

Incentive Contracts for Infrastructure, Litigation and Weak Institutions

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March 14, 2003

Abstract

In this paper we revisit incentive contract design in a simple setting, after developing a model that captures the fact that in weak institutional settings (e.g. high shadow cost of public funds, highly incomplete and/or asymmetric information) the procurement of large scale public works through concession contracts with strong incentives for private firms, may result in excessive litigation over contract terms. This result is possible because we assume that parties in litigation can influence (by purchasing *better or more* legal services) the observable merits of their case. Governments with a high shadow cost of public funds have an inherent disadvantage in these litigation contests. We show that a commitment to a prespecified level of litigation effort by the government within a weak institutional setting is a more efficient procurement mechanism.

Keywords: Incentive Contracts, Infrastructure Provision, Litigation, Asymmetric Information

JEL Classification Codes: D8, H57, H54, K41, K23, L51