Political Contestability, Scrutiny, and Public Contracting

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Findings

- Political risks from opportunistic third parties (TPO) as key hazard of public transactions
- Specitivity and rigidity in public contracting are a political risk adaptation by public agents
- Public agents limit the risk of third parties' challenges through formalities and rigidities
- ... externalizing the associated costs to the public at large
- Scrutiny increases public contracting efficiency in costly litigation environments, concentrated (politically) contestable markets, and with upward biased beliefs about benefits of challenge

Signaling process: hazards into rigidity—agents and timing

Preliminaries:
- Public agent's perspective
- Simple short-term contract for standard goods/service
- Sunk costs ignored to abstract from governmental opportunism

Public agent:
- Receives project features and budget
- Minimizes political risks by contract specificity and rigidity
- Increases cost of challenge c (highward move of cost of litigation)
- Thus it decreases the probability p of which an opportunistic challenge pays off.
- The endogeneity of opportunistic challenge provides contractual properties consistent with public contracting practice:
  - Larger contracts yield higher expected benefits for opportunistic third parties, thus higher ρ
  - The more dispersed TPB's beliefs, lower [higher] c leads to lower [higher] ρ
  - ρ is sensitive to the institutional environment determining collusion and c
  - The rule of law implies, ceteris paribus, higher ρ
  - Exogenous institutional changes [e.g., environmental norms] produce a new cumulative probability of challenge distribution, which will first-order stochastically dominate the former distribution when the legal system becomes more restrictive

Optimal contract specificity and rigidity

Lemma
The sum curve of expected political costs \( E(T) \) plus adaptation costs \( K \) is U-shaped and has an interior global minimum at \( R \)

Corollary
In the presence of TPO, the sequential equilibrium public contract that minimizes political and adaptation costs is specific and rigid, exig more expensive in its design, implementation, and control than the theoretical first-best in the absence of TPO

Political and market structure

- Benefits from a challenge can go to any political competitor, not necessarily to the challenger. As \( \zeta < 0 \) (atomized political opposition), there will be no TPO challenges (as in a mono-partisan or autocratic system)
- Analogically, \( \zeta \) may describe the bidders' market structure

Scrutiny: calibration of beliefs

An increase in scrutiny lowers the informational asymmetry between the actual political costs for the incumbent public agent and the third parties' beliefs about the political benefits from an opportunistic challenge and leads to leads to an increase \( \rho \) at low c and to a reduction in c at high c

Biased third parties' expectations

An increase in scrutiny also updates third parties' distribution of beliefs about the political benefits from an opportunistic challenge. High scrutiny regimes are efficient (lower \( \rho \)), thus lower \( R \) and \( P \) for high litigation costs environments \( c \) and with upward biased third party beliefs


References