k'} \notin w$. Consider assortative swapping $\Rightarrow_{(k', k')}$, then we have $P_{k'}$ and $P_{k'}$ by Lemma 1. Repeating this argument, we have P_k and P_k . This proves P_k and P_k .

Due to the assortative structure, one might think that LCS is a singleton of the assortative matching $f \in g$. However, the other direction of inclusion relationship does not hold in the model with externalities: LCS includes not only $f \in g$, but also many other matchings. Perhaps surprisingly, LCS in Example 1 coincides with the set of all matchings M , including the empty matching.

Proposition 2. In Example 1, $LCS(M) = M$.

To prove the above statement, we introduce some notations. Let the sets of matchings with three, two, one, and zero pairs be $M^3 = \{f \in M : \exists x \in M [W : (x) = xg] = 0g\}$, $M^2 = \{f \in M : \exists x \in M [W : (x) = xg] = 2g\}$, $M^1 = \{f \in M : \exists x \in M [W : (x) = xg] = 4g\}$, and $M^0 = \{f \in M : \exists x \in M [W : (x) = xg] = 6g\}$, respectively.

For use later, we calculate m_1 's payoffs under a few relevant matchings:

(i) $m_1 = f(m_1; w_1); (m_2; w_2); (m_3; w_3)g$:

$$U_{m_1}(m_1) = 1 \cdot \frac{2 \cdot \frac{1}{2}}{\frac{1}{2} + \frac{1}{18} + \frac{1}{14}} + 1 \cdot \frac{2 \cdot \frac{1}{2}}{\frac{1}{2} + \frac{1}{18} + \frac{1}{14}} \cdot \frac{1}{2} = 0.31209$$

(ii) $m_2 = f(m_1; w_3); (m_2; w_1)g$:

$$U_{m_1}(m_2) = 1 \cdot \frac{\frac{1}{17}}{\frac{1}{17} + \frac{1}{19}} + 1 \cdot \frac{\frac{1}{17}}{\frac{1}{17} + \frac{1}{19}}$$

ability: i.e., for x with $(x) \notin x$, $U(\mu) = 1$ if $(x) = m_1$ or $(x) = w_1$, $U(\mu) = 1 - \epsilon$ if $(x) = m_2$ or $(x) = w_2$, and $U(\mu) = 1 - 2\epsilon$ if $(x) = m_3$ or $(x) = w_3$, where $\epsilon > 0$ is arbitrarily close to zero. This construction of payoffs of single pair matchings guarantees that for all $\mu \in M^1$, all $\mu \in M^3 \succeq M^2$, and all x with $(x) \notin x$ and $(x) \notin x$, P holds.

In this particular example, we can also show through direct calculation that for all $\mu \in M^2$, all $\mu \in M^3$, and all x with $(x) \notin x$ (and $(x) \notin x$), P holds. The calculations show that $U_{m_1}(\mu_1) < U_{m_1}(\mu_2)$ holds even though μ_1 is the most preferable matching in M^3 for m_1 and μ_2 is the least preferable in M^2 for m_1 . We write down this property formally.

Strong Negative Externalities in Size (SNES). Suppose that (i) $\mu \in M^1$ and $\mu \in M^2 \succeq M^3$, or (ii) $\mu \in M^2$ and $\mu \in M^3$. If for all $x \in M \cup W$ with $(x) \notin x$ and $(x) \notin x$, P holds.

With SNES, we can show the following claim.

Claim. In Example 1, $M^1 \succeq M^2 \succeq M^3$ is consistent.

Proof.

$\succcurlyeq M^1$, then there is $\succcurlyeq M^2$ with $\succcurlyeq M^1$ by matching a pair excluding the original deviator. Clearly, the original deviator does not benefit. If a deviation pair creates $\succcurlyeq M^2$, then there is $\succcurlyeq M^3$ with $\succcurlyeq M^2$ by matching two single agents. By SNES, the original deviation is not profitable. If a deviation $(m; w)$ creates $\succcurlyeq M^3$ by matching two single agents, then w can deviate with m

3.2 LCS under the Knuth Effectiveness Function

We consider the effectiveness function introduced by Knuth (1976) in this section. In our problem, unmatched agents get the lowest payoff of zero, since he/she cannot participate in the contest.

Diamantoudi and Xue (2003) showed that if a hedonic game satisfies the top-coalition property, then LCS is the singleton core, which is the assortative matching in the one-to-one matching problem without externalities. Does the same result hold in our problem under the effectiveness function with swapping? The following proposition shows that the answer is affirmative.

Proposition 3. In the pairs competition problem, LCS under effectiveness function \Rightarrow only includes μ : i.e., $LCS(\mu) = \{f, g\}$.

Proof. First notice $LCS(\mu) \subseteq M$. If μ has unmatched singles, any unmatched pair $(m; w)$ can deviate from μ to obtain positive payoffs. Since both m and w will have partners under effectiveness function \Rightarrow , after the deviation they retain positive payoffs, regardless of subsequent deviations. Since m and w obtain zero payoffs from matching μ , they certainly deviate from μ . Thus, $\mu \notin LCS(\mu)$, and we conclude $LCS(\mu) \subseteq M$.

Now, we will prove $LCS(\mu) = \{f, g\}$. First, we prove the following claim.

Claim. For all $\mu \in LCS(\mu)$, we have $\mu(m_1) = w_1$.

Proof of Claim. Consider a set of full matchings in which m_1 and w_1 are not matched: $M_1 = \{\mu \in M : (m_1) \notin w_1\}$. This is a finite set, and the elements of M_1, μ^1, μ^2, \dots can be ordered

By the same argument, we conclude $M_2 \setminus \text{LCS}(M) = \emptyset$. So, we move on to $M_3 = \{m_1, m_2, m_3\}$. In M_3 , $(m_1) = w_1$; $(m_2) = w_2$ and $(m_3) \notin w_3$, and so on. This proves that only M_1 remains in $\text{LCS}(M)$. We completed the proof. \square

4 Concluding Remarks

In this paper, we analyzed farsighted agents in a one-to-one matching problem with externalities and the assortative structure. In the matching problem without externalities of Becker (1973), the assortative matching is a quite robust prediction irrespective of pairwise or coalitional deviations and the choice of effectiveness function. However, with externalities, we showed that the choice of effectiveness function is crucial: In cities, we saw that assortative matching is not robust to coalitional deviations when the effectiveness function is not assortative.

solution concept for farsighted agents. The farsighted stable set—vNM stable set defined by indirect domination—have been extensively investigated in the recent literature. It is easy to see that the singleton set of the assortative matching f^g is a farsighted stable set in our problem since f^g indirectly dominates any other matchings. The question is whether or not this is the unique farsighted stable set in the pairs competition problem. Harsanyi's (1974) indirect domination requires every coalition participating in the chain reaction of proposals and counter-proposals to

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