

But Who will Monitor the Monitor?*

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Abstract

Consider a group of individuals in a strategic environment with moral hazard and adverse selection, and suppose that providing incentives for a given outcome requires a monitor to detect deviations. What about the monitor's deviations? In this paper I propose a contract that makes the monitor responsible for the monitoring technology, and thereby successfully provides incentives even when the monitor's observations are not only private, but costly, too. I also characterize exactly when such a contract can provide monitors with the right incentives to perform. In doing so, I emphasize virtual enforcement and suggest its implications for the theory of repeated games.

JEL Classification: D21, D23, D82.

Keywords: contracts, private monitoring, communication, costly subjective evaluation.

*Alchian and Demsetz (1972, p. 782).

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