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under Financial and Fiscal Constraints**

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The Optimality of Public-Private Partnerships under Financial and Fiscal Constraints

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Abstract

To implement a public project, the government may delegate two sequential tasks to different agents (i.e., sequential contracts) or a single one (i.e., partnership contract). There is no production externality between tasks. Agents are risk-neutral but face financial constraints. The partnership contract relies on history-dependent incentives and corrects moral hazard more effectively than the sequential contracts. Thus, it dominates the latter in social welfare terms unless bundling different tasks is coupled with a severe deterioration of the agent's financial conditions. The same results hold also when the government's contractual capacity is limited by renegotiation-proof and fiscal constraints. Our results shed a new light on the role of firms' financial conditions, and particularly on the relationship between them and the fiscal constraint, in driving the cost-benefit analysis of public-private partnerships.

Keywords: Sequential moral hazard, Bundling, Limited liability, Budget constraint, Memory contracts

JEL classification: D86, H11, H57, L33

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1 Introduction

The involvement of private companies in the design, construction, and operation of public infrastructures and services is a well-established practice (Bezançon, 2005). However, in the last thirty years, two distinctive features have characterized the evolution of new forms of public-private partnerships (PPPs) in contrast to traditional concession contracts: a greater emphasis on the “value for money” for taxpayers; and a growing institutional and financial complexity.¹

Although potential efficiency gains of PPPs, which may derive from enhanced management of tasks and risks, have been extensively analyzed by the economic literature (e.g., Iossa and Martimort, 2015), fiscal and financial determinants of PPP investments are much less clear. Empirical analyzes showed a positive correlation between stricter fiscal constraints and the choice to undertake PPPs (Hammami et al., 2006; Albalade et al., 2015) that do not find convincing explanations in the literature. While normative economics highlights the irrelevance of financial leverage arguments in favor of PPPs (Engel et al., 2013), intuitive political economy interpretations of the link between fiscal stress and PPP investments – e.g., debt-hiding and non-compliance to fiscal rules (Von Hagen and Wolff, 2006; Buti et al., 2007; Maskin and Tirole, 2008) – have not been corroborated by compelling empirical analyzes.²

More recently, cursory evidence suggests the existence of transmission channels between the fluctuations of PPP investments and financial markets volatility, and a more complex relationship between the former and the fiscal constraints. For example, the share of PPPs on total public investments of the EU countries suddenly dropped after the 2008 financial crisis and remained low afterwards, while the debt-to-GDP ratio soared in the same period (see Figure 1). The financial crisis has affected PPPs by, for instance, cutting available credit. Before the crisis, the ratings of PPP project bonds were enhanced by high-rating monoline insurance companies

¹An important characteristic of new forms of PPPs is the assignment of different tasks of the public project to a single *special purpose vehicle* (or consortium) established by firms that also act as subcontractors of the consortium itself. Such bundling agreements are implemented through different contractual arrangements, taking into account country-specific legislations (Engel et al., 2014).

²In the case of France, Buso et al. (2017) confirm the correlation between adverse conditions of local public finance and the decision of municipalities to start PPPs. But, relying on a quasi-experimental setting, they rule out any debt-hiding motive as explanation of such behavior.

that acted as guarantors against project risks. After the 2008 crisis, most insurers were downgraded, thus reducing the liquidity of the bond market for infrastructure projects (Burger et al., 2009; EPEC, 2009).

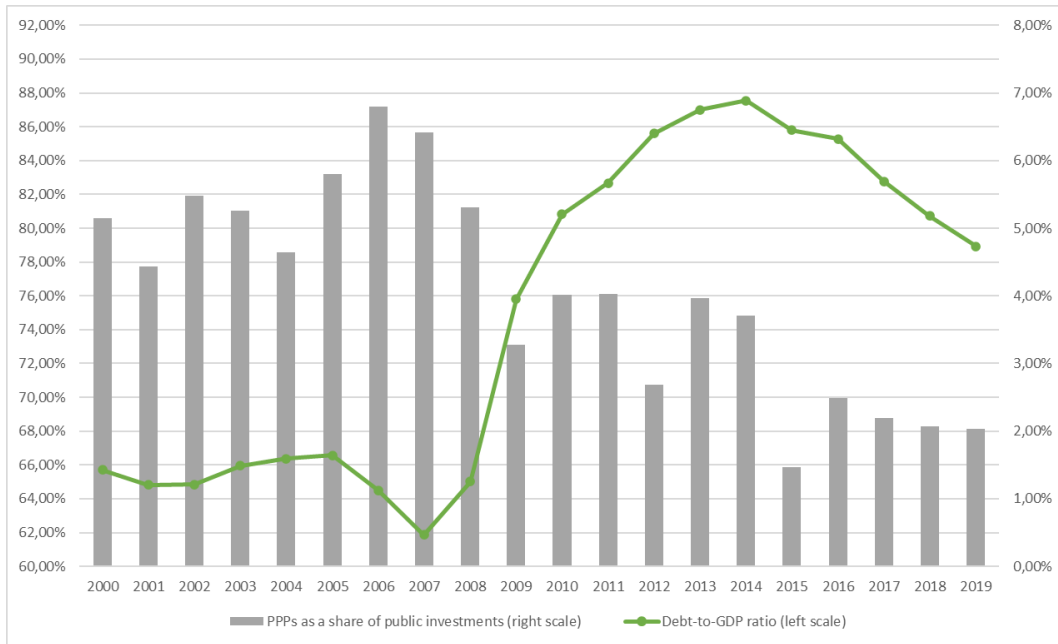


Figure 1: PPPs and government debt of the EU countries from 1990 to 2018

Source: Our elaboration on dataset by EPEC PPP Market Updates (<http://www.eib.org/epec/>), Eurostat and OECD.

Legend: Only contracts above ten millions of euros closed each year in one of the 27 countries of the European Union and the UK are considered. General government debt and investment expenditures are calculated on the basis of the Eurostat and OECD datasets.

Few papers in the extant literature have theoretically investigated the role of finance in PPPs and they basically focused on the monitoring technology of financial intermediaries (Iossa and Martimort, 2012, 2015). In this paper, we analyze the impact of financial and fiscal constraints on incentives, relying on a standard representation of a public project as a *sequential moral hazard* problem, where an infrastructure is build, in the first place, and then it is operated (Engel et al., 2014). To this aim, we consider a risk-neutral principal (or government), who faces a potentially binding budget (or fiscal) constraint, and delegates the implementation of two sequential tasks (i.e., building and operation) to risk-neutral agents, who face limited liability (or financial) constraints. Each task has a contractible output (e.g., infras-

structure quality and operational costs) that is affected by the agent’s task-specific effort and by an exogenous shock. As usual in this literature, the government can use alternative contractual schemes: under unbundled or *sequential* contracts, two agents (i.e., the builder and the operator) are hired to independently implement tasks; under bundled or *partnership* contract, a single agent (i.e., a consortium of the building and operating firms) is hired to implement the two tasks. To better understand the role of the financial and fiscal constraints in the optimal design of contracts, we abstract from any production externality between the building and operating tasks.³

We obtain three main findings. First, abstracting from any difference in financial constraints across private firms, the government is able to design more effective incentive schemes under partnership than sequential contracting. This *moral-hazard correction* component of the welfare comparison is driven by a kind of *financial externality*, that endogenously arises between the building and operating tasks because of the history-dependent nature of the partnership contract, which is absent in the sequential contracts.

A second result is that the welfare comparison of outcomes under the sequential and partnership contracts is also driven by the *limited liability differential* – i.e., by the heterogeneity of financial wealth – among firms. In other terms, if the aggregate financial “pockets” of the builder and operator under the sequential contracts are “deeper” than that of the consortium of firms under the partnership contract, the government may be able to design better incentive schemes in the former case than in the latter.⁴ Of course, if such financial effect is not strong enough, moral-hazard correction prevails and the partnership contract dominates the sequential contracts in terms of social welfare.

In our setting, the limited liability differential is exogenous and can take both positive or negative values, depending on financial market conditions. We can interpret such conditions in the light of relevant findings from the corporate finance

³We also abstract from any agency problem within the private consortium, which may actually affect the structure of the optimal contract (Hoppe et al., 2013; Greco, 2015). Moreover, we consider complete contracts.

⁴This is a straightforward implication of the well-known result that, if the limited liability constraint is relaxed, the principal is able to reach the first best by punishing the agent in case of bad outcomes.

literature. On one side, when firms bundle within a consortium (e.g., establish a special purpose vehicle), a *coinsurance* (or *trading adjuvant*) effect may improve the rating of financial assets that the consortium issues, thus expanding consortium's financial wealth (i.e., loosening the limited liability constraint) in contrast to the aggregate financial wealth of individual firms (Whinston, 1990; Banal-Estanol et al., 2013; Farhi and Tirole, 2015).⁵ On the other side, the financial assets issued by the consortium may be less liquid because of a *risk-contagion* (or *insulation*) effect, which tightens the consortium's limited liability constraint in contrast to the aggregate of individual firms (Gorton and Pennacchi, 1990; De Marzo and Duffie, 1999; Banal-Estanol et al., 2013; Farhi and Tirole, 2015). The risk-contagion effect may prevail in the presence of *high uncertainty on financial markets* (e.g., when returns are low on average, very volatile, negatively skewed, and/or positively correlated) or costly bankruptcy procedures and weaker creditor rights (Banal-Estanol et al., 2013).

A third result of our paper is that the described findings are retrieved also when we consider that the contracting capacity of the government may be limited by the renegotiation-proof and fiscal constraints. Also in this framework, the partnership contract is more effective at correcting moral hazard, thanks to its history-dependent nature. Moreover, we uncover that fiscal and financial constraints are intertwined. Particularly, if bundling does not involve a stricter limited liability constraint (i.e., the coinsurance prevails over the risk-contagion effect), then the fiscal constraint does not affect the capacity of the partnership contract to create more welfare than the sequential contracts. However, if the risk-contagion effect is sufficiently strong such that bundling shrinks the agent's financial wealth, a stricter fiscal constraint may change the welfare ranking between the partnership and sequential contracts. In other words, when agents face heterogeneous limited liability constraints and financial uncertainty is high, the fiscal constraint may affect the cost-benefit comparison between PPPs and traditional procurement.

Our analysis of the financial and fiscal drivers of the welfare comparison between the partnership and sequential contracts (i.e., the balance between the moral hazard

⁵In the case of PPPs, an additional benefit may arise from the involvement of outside financiers in evaluating risks, thus reducing asymmetric information and further relaxing the limited liability constraint (Iossa and Martimort, 2015).

correction and the limited liability differential components) provides a new explanation of the apparent negative impact of high financial markets volatility on PPP investments (Figure 1). Such a theoretical prediction can be exploited to construct *robust* empirical tests of the impact of (financial and) fiscal constraints on PPP investments and shed new light on this hotly debated issue.

The paper is structured as follows. The Section 2 discusses the links of our work with different strands of the literature on PPPs and contract theory. The Section 3 presents the model setup. The Section 4 analyzes the sequential and partnership contracts in a baseline setting where the government’s contracting capacity is limited only by participation, incentive and limited liability constraints of the agents. Then, the Section 5 extends the analysis to consider that the government cannot commit not to renegotiate contracts and faces a fiscal constraint. Finally, the Section 6 concludes.

2 Related literature

In this paper we develop a model that analyzes the bundling of tasks in a context of asymmetric information and financial constraints.⁶ The optimality of bundling tasks in PPPs was studied for the first time by Hart (2003) in a context of incomplete contracting. According to this seminal study, PPPs may provide incentives for desirable investments that improve service quality, but also for undesirable investments that reduce costs at the expense of service quality. Starting from this analysis, the pros and cons of bundled contracts in the presence of related tasks have been investigated through models that either include agency issues or consider the financial aspect of PPPs.

Agency problems are of two forms: adverse selection and moral hazard. Adverse selection models applied to PPPs analyze situations where, in the first stage, the private player has or can gather an informational advantage over the principal about future costs (Hoppe and Schmitz, 2013; Buso, 2019). However, a possible problem of moral hazard may arise if the private player can exert effort during the building stage

⁶Although we analyze the impact of private and public financial constraints on the decision to adopt PPPs, it is beyond the scope of this paper to endogenize the financial structure of PPPs (Fay et al., 2021) or analyze the role of financial intermediaries (Iossa and Martimort, 2015).

that is not verifiable by the government and has a direct effect on the costs incurred during the operating stage (Martimort and Pouyet, 2008; Iossa and Martimort, 2015). Alternatively, some recent contributions to the PPP literature consider two-stage repeated moral hazard models where risk-neutral firms are protected by limited liability.⁷ Martimort and Straub (2016) develop a two-stage moral hazard model where the second-stage reward cannot depend on the first-stage outcome, and the effort level has to satisfy an irreversibility constraint such that it cannot be smaller in the second stage than in the first one. Close to our setting, Hoppe and Schmitz (2021) do not consider any irreversibility constraint and allow for history-dependent (or memory) contracts. Our contribution is characterized by important differences with respect to Hoppe and Schmitz (2021). First, we do not consider any production externality between the two stages. Second, we assume that the principal faces a budget constraint. Third, we allow the exogenous wealth featuring the limited liability constraints to differ between bundled and unbundled contracts. The latter extension helps us to highlight the crucial role of financial constraints as a driver of the choice between PPPs and traditional procurement.

As for the fiscal aspect of PPPs, Engel et al. (2013) develop a model where the private firm is risk averse and receives as a compensation for its efforts a combination of state-dependent user fees and subsidies. In a framework characterized by demand uncertainty, the authors show that the presence of a budget constraint is not a sufficient reason to opt for PPPs. The intuition is that, adopting an intertemporal perspective, a PPP allows the government to postpone the disbursement of payments, but does not release public funds. In a context of multiple tasks and moral hazard, Schmitz (2013) analyzes the optimality of bundling tasks in PPPs when the government is budget-constrained and private firms are protected by limited liability. Differently from Schmitz (2013), in our setting tasks are sequential and asymmetric – i.e., one of them comes before the other and they affect in different ways the principal’s objective function – which explains why, in our extended setting, we have history-dependent contracts and we find that, when limited liability constraints are not looser under the sequential contracts than under the partner-

⁷The analysis of repeated moral hazard models where agents are risk neutral and protected by limited liability is analyzed, among others, by Ohlendorf and Schmitz (2012). However, they do not focus on the differences between bundling and unbundling.

ship contract, PPPs are preferred to traditional procurement from the social welfare point of view even if the principal faces a binding budget constraint.

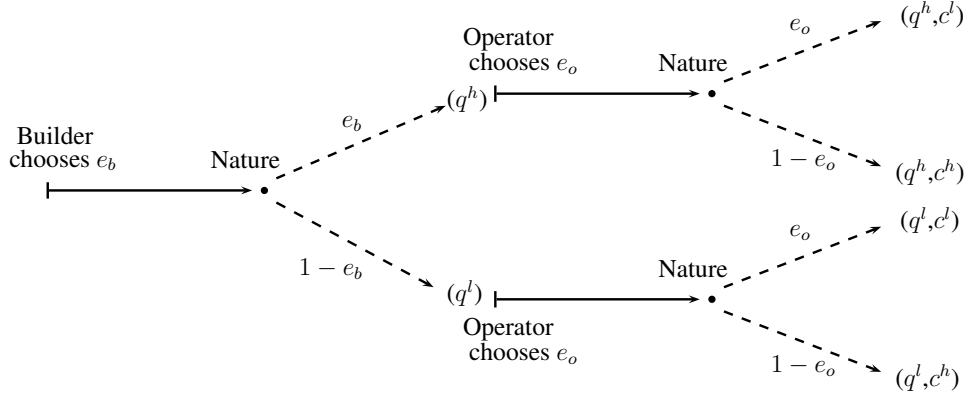


Figure 2: Sequential structure of the game

3 The model

A public infrastructure has to be built and operated. The gross social surplus generated by the public infrastructure is Sq , where q is the level of infrastructure quality and $S > 0$ its social marginal benefit. The infrastructure quality is determined in the first phase of the public infrastructure cycle (see Figure 2), as a random outcome of the builder's productive effort $e_b \in [0, 1]$. We assume that quality is high q^h , with probability e_b , and low q^l , with probability $1 - e_b$. Investing in quality entails a monetary cost kq (with $k < S$) and a non-monetary (or management) cost for the builder $\phi(e_b)$, where $\phi(0) = 0$ and $\phi(1) > (S - k)q^h$, moreover $\phi'(e_b) \geq 0$, $\phi''(e_b) > 0$, and $e_b \frac{\phi'''(e_b)}{\phi''(e_b)} > -2$ for all e_b .

The operational costs c are determined during the second, service-provision phase of the public infrastructure cycle (see Figure 2) as a random variable of the operator's effort to cut costs $e_o \in [0, 1]$. Operation costs are low c^l , with probability e_o , and high c^h , with probability $1 - e_o$.⁸ The non-monetary cost of the operator is $\psi(e_o)$, where

⁸We abstract from possible production externalities between the building and operation tasks, which are common in the literature on PPPs. These would imply that a component of costs is determined by the quality of infrastructure, as in Hoppe and Schmitz (2021), but would not change our main findings.

$\psi(0) = 0$ and $\psi(1) > c^h - c^l$, moreover $\psi'(e_o) \geq 0$, $\psi''(e_o) > 0$ and $e_o \frac{\psi'''(e_o)}{\psi''(e_o)} > -2$ for all e_o .⁹

We assume that the government maximizes the expected net social value of the public infrastructure $W = Sq - T$, where T are the total payments to the private contractors that carry out the building and operating tasks. In designing contracts, the government may face two constraints. First, the impossibility to commit to contractual clauses, which implies that contract should satisfy a *renegotiation-proof constraint* (RPC). Second, a state-independent cap to possible government expenditures on the considered infrastructural project. We model the latter *budget constraint* (BC) as an upper bound to total payments to the private contractors, i.e., $F \geq T$.

The government cannot directly verify the effort of its contractors during the investment and operation phases. But it can *ex post* verify the level of infrastructure's quality q and operational costs c . We assume that the public procurement procedures are such that the government has all the bargaining power (e.g., it designs a public tender). In our analysis, we focus on two contractual schemes that the government may choose. Under the *sequential contracts* (i.e, so-called "traditional procurement" in the literature on PPPs), the contracting game is such that: the government proposes a take-it-or-leave-it contract to the builder, specifying a payment $t_b(q, c)$; then it offers a contract to the operator with a payment $t_o(q, c)$. Under the *partnership contract*, the government chooses to bundle all tasks by contracting with a single consortium of firms acting as builder and operator.¹⁰ The total payment to the consortium that is specified by the bundled contract is $t(q, c)$.

Under the sequential contracts, the state-contingent monetary profit of the building firm is $\pi_b = t_b(q, c) - kq$ and the state-contingent utility of the building firm's management, which factors in the managerial effort, is $u_b = \pi_b - \phi(e_b)$; while the state-contingent monetary profit of the operating firm is $\pi_o = t_o(q, c) - c$ and the state-contingent utility of the operating firm's management is $u_o = \pi_o - \phi(e_o)$. Firms have to accept the contract that is offered by the government (e.g., they have to

⁹The conditions on the third derivatives of $\phi(\cdot)$ and $\psi(\cdot)$ are necessary to warrant the concavity of the government's optimization problem.

¹⁰In our analysis, we abstract from possible agency problems within the consortium of the builder and operator. Such problems may reduce the value for money that the government can get out of the partnership contract (Greco, 2015).

participate in a public tender), hence a feasible contract has to satisfy the following *participation constraint* (PC): $E(u_b) \geq 0$, for the builder, and $E(u_o) \geq 0$, for the operator, where we normalize to zero the reservation utility of firms' management. Moreover, we assume that each firm faces a state-independent *limited-liability constraint* (LLC) such that the ex post monetary profit cannot drop below the firm's financial wealth. Particularly, $\pi_b \geq -l_b$ and $\pi_o \geq -l_o$, where l_b and l_o are the financial wealth of the builder and the operator, respectively.

Under the partnership contract, the state-contingent monetary profit of the consortium carrying out both the building and operating tasks is $\pi_p = t(q, c) - kq - c$ and the state-contingent utility of the consortium's management is $u_p = \pi_p - \phi(e_b) - \phi(e_o)$. Also the consortium faces a PC $E(u_p) \geq 0$, and a LLC $\pi_p \geq -l_c$, where l_c is the consortium's financial wealth.

Finally, we assume that the fiscal constraint of the government (BC) and the financial constraints of the firms (LLCs) are such that the first-best investment and operational costs can be financed in all possible states of the world and, particularly, in the state of the world $\{q^h, c^h\}$ which involves the maximum level of investment and operational costs under both the sequential and partnership contracts, i.e., $F + \min\{l_b + l_o, l_c\} \geq kq^h + c^h$.¹¹

4 Contracting under private financial constraints

To make our analysis more tractable, we proceed in two steps. In this section, we focus on the comparison between the partnership and sequential contracts that have to satisfy agents' participation, incentives and financial constraints, while government can fully commit to contracts and does not face any fiscal constraint.

4.1 The first best solution

As a benchmark, we consider the case where the government can observe the contractors' efforts e_b and e_o . Thus, payments to contractors can be conditioned only

¹¹In the real world, we may have public investment projects which are abandoned in very adverse fiscal and/or financial conditions. We leave the analysis of a more complex model including such cases for future research.

on effort and have to satisfy the PC, which can be written as follows:¹²

$$t_b - k[e_b q^h + (1 - e_b)q^l] - \phi(e_b) + t_o - e_o c^l - (1 - e_o)c^h - \psi(e_o) \geq 0. \quad (1)$$

The government aims at reducing the payments to contractors. Thus (1) is binding and the maximization problem of the government is:

$$\max_{e_b, e_o} (S - k)[e_b q^h + (1 - e_b)q^l] - \phi(e_b) - e_o c^l - (1 - e_o)c^h - \psi(e_o).$$

The first-best optimal efforts, e_b^* and e_o^* , are such that:

$$\phi'(e_b^*) = (S - k)(q^h - q^l), \quad (2)$$

$$\psi'(e_o^*) = c^h - c^l. \quad (3)$$

The first best solution can be implemented by the government even if it cannot observe the efforts of the agents, provided that the LLCs of the agents do not bind at the (second best) optimum. In this case, the government can extract the full information rent from the firms. Therefore, we have the following result:

Proposition 1 *If LLCs are not binding, the sequential and partnership contracts determine the same first-best level of efforts and social welfare.*

4.2 Sequential contracts

In this case, the government awards two contracts – one for each phase or task of the public infrastructure cycle – to different firms, the builder and the operator.

¹²It is worth to notice that the same first-best optimal solution can be obtained if, instead of a single PC (1), we consider two separate PCs:

$$t_b - k[e_b q^h + (1 - e_b)q^l] - \phi(e_b) \geq 0$$

for the builder, and

$$t_o - e_o c^l - (1 - e_o)c^h - \psi(e_o) \geq 0$$

for the operator.

4.2.1 Implementable sequential contracts

For the characterization of implementable contracts, we proceed by backward induction. Any contract awarded by the government to the operator has to satisfy the PC, ICC and LLC. As shown in the Figure 2, at the operation phase the state of the world is characterized by the realized quality of the infrastructure. Thus, the operator's PC and ICC may, in general, depend on the realization of q and can be written as follows:

$$\max_{e_o} e_o(t_o(q, c^l) - c^l) + (1 - e_o)(t_o(q, c^h) - c^h) - \psi(e_o) \geq 0. \quad (4)$$

The LLCs can be written as:

$$\begin{aligned} \pi_o(q, c^l) &= t_o(q, c^l) - c^l \geq -l_o; \\ \pi_o(q, c^h) &= t_o(q, c^h) - c^h \geq -l_o. \end{aligned}$$

By the assumptions on the shape of $\psi(\cdot)$, the second-order condition of the problem (4) is negative, hence the solution is unique. Thus, following the first-order approach, the ICC can be written as:

$$(t_o(q, c^l) - c^l) - (t_o(q, c^h) - c^h) = \psi'(e_o) \geq 0. \quad (5)$$

Among the implementable sequential contracts, everything else equal, the government chooses payments involving the least fiscal burden. Thus, by the LLCs and ICC, the state-contingent, implementable payments to the operator can be written as:

$$t_o(q, c^h) = t_o(c^h) = c^h - l_o \quad (6)$$

$$t_o(q, c^l) = t_o(c^l) = c^l + \psi'(e_o) - l_o. \quad (7)$$

Let us remark that the implementable payments, and the operator's effort that they induce, do not depend on q , but only on c^l , c^h and on the shape of the non-monetary cost function, $\psi(\cdot)$.

Anticipating the effort of the operator e_o (that is induced by the operation con-

tract awarded by the government), any implementable building contract have also to satisfy the PC and ICC,

$$\begin{aligned} & \max_{e_b} e_b(e_o t_b(q^h, c^l) + (1 - e_o)t_b(q^h, c^h) - kq^h) + \\ & +(1 - e_b)(e_o t_b(q^l, c^l) + (1 - e_o)t_b(q^l, c^h) - kq^l) - \phi(e_b) \geq 0, \end{aligned} \quad (8)$$

as well as the LLCs,

$$\begin{aligned} \pi_b(q^h, c^l) &= t_b(q^h, c^l) - kq^h \geq -l_b, \\ \pi_b(q^h, c^h) &= t_b(q^h, c^h) - kq^h \geq -l_b, \\ \pi_b(q^l, c^l) &= t_b(q^l, c^l) - kq^l \geq -l_b, \\ \pi_b(q^l, c^h) &= t_b(q^l, c^h) - kq^l \geq -l_b. \end{aligned}$$

As in the case of the operation contract, by the assumptions on the shape of $\phi(\cdot)$, the second order condition of the problem (8) is negative and, following the first order approach, the ICC can be written as:

$$\begin{aligned} & [e_o t_b(q^h, c^l) + (1 - e_o)t_b(q^h, c^h) - kq^h] + \\ & -(e_o t_b(q^l, c^l) + (1 - e_o)t_b(q^l, c^h) - kq^l) = \phi'(e_b) \geq 0, \end{aligned} \quad (9)$$

Again, considering that the government aims at reducing the payments to contractors, by the LLCs and ICC we can characterize the state-contingent, implementable payments to the builder as follows:

$$t_b(q^l, c^l) = t_b(q^l, c^h) = t_b(q^l) = kq^l - l_b \quad (10)$$

$$e_o t_b(q^h, c^l) + (1 - e_o)t_b(q^h, c^h) = kq^h + \phi'(e_b) - l_b. \quad (11)$$

It is worth noticing that the implementable payments to the builder are independent of the realized operational costs when the quality of the infrastructure is low, while they may be also contingent on the realization of operational costs when the quality of the infrastructure is high.

As we show in the Appendix (Lemma I.1), for sufficiently low l_b and l_o , the PCs do not limit the set of implementable sequential contracts. The intuition is that,

if the financial wealth of the firm (i.e., l_b , for the builder, or l_o , for the operator) is sufficiently large, the PC is binding and the expected information rent is equal to zero. In such a case, as argued in the Proposition 1, the first best solutions are implemented. In the following, we assume that this is never the case.

4.2.2 Optimal sequential contracts

The government maximizes the following expected social welfare function:

$$\begin{aligned} \max_{e_b, e_o} & e_b [S q^h - e_o (t_b(q^h, c^l) + t_o(c^l)) - (1 - e_o)(t_b(q^h, c^h) + t_o(c^h))] + \\ & + (1 - e_b) [S q^l - e_o (t_b(q^l, c^l) + t_o(c^l)) - (1 - e_o)(t_b(q^l, c^h) + t_o(c^h))]. \end{aligned} \quad (12)$$

Substituting the payment schedules that satisfy the ICCs and LLCs of the builder (10)-(11) and the operator (6)-(7) in (12), the government's maximization problem can be written as:

$$\begin{aligned} \max_{e_b, e_o} & (S - k) q^l - c^h + l_b + l_o + e_o (c^h - c^l - \psi'(e_o)) + \\ & + e_b [(S - k)(q^h - q^l) - \phi'(e_b)]. \end{aligned} \quad (13)$$

By the problem (13), we obtain the optimization conditions that characterize the second-best optimal efforts under sequential contracts:

$$\phi'(e_b^s) = (S - k)(q^h - q^l) - e_b^s \phi''(e_b^s); \quad (14)$$

$$\psi'(e_o^s) = c^h - c^l - e_o^s \psi''(e_o^s). \quad (15)$$

By inspection of the optimization conditions in first best – (2) and (3) – and in second best – (14) and (15), we have the following result:

Proposition 2 *Under the sequential contracts, the second-best optimal efforts of the builder and operator are strictly smaller than the first-best ones.*

As usual in moral hazard problems, the introduction of (binding) LLCs increases the cost of inducing agents' efforts, thus introducing a second-best optimal downward distortion of the efforts.

4.3 Partnership contract

In this case, the government awards a single (bundled) contract to a consortium carrying out both the building and operation tasks.

4.3.1 Implementable partnership contracts

The feasible payment functions have to satisfy the PC and ICC of the consortium, which can be written as:

$$\begin{aligned} \max_{e_b, e_o^h, e_o^l} e_b [e_o^h (t(q^h, c^l) - c^l) + (1 - e_o^h) (t(q^h, c^h) - c^h) - kq^h - \psi(e_o^h)] + \\ + (1 - e_b) [e_o^l (t(q^l, c^l) - c^l) + (1 - e_o^l) (t(q^l, c^h) - c^h) - kq^l - \psi(e_o^l)] + \\ - \phi(e_b) \geq 0. \end{aligned} \quad (16)$$

Similarly, the LLCs have to be satisfied:

$$t(q^h, c^l) - kq^h - c^l \geq -l_c, \quad (17)$$

$$t(q^h, c^h) - kq^h - c^h \geq -l_c, \quad (18)$$

$$t(q^l, c^l) - kq^l - c^l \geq -l_c, \quad (19)$$

$$t(q^l, c^h) - kq^l - c^h \geq -l_c. \quad (20)$$

Also in this case we can rely on the first-order approach.¹³ Thus, the consortium's ICC is represented by the following system of optimization conditions:

$$\begin{aligned} [e_o^h (t(q^h, c^l) - c^l) + (1 - e_o^h) (t(q^h, c^h) - c^h) - kq^h - \psi(e_o^h)] + \\ - [e_o^l (t(q^l, c^l) - c^l) + (1 - e_o^l) (t(q^l, c^h) - c^h) - kq^l - \psi(e_o^l)] = \\ = \phi'(e_b) \geq 0; \end{aligned} \quad (21)$$

$$(t(q^h, c^l) - c^l) - (t(q^h, c^h) - c^h) = \psi'(e_o^h) \geq 0; \quad (22)$$

$$(t(q^l, c^l) - c^l) - (t(q^l, c^h) - c^h) = \psi'(e_o^l) \geq 0. \quad (23)$$

These conditions imply that the contract is robust also against state-contingent

¹³In the considered setting, the first-order approach characterizes the optimal solutions for the consortium, given that the Hessian matrix of the second-order partial derivatives of its objective function (16) is definite negative.

deviations of the consortium, after q is realized. In other terms, the system of equations (21-23) satisfies both the ex ante and ex interim consortium's ICC.

Similarly to what we obtained in the case of sequential contracts, by the characterization of feasible payments to the consortium, we show in the Appendix (Lemma I.2) that, for sufficiently low l_c , the PC does not limit the set of implementable partnership contracts. Again, the intuition is that if the consortium's financial wealth is sufficiently large, the PC is binding, the expected information rent is equal to zero and the first-best solution can be implemented (Proposition 1 holds). In the following, we assume that this is never the case.

In the Appendix (Lemma I.3), we show that, among the LLCs, only the condition (20) binds. Thus, considering that the government aims at minimizing the payments to the consortium (other things equal), by the LLCs and ICC, we characterize the state-contingent, implementable payment functions as follows:

$$t(q^l, c^h) = kq^l + c^h - l_c, \quad (24)$$

$$t(q^l, c^l) = kq^l + c^l - l_c + \psi'(e_o^l), \quad (25)$$

$$t(q^h, c^h) = kq^h + c^h - l_c + \tau(e_o^l, e_o^h, e_b), \quad (26)$$

$$t(q^h, c^l) = kq^h + c^l - l_c + \tau(e_o^l, e_o^h, e_b) + \psi'(e_o^h), \quad (27)$$

where, as shown in the Appendix (see the proof of the Lemma I.3),

$$\tau(e_o^l, e_o^h, e_b) = e_o^l \psi'(e_o^l) - \psi(e_o^l) - e_o^h \psi'(e_o^h) + \psi(e_o^h) + \phi'(e_b) \geq 0.$$

4.3.2 Optimal partnership contract

The optimization problem of the government is:

$$\begin{aligned} \max_{e_b, e_o^h, e_o^l} e_b [Sq^h - e_o^h t(q^h, c^l) - (1 - e_o^h) t(q^h, c^h)] + \\ + (1 - e_b) [Sq^l - e_o^l t(q^l, c^l) - (1 - e_o^l) t(q^l, c^h)]. \end{aligned} \quad (28)$$

Again, substituting the payment schedules that satisfy the ICC and LLCs of the consortium (24)-(25) in (28), the government's maximization problem can be written

as:

$$\begin{aligned} & \max_{e_b, e_o^h, e_o^l} (S - k)q^l - c^h + l_c + e_o^l(c^h - c^l - \psi'(e_o^l)) + \quad (29) \\ & + e_b[(S - k)(q^h - q^l) - \phi'(e_b) + (e_o^h - e_o^l)(c^h - c^l) + \psi(e_o^l) - \psi(e_o^h)] \end{aligned}$$

Under the partnership contract, the second-best optimal efforts in the building phase e_b^p , in the operation phase when the quality of infrastructure is high e_o^{hp} , and when it is low e_o^{lp} are determined by the following optimization conditions:

$$\phi'(e_b^p) = (S - k)(q^h - q^l) + (e_o^{hp} - e_o^{lp})(c^h - c^l) + \psi(e_o^{lp}) - \psi(e_o^{hp}) - e_b^p \phi''(e_b^p) \quad (30)$$

$$\psi'(e_o^{hp}) = c^h - c^l \quad (31)$$

$$\psi'(e_o^{lp}) = c^h - c^l - \frac{e_o^{lp}}{1 - e_b^p} \psi''(e_o^{lp}) \quad (32)$$

We observe that, at the optimum, the government actually exploits the possibility of writing partnership contracts with memory, given that the operation effort is different depending on the realized quality of the infrastructure.

By the optimization conditions (30)-(32), we obtain two results which help us to delve into the analysis of the optimal partnership contract. The first result compares the second-best optimal efforts induced by the partnership contract with the first-best ones:

Proposition 3 *Under the partnership contract, the second-best optimal effort of the builder can be smaller, equal or larger than the first-best one, while the second-best optimal effort of the operator is equal (or lower) than the first-best one when the quality of the infrastructure is high (or low).*

Proof. See the Appendix. ■

From the Proposition 3, two important differences with respect to the sequential contracts arise. First, the partnership contract allows the government to implement the first-best optimal operation effort when the quality of infrastructure is high. Second, the second-best optimal building effort is not necessarily below the first-best one.

Building on these results, we can compare the builder's and operator's efforts of the partnership and sequential contracts:

Proposition 4 *The second-best optimal effort of the builder under the partnership contract is strictly larger than under the sequential contracts. The second-best optimal effort of the operator under the partnership contract, when infrastructure quality is high (or low), is strictly larger (or smaller) than under the sequential contracts.*

Proof. See the Appendix. ■

The Proposition 4 relies on the well-known result that history-dependent contracts improve the welfare of the principal in models of dynamic moral hazard (e.g., Iossa and Martimort, 2015, p. 31-32). Even though no production externality exists between the building and operating tasks, the partnership contract allows the principal to design more powerful (and less costly) incentive schemes to reward or punish, in the second stage, the perceived insufficient effort of the agent in the first phase. Such a mechanism cannot be used in the framework of sequential contracts, given that the agent of the first stage is not the same of the second stage.¹⁴

4.4 Partnership vs sequential contracts: welfare analysis

Substituting the second-best optimal efforts in the government's objective function, we can write the maximum social welfare under the partnership contract as:

$$W^p = (S - k)q^l - c^h + l_c + e_o^{lp}(c^h - c^l - \psi'(e_o^{lp})) + e_b^{p2}\phi''(e_b^p);$$

and the maximum social welfare under the sequential contracts as:

$$W^s = (S - k)q^l - c^h + l_b + l_o + e_o^s(c^h - c^l - \psi'(e_o^s)) + e_b^{s2}\phi''(e_b^s).$$

¹⁴We may find examples of history-dependent clauses in real-world long-term concessions. For example, airports PPPs in Sao Paulo (Brasil), Rio de Janeiro (Brasil) and Santiago de Chile include incentives to attract demand and an history-dependent mechanism for capacity expansion. If the concessionaire's effort to attract air traffic is successful, then the concession is expanded and allows the concessionaire to invest in new airport capacity. Our theoretical findings can be interpreted as a suggestion to expand similar history-dependent clauses in PPPs.

Thus, the total increase (or reduction) of the social welfare that is determined by the partnership contract, compared to the sequential contracts, can be written as:

$$\Delta W = W^p - W^s = MHC + l_c - l_b - l_o, \quad (33)$$

where:

$$MHC = e_o^{lp}(c^h - c^l - \psi'(e_o^{lp})) - e_o^s(c^h - c^l - \psi'(e_o^s)) + e_b^{p2}\phi''(e_b^p) - e_b^{s2}\phi''(e_b^s)$$

is the component of the social welfare variation which is driven by the enhanced capacity to control moral hazard through the partnership contract compared to the sequential contracts (i.e., *moral hazard correction*); and $l_c - l_b - l_o$ is the component of the social welfare variation which derives by the larger (or smaller) financial wealth of the consortium under the partnership contract compared to aggregate of the building and operating firms under the sequential contracts (i.e., *limited liability differential*).

In our setting, $l_c - l_b - l_o$ is an exogenous component of the welfare difference which can take positive or negative values, depending on financial market conditions. As discussed in the Introduction, the corporate finance literature provides us with an interpretation of different signs of such a component. If the coinsurance effect prevails on the risk-contagion effect when firms are *bundled* within a consortium, then $l_c > l_b + l_o$. If the opposite is true, $l_c < l_b + l_o$. The latter situation is likely to arise when the financial markets feature high volatility, low risk appetite and, hence, low overall liquidity of risky assets, which may spread asymmetric information among traders (Banal-Estanol et al., 2013; Farhi and Tirole, 2015). Considering this interpretation of the limited liability differential, we have the following important result:

Proposition 5 *When $l_c \geq l_b + l_o$, the partnership contract always dominates the sequential contracts in social welfare terms.*

Proof. See the Appendix. ■

The interpretation of the Proposition 5 is that, as already pointed out, the partnership contract is history-dependent, which affords the principal a more powerful

incentive mechanism. Therefore, the MHC component of the social welfare difference between the partnership and sequential contracts is always strictly positive. Moreover, when the volatility of financial markets is low the LLCs are equally or less constraining under the partnership than under the sequential contracts (i.e., $l_c \geq l_b + l_o$). In turn, the government may transfer more risk on the agent and, thus, design higher-powered incentive contracts in the former than in the latter case, which involves a smaller loss of efficiency with respect to the first best allocation.

On the contrary, if financial markets are affected by high uncertainty, such that the risk-contagion effect prevails on coinsurance (i.e., $l_c < l_b + l_o$), then the sequential contracts may become socially optimal. In particular, we have the following result:

Corollary 1 *The sequential contracts dominate the partnership contract in social welfare terms if and only if:*

$$-(l_c - l_b - l_o) > MHC.$$

By the proof of the Proposition 5, we know that $MHC > 0$. Therefore, a necessary condition for the sequential contracts to improve the social welfare with respect to the partnership contract is that financial constraints are stricter in the case of bundled tasks than in the case of unbundled tasks, i.e., $l_c < l_b + l_o$.

5 Limited contracting capacity of the government

In what follows, we extend the model of the Section 4 to take into consideration two types of constraints that, in the real world, limit the contracting capacity of governments. We first relax the assumption that contracts cannot be renegotiated (Section 5.1). Then, we also introduce a binding fiscal constraint (Section 5.2).

5.1 Renegotiation

Renegotiation may affect only the partnership contract, which includes clauses regarding both sequential tasks. Particularly, if we relax the assumption that government can perfectly commit to the initial contract, after the quality of the infrastructure is determined, the government and the consortium may find mutually

convenient to renegotiate the contractual clauses that regulate the operation task. In turn, the set of feasible contracts has also to satisfy the RPC, which may reduce the efficiency of the optimal partnership contract and, at least in principle, affect the results that we obtained in the Section 4.

5.1.1 Implementable partnership contracts

When the government cannot commit not to renegotiate contracts, the implementable partnership contracts have to satisfy the PC and ICC constraints from an *ex ante* (see Section 4.3.1) as well as *ex interim* perspective. Particularly, the *ex interim* PC and ICC can be written as:

$$\max_{e_o^i} e_o^i(t(q^i, c^l) - c^l) + (1 - e_o^i)(t(q^i, c^h) - c^h) - kq^i - \psi(e_o^i) - \phi(e_b^p) \geq E(u_o^{ip}), \quad (34)$$

where q^i , with $i \in \{h, l\}$, is the realization of the infrastructure quality, after the (optimal) first-period investment e_b^p has been implemented, e_o^i is the operation effort that the consortium implements in the second stage (taking into consideration the renegotiated contract), and

$$E(u_o^{ip}) = e_o^{ip}(t(q^i, c^l) - c^l) + (1 - e_o^{ip})(t(q^i, c^h) - c^h) - kq^i - \psi(e_o^{ip}) - \phi(e_b^p)$$

is the net expected utility that the consortium would obtain under the full-commitment contract, with e_o^{ip} the optimal full-commitment efforts of the consortium depending on the realization of q^i , which is determined by the optimization conditions (31)-(32).

As in the Section 4.3, the LLCs (17)-(20) have to be satisfied.

By the first-order approach, we can substitute the ICC with the condition:

$$(t(q^i, c^l) - c^l) - (t(q^i, c^h) - c^h) = \psi'(e_o^i) \geq 0, \quad (35)$$

which corresponds to the condition (22) or (23) in case $i = h$ or $i = l$, respectively.

Considering that the government aims at minimizing the (renegotiated) payments to the consortium, by the LLCs (17)-(20) and the *ex interim* ICC (35), the *ex interim* utility of the consortium's management in the case of renegotiation can

be written as:

$$E(u_o^i) = e_o^i \psi'(e_o^i) - \psi(e_o^i) - l_c - \phi(e_b^p), \quad (36)$$

where $i \in \{h, l\}$. The same expression (36), with e_o^{ip} instead of e_o^i , represents the ex interim utility of the consortium's management when the full-commitment contract is implemented. Moreover, we remark that $\frac{\partial E(u_o^i)}{\partial e_o^i} = e_o^i \psi''(e_o^i) \geq 0$, with strict inequality when $e_o^i > 0$, which brings us to the following result:

Lemma 1 *The operation-task clauses of the full-commitment partnership contract are renegotiated if and only if $e_o^i > e_o^{ip}$.*

Compared to the full-commitment case, only if the government is willing to renegotiate a larger operating effort it may warrant an improvement of the ex interim utility of the consortium, which makes renegotiation feasible. Conversely, when the condition of the Lemma 1 is violated (i.e., $e_o^i \leq e_o^{ip}$), the full-commitment partnership contract is also robust against any possible renegotiation.

Therefore, in the optimization problem of the government we can substitute the ex interim PC with the RPC, which can be simply introduced as a lower bound on the level of the quality-contingent operation effort, i.e., $e_o^i \geq e_o^{ip}$ for $i \in \{h, l\}$.

5.1.2 Optimal partnership contracts

If the ex interim PC (34) is satisfied, the optimization problem of the government that is willing to renegotiate the contractual clauses about the operational phase coincides with the optimization problem of the government about the operation task under the sequential contracts (see Section 4.2.2). However, the quality-contingent operation effort cannot be set below the full-commitment one, because of the ex interim PC of the consortium. In other terms, the government is always willing to renegotiate e_o^{ip} , considering the ex interim social welfare, and implement e_o^s instead. By the Propositions 3 and 4, we know that $e_o^* = e_o^{hp} > e_o^s > e_o^{lp}$. Thus, by the Lemma 1, the renegotiation of the full-commitment contract takes place when quality is low (given that both the social welfare and the utility of the consortium's management may grow), but not when it is high (given that in such a case any renegotiation would hurt the consortium's management).

It is worth to notice that also the optimal renegotiation-proof partnership contract is history-dependent. Therefore, we have the following result:

Corollary 2 *The Proposition 5 holds also when the government cannot commit not to renegotiate contractual clauses.*

Proof. See the Appendix. ■

Let us focus on the intuition of the Corollary 2. The Proposition 5 relies on the enhanced capacity of the partnership contract to control moral hazard by incorporating a memory mechanism which increases the rent of the consortium when quality is high – above the level that is reached with sequential contracts – and reduces it when the quality is low. The latter mechanism (the punishment) cannot be implemented with a renegotiation-proof partnership contract, while the former can still be implemented. In turn, the welfare-improving effect of the history-dependent structure of the partnership contract is not fully destroyed by the impossibility to commit not to renegotiate, though the power of incentives on the building effort is reduced. Particularly, by the optimization condition (30), we see that the building effort is strictly lower when the partnership contract has to satisfy the RPC than under full commitment.

5.2 Fiscal constraint

We now extend the model of the previous section, which already takes into account the RPC, to consider the BC as an additional limit to the capacity of the government to design contractual clauses. Relying on the characterization of the implementable and optimal contracts of the previous sections, we analyze the maximum, state-contingent payments from the government to contractors which may be affected by the fiscal constraint both under the sequential and partnership contracts. Then we study how a fiscal constraint that limits the maximum level of payments changes our previous results.

5.2.1 Sequential contracts

Let us first analyze the *maximum fiscal burden* of government payments to firms under the sequential contracts, in order to understand in which states of the world the fiscal constraint may bind.

From the LLCs and ICCs of the builder and the operator (see Section 4.2.1), it is easy to check that any implementable payments to the builder (10)-(11) and operator (6)-(7) are such that:

$$\begin{aligned} t_b(q^h, c^h) + t_o(c^h) &\geq t_b(q^l) + t_o(c^h), \\ t_b(q^h, c^l) + t_o(c^l) &\geq t_b(q^l) + t_o(c^l). \end{aligned}$$

Moreover, we observe that the government can implement different payment schedules to reach the same outcome. Particularly, when the quality is high, the feasible payments to the builder have to satisfy the condition (11), which implies that either $t_b(q^h, c^l) + t_o(c^l)$ or $t_b(q^h, c^h) + t_o(c^h)$ may entail the largest fiscal outlays for the government. However, we are able to establish the following result:

Lemma 2 *The BC binds if and only if:*

$$t_b(q^h, c^h) + t_o(c^h) = t_b(q^h, c^l) + t_o(c^l). \quad (37)$$

Moreover, the maximum fiscal burden is associated to payments on the left- and right-hand sides of the equation (37).

Proof. See the Appendix ■

We now assume that the condition (37) holds and that the BC (potentially) affects the optimal sequential contracts only in the states of the world $\{q^h, c^h\}$ and $\{q^h, c^l\}$ that entail the most expensive payments.¹⁵ Therefore, the government maximizes the problem (12) under the BCs:

$$F \geq t_b(q^h, c^l) + t_o(c^l) \quad \text{and} \quad F \geq t_b(q^h, c^h) + t_o(c^h). \quad (38)$$

¹⁵If the BC becomes very stringent such that also the less expensive payments become unaffordable for the government, the principal loses the capacity to provide incentives that induce the agent(s) to implement different levels of efforts in different states of the world.

However, given the Lemma 2, it is easy to show that the BCs (38) boil down into a single constraint. Thus, substituting the payment schedules that satisfy the ICCs and LLCs of the builder and the operator in the government optimization problem (12) under the BC (38), the government's maximization problem can be written as:

$$\begin{aligned} & \max_{e_b, e_o} (S - k)q^l - c^h + l_b + l_o + \\ & + e_o(c^h - c^l - \psi'(e_o)) + e_b[(S - k)(q^h - q^l) - \phi'(e_b)] + \\ & + \lambda[F + l_b + l_o - kq^h - c^h - \phi'(e_b) + e_o(c^h - c^l - \psi'(e_o))], \end{aligned} \quad (39)$$

where λ is the Lagrangian multiplier of the BC. By the problem (39), we obtain the optimization conditions that characterize the second-best optimal efforts under the sequential contracts with the fiscal constraint:

$$\phi'(e_b^{sf}) = (S - k)(q^h - q^l) - (e_b^{sf} + \lambda)\phi''(e_b^{sf}), \quad (40)$$

$$\psi'(e_o^{sf}) = c^h - c^l - e_o^{sf}\psi''(e_o^{sf}). \quad (41)$$

We obtain interesting findings. First, the optimal operation contract is not affected by the fiscal constraint (i.e., $e_o^{sf} = e_o^s$), while the building contract is. Particularly, if $\lambda > 0$ (i.e., the BC binds), the builder's effort is strictly smaller than in the case without the fiscal constraint: $e_b^{sf} < e_b^s$. Moreover, considering that the BC is binding and $e_o^{sf} = e_o^s$, the optimization condition (40) can also be written as follows:

$$\phi'(e_b^{sf}) = F + l_b + l_o - kq^h - c^h + (e_o^s)^2\psi''(e_o^s), \quad (42)$$

from which we see that, under a binding fiscal constraint, e_b^{sf} is determined by the available fiscal and financial resources (i.e., $F + l_b + l_o$) and $\frac{de_b^{sf}}{dF} = \frac{de_b^{sf}}{dl_b} = \frac{de_b^{sf}}{dl_o} = \frac{1}{\phi''(e_b^{sf})} > 0$.

The reason why only the optimal building contract is affected by the fiscal constraint is that we are considering a model with sequential moral hazard where different tasks influence the final outcome in an asymmetric way. Particularly, by providing costly incentives to increase the building effort, in the first phase, the government faces a trade off between the objective to foster higher social welfare

and the fiscal constraint. For this reason, the optimal building effort is lower under the fiscal constraint than in absence of it. Conversely, by providing incentives to increase the operation effort, in the second phase, the government is pursuing an higher social welfare but also reducing the payment to the operator, thus easing the trade off between the objective and the fiscal constraint. To see why this is the case, consider that the payment to the operator – which covers the cost c^i , for any $i \in \{h, l\}$, and the information rent when the operation cost is c^l – is lower in the states of the world where the cost is c^l than in the states of the world where the cost is c^h .

The described results make it evident our contribution to the literature on dynamic moral hazard. To fully understand the role of the principal’s budget constraint in the design of optimal contracts and in the comparison between bundling and unbundling in frameworks featuring sequential moral hazard, we cannot rely only on the findings of models of repeated moral hazard. The reason is that in the latter the efforts of the agents influence *symmetrically* the principal’s objective function. Therefore, the way the principal’s budget constraint distorts the second-best efforts is the same for all sequential tasks. Our model shows that the results may differ quite sensibly when we consider that sequential tasks affect in an asymmetric way the principal’s objective function.

5.2.2 Partnership contract

We now analyze the effect of the fiscal constraint on the optimal renegotiation-proof partnership contract. Let us first remark that the RPC does not change with respect to the Section 5.1. The reason is that, as shown in the previous section, the fiscal constraint does not affect the second-best optimal effort of the operator that the government is willing to implement under the sequential contracts, which – as shown in the Lemma 1 – is the lower bound of admissible operation efforts for any renegotiation-proof partnership contract.

Again, we analyze the fiscal burden associated to the optimal payments (without BC) in different states of the world. By the analysis of the Section 4.3.1, we know

that the implementable payment schemes (24)-(25) are such that:

$$\begin{aligned} t(q^h, c^h) &> t(q^l, c^h), \\ t(q^h, c^l) &\geq t(q^l, c^l). \end{aligned}$$

Hence, as under the sequential contracts, both $t(q^h, c^h)$ and/or $t(q^h, c^l)$ may entail the maximum fiscal burden.

Therefore, the government maximizes the problem (28) under the RPC (i.e., $e_o^l \geq e_o^s$) and the BCs:

$$F \geq t(q^h, c^h) \quad \text{and} \quad F \geq t(q^h, c^l). \quad (43)$$

By the expressions of implementable payments under partnership contracts when the quality of the infrastructure is high (26) and (27), we see that $t(q^h, c^h) = t(q^h, c^l)$ if and only if $\psi'(e_o^h) = c^h - c^l$. In principle, we may have that the government, at the optimum, aims at distorting the operator's effort in the state of the world with high infrastructure quality with respect to the first-best one. Particularly, if the second-best optimal operator's effort is $e_o^h < e^*$ (or $e_o^h > e^*$), then $t(q^h, c^h) > t(q^h, c^l)$ (or $t(q^h, c^h) < t(q^h, c^l)$).¹⁶

Therefore, substituting the payment schedules that satisfy the ICCs and LLCs of the builder and operator in the government optimization problem (28) under the RPC (i.e., $e_o^l \geq e_o^s$) and both BCs (43), the government's maximization problem can

¹⁶If we substitute the optimal efforts for the building and operating tasks that maximize the government's objective function under the RPC (and without the BC), the maximum optimal payments from the government to the consortium are:

$$t(q^h, c^h) = kq^h + c^h - l_c + e_o^s \psi'(e_o^s) - \psi(e_o^s) - e_o^{hp} \psi'(e_o^{hp}) + \psi(e_o^{hp}) + \phi'(e_b) = t(q^h, c^l).$$

However, this is not necessarily generally true under a binding fiscal constraint.

be written as:

$$\begin{aligned}
& \max_{e_b, e_o^h, e_o^l} (S - k)q^l - c^h + l_c + e_o^l(c^h - c^l - \psi'(e_o^l)) + \\
& + e_b[(S - k)(q^h - q^l) - \phi'(e_b) + (e_o^h - e_o^l)(c^h - c^l) + \psi(e_o^l) - \psi(e_o^h)] + \quad (44) \\
& + \lambda_{hh}(F + l_c - kq^h - c^h - e_o^l\psi'(e_o^l) + \psi(e_o^l) + e_o^h\psi'(e_o^h) - \psi(e_o^h) - \phi'(e_b)) + \\
& + \lambda_{hl}[F + l_c - kq^h - c^l - e_o^l\psi'(e_o^l) + \psi(e_o^l) + (e_o^h - 1)\psi'(e_o^h) - \psi(e_o^h) - \phi'(e_b)] + \\
& + \mu(e_o^l - e_o^s),
\end{aligned}$$

where λ_{hh} , λ_{hl} and μ are the Lagrangian multipliers of the BCs (43) and of the RPC, respectively. By the problem (44), we derive the optimization conditions:

$$\begin{aligned}
\phi'(e_b^{pf}) = (S - k)(q^h - q^l) + (e_o^{hpf} - e_o^{lpf})(c^h - c^l) + \psi(e_o^{lpf}) - \psi(e_o^{hpf}) + \quad (45) \\
-(e_b^{pf} + \lambda_{hh} + \lambda_{hl})\phi''(e_b^{pf}),
\end{aligned}$$

$$\psi'(e_o^{hpf}) = c^h - c^l + \frac{\lambda_{hh}e_o^h - \lambda_{hl}(1 - e_o^h)}{e_b^{pf}}\psi''(e_o^{hpf}), \quad (46)$$

$$\psi'(e_o^{lpf}) = c^h - c^l + \frac{\mu - (1 + \lambda_{hh} + \lambda_{hl})e_o^{lpf}\psi''(e_o^{lpf})}{1 - e_b^{pf}}. \quad (47)$$

From the optimization conditions (45)-(47), we derive the following results:

Proposition 6 *When the government is constrained by the RPC and BC, the second-best optimal effort of the builder under the partnership contract is strictly larger than under the sequential contracts, provided that $l_c - l_b - l_o$ is not too negative. The second-best optimal effort of the operator under the partnership contract, when infrastructure quality is high (or low), is the first-best one (or equal to the second-best optimal effort under the sequential contracts).*

Proof. See the Appendix. ■

The interpretation of the Proposition 6 is that when the fiscal constraint limits (in a symmetric way) the maximum payments that the government can award to its agents under both the partnership and sequential contracts, still the history-dependent mechanism allows the former contractual scheme to outperform the latter in correcting moral hazard. Particularly, the optimal effort in the operation phase

is the first-best one e_o^* , when the infrastructure quality is high, and the sequential contract one e_o^s , when the infrastructure quality is low. If the financial wealth of the agents is not too much unbalanced against bundling (i.e., $l_c - l_b - l_o$ not too much negative), then the partnership contract provides stronger incentives to push up the building effort.

Also under the partnership contract as already observed in the Section 5.2.1 for the sequential contracts, the Proposition 6 allows us to prove that the BC affects only the optimal building effort, which increases the fiscal cost of an additional unit of social welfare, while it does not affect the optimal operational effort, which helps at increasing the social welfare while reducing the government's payments to the consortium.¹⁷ Particularly, given that the BC is binding in the states of the world $\{q^h, c^h\}$ and $\{q^h, c^l\}$ and given that $e_o^{hpf} = e_o^*$ and $e_o^{lpf} = e_o^s$, we can characterize the optimal building effort as follows:

$$\phi'(e_b^{pf}) = F + l_c - kq^h - c^h - e_o^s \psi'(e_o^s) + \psi(e_o^s) + e_o^* \psi'(e_o^*) - \psi(e_o^*), \quad (48)$$

from which we see that, under a binding fiscal constraint, e_b^{pf} depends on the aggregate available fiscal and financial resources (i.e., $F + l_c$) and $\frac{de_b^{pf}}{dF} = \frac{de_b^{pf}}{dl_c} = \frac{1}{\phi''(e_b^{pf})} > 0$.

5.2.3 Partnership vs sequential contracts: welfare analysis

In this section, we assess the impact of the fiscal constraint on the relative performance of the partnership and sequential contracts in terms of social welfare. We preliminary observe that the maximum fiscal burden is associated with the optimal payments featuring an high quality of the infrastructure under both the sequential (Section 5.2.1) and partnership (Section 5.2.2) contracts. The difference between the maximum fiscal burden under the sequential and partnership contracts may be positive or negative depending on the technology and on private financial condi-

¹⁷It is worth to remark that the latter result may not hold when the government can commit to implement the ex ante contractual clauses. If we solve the problem (44) without the RPC, we obtain the equivalent of the optimization condition (47) which shows that the optimal effort e_o^{lpf} is, in general, smaller when the fiscal constraint binds (i.e., the Lagrangian multipliers λ_{hh} and λ_{hl} are strictly positive).

tions.¹⁸ To save space, in the following we consider only the most interesting case, which is when both the sequential and partnership contracts are affected by the government's BC.

Substituting the optimal building and operating efforts in the government's objective function, when both the RPC and the BC bind, we can write the maximum social welfare under the partnership contract as:

$$W^{pf} = (S - k)q^l - c^h + l_c + e_o^s(c^h - c^l - \psi'(e_o^s)) + e_b^{pf} [(S - k)(q^h - q^l) - \phi'(e_b^{pf}) + (e_o^* - e_o^s)(c^h - c^l) + \psi(e_o^s) - \psi(e_o^*)]$$

and the maximum social welfare under the sequential contracts as:

$$W^{sf} = (S - k)q^l - c^h + l_b + l_o + e_o^s(c^h - c^l - \psi'(e_o^s)) + e_b^{sf} [(S - k)(q^h - q^l) - \phi'(e_b^{sf})].$$

Thus, using the expressions (42) and (48) to substitute, respectively, $\phi'(e_b^{sf})$ and $\phi'(e_b^{pf})$, the difference between the maximum social welfare under the partnership

¹⁸Considering the optimization conditions (14)-(15) and (30)-(32), the difference between the maximum payments under the sequential and partnership contracts is:

$$\bar{T}^s - \bar{T}^p = e_b^p \phi''(e_b^p) - e_b^s \phi''(e_b^s) + l_c - l_b - l_o,$$

where

$$\begin{aligned} \bar{T}^s &= t_b(q^h, c^h) + t_o(c^h) = t_b(q^h, c^l) + t_o(c^l) = kq^h + c^h - l_b - l_o + \phi'(e_b^s) - e_o^s(c^h - c^l - \psi'(e_o^s)) \\ \bar{T}^p &= t(q^h, c^h) = t(q^h, c^l) = kq^h + c^h - l_c + \phi'(e_b^p) + e_o^s \psi'(e_o^s) - \psi(e_o^s) - e_o^* \psi'(e_o^*) + \psi(e_o^*) \end{aligned}$$

are the maximum payments under the optimal sequential and partnership contracts, respectively. $\bar{T}^s - \bar{T}^p$ is likely to be positive when $l_c \geq l_b + l_o$ (a sufficient condition is that $\phi''(e) + e\phi'''(e) \geq 0$), in which case we may have that the fiscal constraint affects the optimal payments under the sequential contracts but not under the partnership contract (in turn, this would reinforce the result of the Proposition 5). However, the opposite may be true (particularly, when $l_c < l_b + l_o$), in which case the fiscal constraint reduces the efficiency of the partnership contract, while it does not affect the optimal sequential contract.

and sequential contracts can be written as:

$$\begin{aligned} \Delta W &= W^{pf} - W^{sf} = \\ &= (e_b^{pf} - e_b^{sf})[(S - k)(q^h - q^l) - F - l_c + kq^h + c^h - e_o^s(c^h - c^l - \psi'(e_o^s))] + \\ &\quad + (1 - e_b^{sf})(l_c - l_b + l_o). \end{aligned} \quad (49)$$

Thus, we find the following result:

Corollary 3 *The Proposition 5 holds also when the government's contractual capacity is limited by both the RPC and the BC.*

Proof. See the Appendix. ■

By the Corollary 3, we see that also when the fiscal constraint binds the partnership contract is still history-dependent. Thus, when the financial markets feature low uncertainty such that $l_c - l_b - l_o \geq 0$, it outperforms the sequential contracts in terms of social welfare. The latter findings can be interpreted as a generalization of the irrelevance of public finance constraints found by Engel et al. (2013).

However, the same expression (49) highlights, once more, that this result depends on firms' financial conditions. When financial markets are troubled by high uncertainty, bundling different firms within a consortium may reduce their financial wealth (i.e., $l_c - l_b - l_o < 0$), thus reducing the efficiency of the partnership contract with respect to the sequential contracts. A way to see this is to consider the impact of a variation of the fiscal constraint on the welfare differential between the partnership and sequential contracts:

$$\begin{aligned} \frac{d\Delta W}{dF} &= -(e_b^{pf} - e_b^{sf}) - \frac{l_c - l_b - l_o}{\phi''(e_b^{sf})} + \\ &+ \left(\frac{1}{\phi''(e_b^{pf})} - \frac{1}{\phi''(e_b^{sf})} \right) [(S - k)(q^h - q^l) - F + kq^h + c^h - e_o^s(c^h - c^l - \psi'(e_o^s))] \end{aligned} \quad (50)$$

When the private financial conditions are such that $l_c \geq l_b + l_o$, the expression (50) is likely to be negative.¹⁹ In other words, a harder fiscal constraint tends to

¹⁹For example, when $\phi'''(\cdot) = 0$ the last term of the expression (50) disappears and the expression is negative when $l_c \geq l_b + l_o$.

reinforce the preference in terms of social welfare for the partnership contract versus the sequential contracts. When the financial conditions are such that $l_c < l_b + l_o$, the expression (50) may take different signs.

5.2.4 Interaction between financial and fiscal constraints

To better understand the interaction between the fiscal constraint of the government and the financial constraints of the firms and its impact on the welfare comparison between the sequential and partnership contracts, in this section we run a numerical simulation of a simple case which is characterized by the following specification of the non-monetary costs of efforts: $\phi(e_b) = \frac{e_b^2}{2}$ for the building effort; and $\psi(e_o) = \frac{e_o^2}{2}$ for the operation effort.²⁰

We first consider the case in which contracts can be renegotiated but the fiscal constraint does not bind.²¹ Substituting the optimal efforts obtained with our specification in the expression (33), we derive the condition such that the partnership and sequential contracts are equivalent in social welfare terms, which can be written as:

$$\Delta W = \left(\frac{c^h - c^l}{4}\right)^2 \left[\left(\frac{c^h - c^l}{4}\right)^2 + (S - k)(q^h - q^l) \right] + l_c - l_b - l_o = 0. \quad (51)$$

The condition (51) is reported as a red-continuous line in the graph of the Figure 3 with the operational cost differential $c^h - c^l$, on the horizontal axis, and the limited liability differential $l_c - l_b - l_o$, on the vertical axis.

Given that the partnership contract always dominates the sequential contracts when $l_c - l_b - l_o \geq 0$, in the Figure 3 we focus on the case in which $l_c - l_b - l_o < 0$. Particularly, in the area above the red-continuous line, the partnership contract is socially optimal (i.e., $\Delta W > 0$), while below the red-continuous line the sequential contracts is socially optimal (i.e., $\Delta W < 0$).

As a second step, we consider the case in which the BC is binding. Considering

²⁰Under the considered specification, the third derivative of $\phi(\cdot)$ is zero and, thus, the last term of the expression (50) disappears. However, also in such a case the expression (50) may take different signs when $l_c - l_b - l_o < 0$.

²¹In other terms, F is so large that $\lambda_{hh} = \lambda_{hl} = 0$. It is also worth to remark that our numerical results would not qualitatively change considering full-commitment contracts.

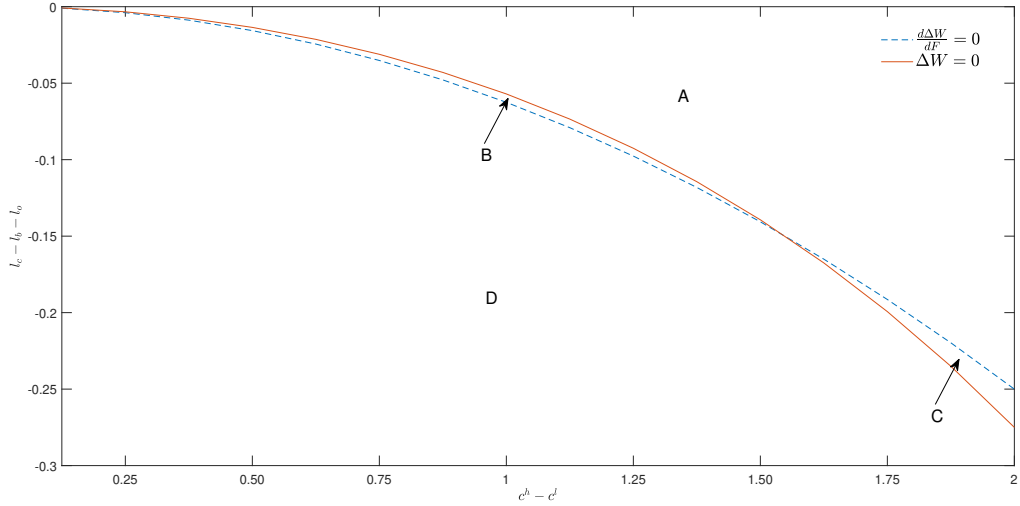


Figure 3: Optimal choice between partnership and sequential contracts

Legend: The graph is derived considering the following values for the model's parameters: $k = 1$, $S = 2$, $q^h = 1$, $q^l = 0.15$.

the expression (50) with our specification²², we derive the following condition:

$$\frac{d\Delta W}{dF} = \left(\frac{c^h - c^l}{4}\right)^2 + l_c - l_b - l_o = 0. \quad (52)$$

We report the condition (52) as a blue-dotted line in the graph of the Figure 3. When F decreases, the government's preference for the partnership contract may increase (above the blue-dotted line) or decrease (below the blue-dotted line).

Considering both conditions (51) and (52), in the Figure 3 we can identify four areas. In the area A (or D) the social welfare is higher under the partnership contract (or the sequential contract) regardless of the amount of available public funds F . The intuition is that, in these areas, the social welfare difference between the partnership and sequential contracts that we obtain without a binding fiscal constraint (i.e., F is large enough) grows when fiscal resources are reduced (i.e., F drops).

²²In our simple case, the last term of expression (50) disappears, given that $\phi'''(\cdot) = 0$, and the formula does not depend on the value of F . Our main results are obtained also with more general specifications of $\phi(\cdot)$.

The most interesting results regard the areas B and C . In the area B , the social welfare is larger under the sequential contracts without a binding BC. However, as we see in the Figure 4 (which reports F on the horizontal axis and ΔW on the vertical axis), when F decreases the social welfare gain of relying on the sequential contracts (i.e., $\Delta W < 0$) is progressively eroded. A sufficiently strict fiscal constraint eventually flips the social welfare ranking between the two alternative contractual schemes (in our example, $\Delta W > 0$ for $F < 0.3$). The opposite is true in the area C (see Figure 5), where the maximum social welfare is reached with the partnership contract without a binding fiscal constraint, but such a welfare gain (i.e., $\Delta W > 0$) is progressively reduced when F decreases. Also in this case, the welfare ranking changes for a sufficiently strict fiscal constraint (i.e., $\Delta W < 0$ for $F < 0.35$).

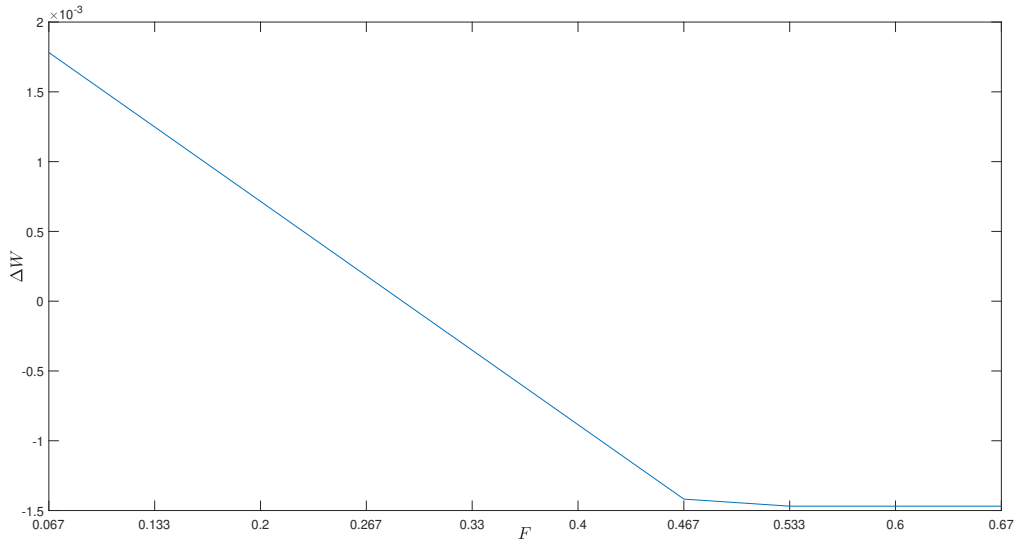


Figure 4: From sequential to partnership contracts (area B of the Figure 3)

Legend: The graph is derived considering the following values for the model's parameters: $k = 1$, $S = 2$, $q^h = 1$, $q^l = 0.15$, $c^h - c^l = 1$, $l_c - l_b - l_o = -0.0585$.

What lessons we can draw from this numerical exercise? From the theoretical point of view, a central role in driving the welfare ranking between the partnership and sequential contracts is played by the power of incentives of the memory contract (in contrast with history-independent contracts). The latter is proxied by the operational cost differential $c^h - c^l$ and represents the enhanced capacity of the

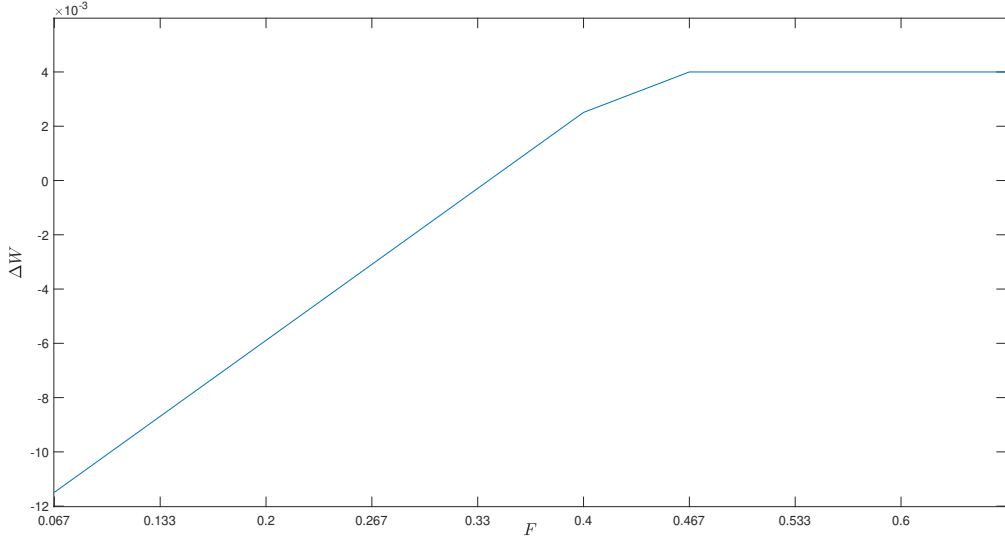


Figure 5: From partnership to sequential contracts (area C of the Figure 3)

Legend: The graph is derived considering the following values for the model's parameters: $k = 1$, $S = 2$, $q^h = 1$, $q^l = 0.15$, $c^h - c^l = 2$, $l_c - l_b - l_o = -0.27$.

partnership contract to correct moral hazard compared to the sequential contracts. Looking at the Figure 3, we see that, given any negative value of the limited liability differential (and the other parameters), as $c^h - c^l$ increases ΔW grows and, above some value of $c^h - c^l$, it turns from negative to positive. The interpretation is that the moral hazard correction component of the social welfare differential eventually more than compensates the limited liability differential. A similar mechanism operates also when we consider the impact of the fiscal constraint on the government's preference for the partnership and sequential contracts. Again, for a sufficiently large power of incentives underlying the memory contract, $\frac{d\Delta W}{dF}$ grows and, above some value of $c^h - c^l$, it flips from negative to positive. If the limited liability differential is negative but above a given threshold (in the example of the Figure 3, $l_c - l_b - l_o = -0.15$) a sufficiently large power of incentives of the memory contract widens the area of parameters in which the partnership contract is socially optimal when the fiscal constraint becomes stricter (i.e., the area B of the Figure 3). Conversely, when the limited liability differential is below a given threshold it also drives the marginal effect of a stricter fiscal constraint (i.e., the area C of the Figure 3).

Our analysis can also be used to retrieve empirically testable predictions. Empirical works find that PPPs are more likely to be implemented by budget-constrained governments (Hammami et al., 2006; Albalade et al., 2015; Buso et al., 2017), but there are no clear theoretical explanations for this correlation. Considering that other exogenous and randomly distributed factors (e.g., a fixed cost to implement PPPs compared to traditional procurement) may also affect the choice of PPPs, our analysis can be interpreted as follows. When $l_c - l_b - l_o$ is positive or slightly negative, fiscal constraints increase the likelihood of PPP investments. Conversely, when $l_c - l_b - l_o$ is very negative, fiscal constraints decrease the likelihood of PPPs. Cursory evidence seems to confirm this prediction (see Figure 1) which has to be rigorously tested through empirical analyses that look at the combined effect of fiscal and financial conditions.

6 Conclusions

Since their introduction in the early 1990s, the evolution of PPPs, in terms of number of projects and investment volumes, has followed an uncertain trend: increasing until the 2008 crisis and decreasing afterwards. Empirical and theoretical analyses suggest some possible determinants explaining the choice of PPPs by local and central authorities, such as the nature of the public infrastructure (technology required, innovation incentives, ecc.) or fiscal and institutional variables. However, none of the previous analyses is able to explain the uncertain trend of PPPs and it is still debated whether PPPs are chosen for efficiency or alternative reasons (e.g., political incentives, the presence of fiscal constraints).

Departing from much of the extant theoretical literature on PPPs, which considers the benefits (or costs) of bundling as related to the presence of positive (or negative) production externalities between sequential tasks (e.g., Hart, 2003; Martimort and Pouyet, 2008; Iossa and Martimort, 2015), this paper focuses on the financial and fiscal determinants of the social welfare differential between PPPs (or partnership contract) and traditional procurement (or sequential contracts). Our results can be summarized as follows.

First, absent any fiscal constraint but in the presence of private financial constraints, we show that the partnership contract allows the government to design a

more powerful incentive scheme, where the operation-phase payment depends not only on the operational costs, but also on the building's quality. Such an history-dependent payment schedule affords the partnership contract with an enhanced capacity (compared to sequential contracts) to control moral hazard. However, the capacity of the partnership contract to generate a welfare gain (compared to the sequential contracts) also depends on the difference between the total financial wealth of the consortium under the partnership contract and of the building and operating firms under the sequential contracts. Following the corporate finance literature, this difference is positive (or negative) if the coinsurance effect – among different firms bundled within the consortium – prevails (or does not prevail) over the risk contagion effect, which happens when the financial markets feature low (or high) volatility.

Second, we show that the previous result is robust against the introduction of renegotiation and the fiscal constraint. In this last case, we show that the impact of the budget constraint can affect the welfare difference between partnership and sequential contracts either negatively or positively. In particular, the impact is likely to be negative when financial markets are affected by very high uncertainty.

These theoretical predictions provide interesting insights for future empirical analyses. The model suggests that the volatility of financial markets is a relevant determinant explaining the adoption of PPPs. Indeed, the impact of the fiscal constraint on the probability to implement PPPs is positive in the presence of low volatility of financial markets and negative otherwise. More generally, to identify the relationship between the fiscal constraint and the choice of PPPs we need to control for the role of private financial conditions.

Our results have also important policy implications. Following the COVID-19 health and economic crisis, national and supranational governments have been developing important packages for infrastructure to support the economic recovery. A crucial policy issue is whether they will choose PPPs or traditional procurement. The message of our paper is that PPPs may help governments to obtain high-quality infrastructures provided that the private sponsors of the projects perform high ratings. Alternatively, governments may provide public guarantees to foster private partners' ratings (EPEC, 2009). Our analysis explains why such a policy may work, though a clear assessment of the cost of government guarantees should

enter the cost-benefit analysis of PPPs.

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I Appendix

Lemma I.1 *Any sequential contracts that satisfy the ICCs and LLCs also satisfy the PCs for sufficiently low l_b and l_o .*

Proof. Substituting the implementable payment functions, that satisfy the ICCs and LLCs, of the builder (10)-(11) in (8) and of the operator (6)-(7) in (4), the PCs can be written as

$$e_b \phi'(e_b) - \phi(e_b) \geq l_b \tag{A1}$$

for the builder, and

$$e_o\psi'(e_o) - \psi(e_o) \geq l_o \quad (\text{A2})$$

the operator. The right-hand side of (A1) and (A2) is equal to zero when $e_b = 0$ and $e_o = 0$, respectively. Moreover, $\frac{\partial}{\partial e}(e\phi'(e) - \phi(e)) = e\phi''(e) > 0$ and $\frac{\partial}{\partial e}(e\psi'(e) - \psi(e)) = e\psi''(e) > 0$ for all $e \in (0, 1)$. Thus, if l_b and l_o are sufficiently low, (A1) and (A2) are satisfied. ■

Lemma I.2 *Any partnership contract that satisfies the ICC and LLC also satisfies the PC for sufficiently low l_c .*

Proof. Substituting (21), (22) and (23) in the agent's objective function, the PC can be written as:

$$t(q^l, c^h) - kq^l - c^h + e_b\phi'(e_b) - \phi(e_b) + e_o^l\psi'(e_o^l) - \psi(e_o^l) \geq 0. \quad (\text{A3})$$

By the proof of Lemma I.1, $e_b\phi'(e_b) - \phi(e_b) \geq 0$ and $e_o^l\psi'(e_o^l) - \psi(e_o^l) \geq 0$. Thus, (20) implies (A3) if $l_c \leq e_b\phi'(e_b) - \phi(e_b) + e_o^l\psi'(e_o^l) - \psi(e_o^l)$. ■

Lemma I.3 *The optimal partnership contract is such that, among the LLCs, only the condition (20) binds.*

Proof. By the optimization condition (22), if the LLC (18) is satisfied, then also the condition (17) is satisfied. In the same way, by the optimization condition (23), if the LLC (20) is satisfied, also the condition (19) is satisfied. We now substitute the optimization conditions (22) and (23) in the condition (21) and, after some algebra, we obtain:

$$t(q^h, c^h) - kq^h - c^h = t(q^l, c^h) - kq^l - c^h + \tau(e_o^l, e_o^h, e_b),$$

where $\tau(e_o^l, e_o^h, e_b) = e_o^l\psi'(e_o^l) - \psi(e_o^l) - e_o^h\psi'(e_o^h) + \psi(e_o^h) + \phi'(e_b)$. If $\tau(e_o^l, e_o^h, e_b) \geq 0$, the LLC (18) is satisfied when the condition (20) is satisfied, and the Lemma

holds. Assume, by contradiction, that $\tau(e_o^l, e_o^h, e_b) < 0$. Under this assumption, we substitute the binding constraints (18), (21), (22) and (23) in (16), thus the government's optimization program can be written as:

$$\begin{aligned} \max_{e_b, e_o^h, e_o^l} & (S - k)q^l - c^h - e_o^l(c^l - c^h) - e_o^h\psi'(e_o^h) - \psi(e_o^l) + \psi(e_o^h) + \phi'(e_b) + \\ & + e_b[(S - k)(q^h - q^l) + (e_o^h - e_o^l)(c^h - c^l) + \psi(e_o^l) - \psi(e_o^h) - \phi'(e_b)] + l_c. \end{aligned}$$

By the first order conditions, we find that:

$$\begin{aligned} \phi'(e_b^p) &= (S - k)(q^h - q^l) + (e_o^{hp} - e_o^{lp})(c^h - c^l) + \psi(e_o^{lp}) - \psi(e_o^{hp}) + (1 - e_b^p)\phi''(e_b^p) \\ \psi'(e_o^{hp}) &= c^h - c^l - \frac{e_o^{hp}}{e_b^p}\psi''(e_o^{hp}) \\ \psi'(e_o^{lp}) &= c^h - c^l, \end{aligned}$$

and, given the properties of the ψ function, we derive that $e_o^{lp} \geq e_o^{hp}$. However, by the proof of the Lemma I.1, $\tau(e_o^l, e_o^h, e_b) < 0$ only if $e_o^{lp} < e_o^{hp}$. Hence, we have a contradiction. ■

Proof of Proposition 3. Contrasting the optimization conditions (3) and (31)-(32): $e_o^* = e_o^{hp} > e_o^{lp}$. By the optimization condition (31),

$$(e_o^{hp} - e_o^{lp})(c^h - c^l) + \psi(e_o^{lp}) - \psi(e_o^{hp}) = e_o^{hp}\psi'(e_o^{hp}) - \psi(e_o^{hp}) - z(e_o^{lp}),$$

where $z(e) \equiv e\psi'(e_o^{hp}) - \psi(e)$ is such that: $z'(e) = \psi'(e_o^{hp}) - \psi'(e)$ is strictly positive (or negative) for all $e < e_o^{hp}$ (or $e > e_o^{hp}$), and it is zero when $e = e_o^{hp}$; $z''(e) = -\psi''(e) < 0$; and $z(e_o^{hp}) = e_o^{hp}\psi'(e_o^{hp}) - \psi(e_o^{hp})$. Thus, $e_o^{hp}\psi'(e_o^{hp}) - \psi(e_o^{hp}) > z(e)$ for all $e \neq e_o^{hp}$, and in particular: $e_o^{hp}\psi'(e_o^{hp}) - \psi(e_o^{hp}) - z(e_o^{lp}) > 0$. Contrasting the optimization conditions (2) and (30), e_b^p can be larger or smaller than e_b^* whenever $(e_o^{hp} - e_o^{lp})(c^h - c^l) + \psi(e_o^{lp}) - \psi(e_o^{hp}) > 0$ is larger or smaller than $e_b^p\phi''(e_b^p) > 0$. ■

Proof of Proposition 4. By the proof of the Proposition 3, we know that: $(e_o^{hp} - e_o^{lp})(c^h - c^l) + \psi(e_o^{lp}) - \psi(e_o^{hp}) > 0$. Considering that, by assumption, $e_b \frac{\phi'''(e_b)}{\phi''(e_b)} > -2$, contrasting the optimization conditions (14) and (30), $e_b^p > e_b^s$. Similarly, given

that, by assumption, $e_o \frac{\phi'''(e_o)}{\phi''(e_o)} > -2$, by the optimization conditions (15) and (31)-(32): $e_o^{hp} = e_o^* > e_o^s > e_o^{lp}$. ■

Proof of Proposition 5. The expression (33) can be written as:

$$\Delta W = W^p - W^p(e_b^s, e_o^s) + W^p(e_b^s, e_o^s) - W^s,$$

where:

$$W^p(e_b^s, e_o^s) = (S - k)q^l - c^h + e_o^s(c^h - c^l - \psi'(e_o^s)) + \\ + e_b^s [(S - k)(q^h - q^l) + (e_o^* - e_o^s)(c^h - c^l) + \psi(e_o^s) - \psi(e_o^*) - \phi'(e_b^s)] + l_c$$

is the value of the social welfare function under the partnership contract if the consortium implements the sequential-contracts optimal efforts for the building task e_b^s and for the operation task when the infrastructure quality is low e_o^s (while it continues to implement e_o^* when the quality is high). Given that the social welfare function of the government reaches a maximum when the building effort is e_b^p and the operation effort in case of low infrastructure quality is e_o^{lp} , then $W^p - W^p(e_b^s, e_o^s) \geq 0$. Using the conditions characterizing the optimal sequential contracts (14)-(15), we can write:

$$W^p(e_b^s, e_o^s) - W^s = e_b^s [(e_o^* - e_o^s)(c^h - c^l) + \psi(e_o^s) - \psi(e_o^*)] + l_c - l_b - l_o.$$

By the argument of the proof of the Proposition 3, it is straightforward to show that $(e_o^* - e_o^s)(c^h - c^l) + \psi(e_o^s) - \psi(e_o^*) > 0$. Therefore, by $l_c \geq l_b + l_o$, $W^p(e_b^s, e_o^s) - W^s > 0$, which completes the proof. ■

Proof of Corollary 2. The proof follows by the same argument of the Proposition 5. ■

Proof of Lemma 2. The maximum implementable payment is $t_b(q^h, c^h) + t_o(c^h)$ and/or $t_b(q^h, c^l) + t_o(c^l)$. Let us remark that the government has some degrees of freedom in reducing $t_b(q^h, c^h)$ or $t_b(q^h, c^l)$, provided that the condition (11) is satisfied. Therefore, any implementable payment scheme that minimizes the maximum

fiscal burden has to be such that the condition (37) is satisfied. This is particularly the case when the BC binds. Substituting the condition (37) in the condition (11), we obtain the formulas of implementable payments

$$t_b(q^h, c^h) = kq^h - l_b + \phi'(e_b) - e_o(c^h - c^l - \psi'(e_o)), \quad (\text{A4})$$

$$t_b(q^h, c^l) = kq^h - l_b + \phi'(e_b) + (1 - e_o)(c^h - c^l - \psi'(e_o)). \quad (\text{A5})$$

However, if $\phi'(e_b) < e_o(c^h - c^l - \psi'(e_o))$, then (A4) would violate the LLC. Therefore, in such a case $t_b(q^h, c^h) + t_o(c^h) = kq^h + c^h - l_b - l_o > t_b(q^h, c^l) + t_o(c^l)$ and, by the assumption that $F + l_b + l_o \geq kq^h + c^h$, the BC cannot bind. By the same argument, if $\phi'(e_b) < -(1 - e_o)(c^h - c^l - \psi'(e_o))$, then (A5) would violate the LLC, and also in such a case the BC cannot bind. In turn, the BC binds only if (37) is satisfied. ■

Lemma I.4 *Assume that the solutions of the problem (44) are strictly positive. Then, $\lambda_{hh} > 0$ if and only if $\lambda_{hl} > 0$. Moreover, at the optimum $e_o^{hpf} = e_o^*$.*

Proof. Assume that, at the optimum, $\lambda_{hh} > 0$. Then, given that the BC of the government in the state of the world $\{q^h, c^h\}$ is binding,

$$c^h = F + l_c - kq^h - e_o^l \psi'(e_o^l) + \psi(e_o^l) + e_o^h \psi'(e_o^h) - \psi(e_o^h) - \phi'(e_b). \quad (\text{A6})$$

Assume, by contradiction, that the BC of the government in the state of the world $\{q^h, c^l\}$ is slack (i.e., $\lambda_{hl} = 0$). Substituting the expression (A6) in the latter, we have that, at the optimum, $c^h - c^l - \psi'(e_o^h) > 0$. However, by the first order condition with respect to e_o^h we have that:

$$0 < e_b(c^h - c^l - \psi'(e_o^h)) + \lambda_{hh} e_o^h \psi''(e_o^h) = \lambda_{hl}(1 - e_o^h) \psi''(e_o^h) = 0,$$

which brings to a contradiction. Thus, $\lambda_{hl} > 0$ and $\psi'(e_o^h) = c^h - c^l$ (hence, $e_o^{hpf} = e_o^*$). Assume now that, at the optimum, $\lambda_{hl} > 0$. Then, by the same argument, it necessarily follows that $\lambda_{hh} > 0$ and $e_o^{hpf} = e_o^*$. ■

Lemma I.5 *The solution of the problem (44) is such that $\mu > 0$ (i.e., $e_o^{lpf} = e_o^s$).*

Proof. By the the first order condition of the problem (44) with respect to e_o^l ,

$$c^h - c^l - \psi'(e_o^l) - e_o^l \psi''(e_o^l) - e_b(c^h - c^l - \psi'(e_o^l)) - (\lambda_{hh} + \lambda_{hl})e_o^l \psi''(e_o^l) + \mu = 0,$$

it is straightforward to see that, if $\mu = 0$ (i.e., $e_o^{lpf} > e_o^s$), $e_o^{lpf} < e_o^l$. However, this brings to a contradiction given that, by the Proposition 4, $e_o^l < e_o^s$. Hence, at the optimum, $\mu > 0$ and $e_o^{lpf} = e_o^s$. ■

Proof of Proposition 6. By the Lemmas I.4 and I.5, we have that the solution of the problem (44) is such that $e_o^{hpf} = e_o^*$ and $e_o^{lpf} = e_o^s$, respectively. Moreover, by the Lemma I.4, the BCs are binding under both the partnership and sequential contracts in the states of the world $\{q^h, c^h\}$ and $\{q^l, c^l\}$. Thus, substituting the binding BCs in the optimization conditions (40) and (45), we can write:

$$\phi'(e_b^{pff}) - \phi'(e_b^{sff}) = l_c - l_b - l_o + \underbrace{(e_o^* - e_o^s)(c^h - c^l) - \psi(e_o^*) + \psi(e_o^s)}_{\delta}.$$

By the proof of the Proposition 3, we know that $\delta > 0$. Thus, $e_b^{pff} > e_b^{sff}$ if $l_c - l_b - l_o > -\delta$. ■

Proof of Corollary 3. By the assumption of the Proposition 5, $l_c - l_b - l_o \geq 0$. Thus, by the Proposition 6, $e_b^{pff} > e_b^{sff}$ and $(1 - e_b^{sff})(l_c - l_b - l_o) \geq 0$. Let us remark that, by the expression (48) and by the optimization condition (45),

$$\begin{aligned} & (S - k)(q^h - q^l) - F - l_c + kq^h + c^h - e_o^s(c^h - c^l - \psi'(e_o^s)) = \\ & = (S - k)(q^h - q^l) - \phi'(e_b^{pff}) + (e_o^* - e_o^s)(c^h - c^l) + \psi(e_o^s) - \psi(e_o^*) = \\ & = (e_b^{pff} + \lambda_{hh} + \lambda_{hl})\phi''(e_b^{pff}) > 0. \end{aligned}$$

Therefore, the social welfare differential (49) is strictly positive. ■