A Theory of Deregulation

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It is well known in the Principal-Agent literature that it is always worth using an informative signal for incentives. When applied to regulation of a firm, any signal of the firm's activity that is informative will be used to regulate the firm. This paper develops a theory of deregulation in which the manager of a firm is able to distort reports of firm activity, making the degree of verifiability of performance endogenous. Sufficient conditions are derived for deregulation to be optimal despite the existence of a signal that contains information about the firm's activity. The
conditions ensure that there is an adverse response by the firm whenever the regulator tries to use the signal for incentives. The approach is robust and avoids knife edge assumptions that would be required in the multitask analysis of Holmstrom and Milgrom (1991). The relation to literature on incomplete contracts is discussed.

"...now it is fairly clear; if reality does not determine the measured value, at least the measured value must determine reality..."
Schrodinger

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