MERCATUS CENTER
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RESEARCH SUMMARY

Infrastructure Building: How to Capture the Potential Benefits of Public-Private Partnerships

The private sector may be able to play a greater role than it currently does in building and maintaining the nation's highways and bridges through public-private partnerships (PPP).

In a PPP, the government contracts with a private firm to manage a project or concession. There may be significant potential benefits from such PPPs compared to traditional government provision. Realizing those benefits requires consideration of a number of important factors, including getting the incentives right.

Robert Krol considers these factors in "Highway Infrastructure: Issues Concerning Private-Sector Participation." According to the author, evidence on the relative advantages of PPPs is mixed. This makes it difficult to draw firm, evidence-based conclusions about them. The chief issue with public-private partnerships is this: How does one handle project revenue uncertainty and still capture the project's potential benefits?

POTENTIAL BENEFITS OF PPPS

- *Projects that are completed on budget and on time.* Reducing construction and operating costs saves taxpayers funds. If PPPs are able to do this (though, as mentioned above, the evidence is inconclusive), these funds can either be used elsewhere or provide tax relief.
- *Transfer of the project's financial risks from taxpayers to investors.* A major problem for private participation in highway investment is accurately forecasting expected traffic flows. By shifting at least some of the traffic flow forecast risk to private investors, these investors have strong incentives to make accurate forecasts.

HOW TO INCREASE THE CHANCES OF CAPTURING POTENTIAL BENEFITS

- *Competitive bidding.* Bidders should take part in a competitive auction for the right to manage a project. A lack of bids suggests a project is not economic and should not be undertaken. To reduce uncertainty and attract more bidders, the length of the concession should depend on the actual traffic volume.
- *No contract renegotiation.* Renegotiations are costly and common in PPPs. But they reduce the incentives to keep costs low and result in a smaller risk transfer. If contracts can be renegotiated, private firms, thinking they can capture additional funds in the renegotiation, might be tempted to submit a lowball bid. They might also be less careful in controlling costs because they may expect to be compensated for cost overruns in the renegotiation.

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- *Potential for bankruptcy*. This ensures firms have an incentive to keep costs down and maintain quality to attract customers (drivers). Only projects that are economically viable—where expected benefits exceed costs—will be bid on. If a highway project is not profitable, the firm would face the same consequences as any other private business.