Mutual Monitoring, None-pecuniar Costs and Optimal Group Size

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by

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Abstract

Social interactions are a form of non-market interaction between individuals, which can be generated by social contact to people in one's residential location.
How is the Effect of social interaction on the group lending? Would you agree on joint liability with a remote stranger? Wouldn't it be better if it was your neighbour or a family member? The difference is about trust or peer monitoring. Peer monitoring is an important partial solution to prevent your partner from betraying you or even free-ride.
Would you participate in a joint liability group of size 5, of 10 of 50 and be required to pay a penalty if borrower goes bankrupt? What would your maximal size be? The bigger the group the more monitoring is necessary. This puts a disadvantage on big groups as monitoring is costly. The costs for the community are non-pecuniary and hide in the cost for the borrower possible punishments of free-riders and to bear risk. The both are inherent in the system of transactions costs and needs to be viewed as a potential disutility function. On the other hand, of course big groups yield the advantage of risk pooling and lower interest rates. Which effect dominates? The rising costs or additional benefits?
In this paper I develop a theoretical model, showing that monitoring costs to analyze how costs of monitoring rise with group size. Up to now the costs-function c(N) of a group with respect to its size lacks some theoretical foundation. I will add this subgame Nash- Equilibrium, and then I compare rising costs with rising benefits and conclude which size of a group would be optimal for joint liability treaties.
Keywords: cost of mutual monitoring, group size, joint liability, microcredit, social capital