

Public–private partnerships and government spending limits[☆]

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Abstract

We consider public–private partnerships, in which a public official selects a project that is then developed and operated by a private contractor. We derive optimal public accounting rules when the official's choice among projects is biased by ideology or social ties or because of pandering to special interests. We give particular emphasis to how the rules should constrain the official's incentive to understate the costs of her pet projects.

In the basic model, we show that the optimal accounting rule takes the form of a budget cap, with a project's expected cost modified to reflect the official's distortionary incentives. If the project can be partially financed privately, then “fixed-price” contracts can serve to curb political misbehavior by “securitizing” public sector liabilities.

We also consider the possibility that development and operations are each handled by different contractors. Such “unbundling” deprives public accountants of forward information about future costs, but can prevent the official from funneling hidden future rents to contractors.

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1. Introduction

Public procurement accounts for a sizeable share of economic activity in most countries. Thus, how to deliver

high-quality public services at low cost to the taxpayer and user is an important problem. An interesting recent development in the effort to find solutions is the growth of *public–private partnerships* (PPPs), both in industrialized countries (e.g., the United Kingdom, as in its Private Finance Initiative launched in 1992) and in emerging economies (e.g., Latin America, Eastern Europe, and China during the 1990s). PPPs have been created for large-scale projects in transportation (rail systems, highways, subways), medical care, telecommunications, energy, water systems, and even orphan drugs.

Although the variety of risk-sharing arrangements and governance structures makes a precise characterization

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difficult, a PPP is usually defined as a *long-term development and service contract* between government and a private partner. The government typically engages its partner both to develop the project and to operate and service it. The partner may bear substantial risk and even raise private finance. Its revenue derives from some combination of government payments and user fees.

In comparing PPPs to more traditional procurement (in which project development on the one hand and operations and maintenance on the other are generally arranged under *separate* contracts), the literature has generally focused on the incentives of the *private partner*. For example, one much-discussed potential advantage of PPPs is that, by “bundling” construction and operations, they induce the developer to internalize cost reductions at the operations stage that are brought about by investment at the development stage.¹ But, by the same token, bundling may lead to a loss in operational efficiency because the best developer might not also be the best operator.² Moreover, it may encourage choices that reduce future costs at the expense of service quality.^{3,4}

The literature’s focus on the private agent is understandable in view of the standard presumption in academic and policy work on public procurement that the government acts to maximize social welfare. Assuming governmental benevolence is a reasonable first step in the analysis of PPPs, but, of course, over-simplifies reality. Accordingly, a fair number of recent studies have departed from the benevolence assumption by supposing that the private partner or other parties may capture the procurement process by side-contracting (colluding) with the government.⁵

¹ Sometimes such internalization can be achieved without bundling if the project developer can be made fully accountable for the profits of the operator who succeeds him, as in case of second-sourcing (Iossa and Legros, 2004). However, internalization may well be imperfect, either because of developer risk aversion (Martimort and Pouyet, 2006) or because of collusion between the operator and its regulator, who can together manipulate accounts to the detriment of the developer (Laffont and Tirole, 1988; Stein, 1989).

² Laffont and Tirole (1988).

³ Hart (2003), Bennett and Iossa (2004), and Martimort and Pouyet (2006). The latter allow for quality incentives as well as observable costs.

⁴ Because of their complexity, PPPs may also be costly to negotiate; see Väilä (2005, Section 5).

⁵ E.g., Grossman and Helpman (1994), Laffont and Martimort (1999), Laffont and Tirole (1991), and Martimort (1999). The literature includes two results on the increased scope for capture under PPP contracts: Martimort and Pouyet (2006) show that separate contracts tend to entail lower-powered incentives and therefore make capture more difficult than under bundling. Laffont and Tirole (1993, chapter 16) argue that separate contracts may be optimal despite the potential efficiency gains from bundling, because a future government (which itself may be corruptible) may undo collusion if not bound by a long-term contract signed by its predecessor.

In this paper we consider a less-explored reason for why procurement projects may not align with the public’s best interest: government officials may have preferences that differ from those of a social welfare maximizer. More specifically, ideology, social or political ties, or the incentive to pander may induce an official to favor the pet projects of particular interest groups—i.e., to practice “pork-barrel” politics—even though these projects may not be justifiable from the standpoint of social welfare. We are particularly interested in how *spending caps* can mitigate the official’s biases.

There is substantial evidence that politicians’ project choices are influenced significantly by the desire to please constituencies and by budgetary constraints. Levin and Tadelis (2006) document that local political institutions in the U.S. have a profound impact on such choices. Less formal evidence in France suggests that efficiency considerations in the production of public goods are often secondary to the government’s determination to deliver visible private benefits to particular interest groups, with costs hidden or delayed as much as possible. For that matter, the very fact that governments in many countries are made to face budgetary constraints at all would be quite mysterious if their goal were truly to maximize social welfare.

Indeed, the marked increase in PPP contracts worldwide is often attributed less to the intrinsic qualities of such contracts than to governments’ attempts to evade budget constraints by taking liabilities off the balance sheet.⁶ For this reason, some commentators worry that accounting gimmickry may become the primary motive behind PPPs, so that “governments may not take the care to properly design contracts to ensure that appropriate incentives are in place” (Mintz and Smart, 2005, page 17; see also IMF, 2005, p. 27).⁷

⁶ Traditionally, many countries often record PPPs off the public sector’s balance sheet. Indeed, PPP financing is often provided via “special purpose vehicles” involving banks and other financial institutions, which can be used as a private veil to hide explicit or implicit government guarantees. To combat this tendency, Eurostat (2004) requires that PPPs be recorded on the public balance sheet unless the private partner carries the construction risk and either the availability or demand risk.

⁷ Interestingly, PPPs are sometimes actually *justified* on the grounds that they alleviate government budgets and substitute cheap private funding for discretionary finance. Engel et al. (2006) show that this argument is highly suspect, as the future user revenue lost by ceding income flows to the private sector exactly offsets the investment savings made by the government early on in the relationship. See Bassetto and Sargent (2005), Beetsma and Uhlig (1999), Blanchard and Giavazzi (2004), Calmfors (2005), Inman and Rubinfeld (1997), Koen and van den Noord (2005), and Milesi-Ferretti (2000) for further discussion of the proper control of public deficits and borrowing.

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