



# Optimal contracting with private military and security companies



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## ABSTRACT

Private military and security companies (PMSCs) have been gaining increasing media and scholarly attention particularly due to their indispensable role in the wars in Afghanistan 2001 and Iraq 2003. Nevertheless, theoretical insights into the agency problems inherent when hiring PMSCs and how to optimally incentivize them are scarce. We study the complex relationship between intervening state, host state, and PMSC, taking into account the diverging interests of all involved parties as well as potential agency problems. We develop a theoretical model to characterize a state's optimal choice whether to perform a task associated with an intervening mission itself, or hire a PMSC and optimally design the contract.

We find that it might be optimal to hire PMSCs even if they are expected to do a worse job than the intervening state would do itself. Furthermore, the government's reputation in rewarding PMSCs for a good performance is crucial and might render it optimal to only deal with a limited number of PMSCs – who are not necessarily always the most efficient providers.

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“We are simply not going to go to war without contractors.”

[Carter (2011)]

## 1. Introduction

The current international security architecture has been undergoing tremendous changes within the last decades. The end of the Cold War in 1990 has disclosed a number of internal armed conflicts in regions of weak or failed statehood which up to that time were hidden under the covert of the rivalry of the two superpowers USA and USSR (Gleditsch et al., 2002). Since 1990, though, most leading industrial countries have not been willing to intervene in armed conflicts anymore, unless their direct strategic interests were in danger (Mandel, 2002; Singer, 2003).

These two contrary developments – the increasing number of armed conflicts around the world as well as the subliminal disinterest of those countries that would be able to intervene – have triggered a rising demand for private military and security services. Today,

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private military and security companies (henceforth PMSCs) offer a wide range of services, including combat operations, military assistance, intelligence, operational and logistics support, static security of individuals and property, advice and training of security forces, de-mining and weapons of destruction, humanitarian aid, research and analysis, and even facility and infrastructure building (Perlo-Freeman and Sköns, 2008; Branović, 2011). The clients of PMSCs are as diverse as the services they offer, ranging from states and international organizations, to transnational companies, humanitarian non-governmental organizations, and even rebel groups (Singer, 2003; Holmqvist, 2005; Mathieu and Dearden, 2007). Particularly the wars in Afghanistan 2001 and Iraq 2003 remarkably increased the use of these companies and showed plainly that present implementation of international security policy is heavily reliant on the support of the private military and security industry. According to the report “Transforming Wartime Contracting” of the U.S. Congress’ Commission on Wartime Contracting,<sup>2</sup> the US Department of Defense, the US Department of State and the US Agency for International Development employed more than 260,000 contractor employees in Afghanistan and in Iraq in 2010. This number exceeds the number of US military and civilian personnel in these countries at that time. Furthermore, from 2002 through 2011 an estimated \$206 billion were spent for these contracts (CWC, 2011).

However, various incidents have manifested that the collaboration between states and PMSCs presents new challenges which – due to the distinct nature of the tasks involved – substantially differ from previously made experiences with subcontracting and privatization. Several occurrences made clear that states that hire PMSCs rely on agents which have their own dynamics and engage in moral hazard. According to the Project on Government Oversight’s Federal Contractor Misconduct Database (FCMD), this misconduct ranges from human rights violations, poor contract performance, government contract fraud, to cost/labor mischarge. For instance, in 1999 DynCorp International personnel engaged in human trafficking and forced prostitution in Bosnia Herzegovina. In 2007 personnel of the company Blackwater Worldwide shot and killed 17 Iraqi civilians. Due to this incident, they lost their contracts with the US government in Iraq but secured new deals with the US government in Afghanistan. In the same year ArmorGroup International personnel, hired to provide security for the US embassy in Kabul, organized humiliating sex games and were unable to guarantee the security of the embassy due to internal inefficiencies (FCMD 2012). In addition, the process of how PMSCs are selected and how contracts with them are negotiated often seems to be very untransparent and cannot avoid a sense of corruption (Dickinson, 2007; Stöber, 2007).

All these issues show quite plainly the implicit risks and imponderabilities of contracting with PMSCs in contingency operations. Despite these malpractices, PMSCs are constantly hired by states, though. Hence, the questions arise (1) why states, while being aware of the complicated agency dilemma inherent when hiring PMSCs, still rely on the services of these companies and (2) how to set the right incentives for and design contracts with these companies to act to the best advantage of their principals.<sup>3</sup>

However, the scholarly debate concerning PMSCs has largely focused on normative questions. Besides, parts of the discussion suffer from polarization – by either condemning or praising the private military and security industry: Advocates of using PMSCs emphasize the strong demand for privatized military and security provision and the industry’s role in filling the security gap (Shearer, 1998; Brooks, 2000). Critics, on the other hand, consider the strong reliance on PMSCs a threat for state authority and the legitimate use of force and fear the blurring of responsibilities, the weakening of democratic mechanisms and the legal gray area that surrounds PMSCs’ activities (Musah and Fayemi, 2000). Both sides, though, are clear about the irreversibility of PMSCs’ presence in the current international security structure. Hence, a third, more pragmatically oriented, strand of the literature has focused on how to establish effective regulatory, monitoring, accountability, and prosecution mechanisms in order to minimize the risks associated with the use of PMSCs (Chesterman and Lehnardt, 2007; Cockayne et al., 2009; Francioni and Ronzitti, 2011). However, studies investigating contextual factors that are conducive to the performance of PMSCs are rare. This is particularly astonishing regarding the increased reliance and use of PMSCs not only by states (whether strong or weak) but also by trans-national corporations or non-governmental organizations (Singer, 2001). To a large extent, this is driven by the difficulty of finding sufficient empirical evidence. Nevertheless, understanding the mechanisms that drive PMSCs’ behavior and identifying parameters which states can influence in order to induce a desired performance of PMSCs helps us minimize the risks and benefit from the advantages associated with the use of PMSCs.

The goal of this paper is to shed light on one particular scenario of PMSC–client interaction: The complex relationship between an intervening state, a host state and a PMSC. We take into account the diverging interests of all involved parties as well as potential agency problems and develop a theoretical moral hazard model to analyze a states’s optimal choice whether to perform a task associated with an international mission itself or engage a PMSC and optimally design the hiring contract.

## 2. Overview

We develop a theoretical moral hazard model to analyze the optimal behavior of a state (“principal”, “she”) which has the option to delegate a military or security task to an agent (“he”), in this case a PMSC. The delegation can take place against the background of various scenarios; for example it might be that the state is dealing with oppositional groups inside its territory as it was the case with the missions of Executive Outcomes and Sandline International in Angola and Sierra Leone in the early 1990s; or it might be that the state aims at improving its military and security structure like it was the case with the support of the Croatian Army by MPRI during the Yugoslavian wars in the late 1990s; or it might be that the state plans to or has already intervened in another country like it has happened during the recent wars in Iraq and Afghanistan, in which the intervening countries hired various PMSCs to fulfill certain military and security tasks (see Singer, 2003).

<sup>2</sup> The Commission on Wartime Contracting was created by the 110th US Congress. The first commissioners were appointed in July 2008.

<sup>3</sup> Of course, there also are plenty of examples of, e.g., human rights violations committed by military personnel. This does not contradict our approach, though, since we assume that operations carried out by the state itself can also fail.

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