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Abstract

Disagreements betwee ancial incentives continue to be hotly discussed. We examine the effects of financial incentives in a class of interactive decision-making situations, called centipede games, in which mutual trust is essential for cooperation. Invoking backward induction, the Nash equilibrium solution for these games is counterintuitive. Our previous research showed that when the number of players in the centipede game is increased from two to three, the game is iterated in time, the players are rematched, and the stakes are unusually high, behavior approaches equilibrium play. Results from the present study show that reducing the size of the stakes elicits dramatically different patterns of behavior. We argue that when mutual trust is involved, the magnitude of financial incentives can induce a considerable difference.

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