

# Briefing Memo

## The Trend of the Private Military & Security Companies (PMSCs) —Terrorist Threat and the Economic Point of View—

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### **Preface**

At around 9:20 pm on November 13, 2015 (local time), coordinated terrorist attacks involving suicide bombing and shootings were carried out in six different locations across Paris and its suburbs. The French authority has determined that Islamic State (IS) terrorists were responsible for these attacks that reportedly claimed 130 lives and injured over 350 people. Although the demand for Private Military and Security Companies (PMSCs) services had rapidly grown due to the conflict in Afghanistan ongoing since 2001, and to the 2003 invasion of Iraq and the stationing of the multinational troops in Iraq, due to the recent shrinking of demand in these areas, PMSCs have begun focusing on counter-terrorism measures. The British Association of Private Security Companies (BAPSC), the industry group for PMSCs in the UK, viewed the security guard activities at the London Olympics (2012) venues, including terror alerts, as a new profit-earning opportunity for PMSCs. Furthermore, during the attack on the Algerian gas plant in January 2013, UK's PMSCs were advising the relevant parties about countermeasures after the attack. The number of terrorism victims in 2014 (32,685, 80% increase from 2013) was the highest since 2000, and the direct damage (human casualty and material damage) for the same year was 52.9 billion dollars (61% more from 2013). Moreover, it is estimated to have surpassed 51.5 billion dollars (in 2014 price) during 2001, which was the year of the 9/11 terrorist attacks in the U.S. (the highest figure since 2000).

### **1. Terrorism and Economics - Cost Imposing Strategy, Sunk Cost and Prospect Theory**

Terrorism targeting at ordinary citizens has an aspect of “cost imposing strategy”. Terrorism can be carried out relatively cheaply with small arms and Improvised Explosive Devices. There are cases like suicide bombing, however it is possible to exact a huge toll on the general public by using time bombs. Conversely, enormous costs are incurred in the prevention of terrorism, such as personnel assignment and installation of equipment, and it is also a “sunk cost” that cannot be recovered. Even if the strengthening of the security was carried out in stadiums, cinemas, concert venues, stations, airports, harbors and commercial facilities where many people gather, only a few out of these locations will be actually targeted by the terrorists. Moreover, even if these facilities were guarded round the clock, the probability of capturing the perpetrators of terrorism is extremely low, as the act of terror is only carried out at a specific time and date. Understandably, publicizing counterterrorism measures may provide sufficient deterrence effect against terrorism. Although many specialists have discussed the prevention of terrorism after the Paris attacks, the majority are of the opinion that it is not physically possible for the army and the police to completely deter terrorism. In terms of expenses, the cost to have the army and the police maintain continuous vigilance against terrorism in an unspecified number of facilities would be astronomical, and is not realistic from the cost-effectiveness viewpoint. In 2014, the expenses incurred by the U.S. for anti-terrorism measures was 186 times that of the amount of damage due to terrorism, and the same for the UK was 263.

For terrorism to achieve the desired effect, the reaction of the victims plays a part. The perpetrators of terrorism try to attain political goals by provoking fear and anxiety in the general public. In other words, their purpose is not

to cause serious direct damage to the general public but to heighten social anxiety, i.e. the final objective is to accomplish the underlying political goal. From this perspective, overreaction based on fear against terrorism is exactly what the perpetrators are after, and this can also be explained by “prospect theory” of behavioral economics. In terms of behavioral principles, people tend to overestimate danger and risk. People who lead normal lives without any problems tend to try to avoid deterioration in their living standards rather than improving them (loss avoidance). Consequently, when a terrorist attack occurs, the public views lean towards the avoidance of the disturbance of the current peaceful lifestyle even if the counter-terrorism measures will incur enormous expenses. That is to say, this will lead to the “sunk costs” accumulation, however after the occurrence of terror attacks the people become tolerant as regards the expense of avoiding danger and risk. This results in the success of the “cost imposing strategy” of terrorists, which shows that terrorism exploits such behavioral principles of human beings.

## **2. The Military, the Police and PMSC - Public Goods, Private Goods and Externalities**

The army and police activities to secure public order is “public goods” in economics, which entails non-rivalness (a service supplied to one person is automatically available for others at no extra cost) and non-excludability (individuals not paying for the goods cannot be effectively excluded from use). The services for securing public order, which are public goods, is not adequately supplied through a market (market failure) and is delivered by governmental organizations like the army or the police outside the market. On the other hand, although PMSCs provide warning services and security services, they are no more than providers of “private goods” that aim to secure the safety of individual cases based on contracts. Since they are private goods, the accumulated total cost will increase as the service supply increases, and non-contracting parties will not be able to use the services (excludability). Furthermore, the army and police secure public order of the countries including territorial waters and airspace (area), while the PMSC protects clients (points) from the threats of terrorism.

Whether it is the securing public order in the form of public goods provided by the army and the police, or the warning or security services offered by the PMSCs in the form of private goods, they both have a positive “externality” aspect. Externality is defined as an economic activity imposing the positive effect on an unrelated third party. For example, if the economic activity such as consumption slowed down due to a social unrest triggered by a terrorist attack, when public goods like the army and police activities are provided, the social anxiety is removed and the economic activity (consumption) is restored. In this case, the army and police activities aimed at securing public order are having a desirable influence (positive externality) on the behavior of the consumers. PMSCs do not have the right to arrest people and can only provide warning or security services for contracting parties. Even so, if they can identify terrorists, leading to police making an arrest, the warning services offered by PMSCs will have a positive externality. Since both parties complement each other in this way to ensure security, it is preferable to use PMSCs for counter-terrorism measures at locations where many people gather, and have the cost of the expenses borne by the users (be added to the entry fees, etc.). The number of users may decrease due to the increase in the user charges, but this number should settle at a reasonable equilibrium level incorporating the sunk costs necessary to eliminate the dangers of terrorism. For example, if the counterterrorism security at concert venues is carried out solely by the army or the police (suppliers of public goods), even people who do not go to the concerts will have to bear the expenses (the majority of which are sunk costs) in the form of tax, and yet those who will mainly benefit from it are the audience at the concert (and the promoters). However once PMSCs are introduced, the sunk costs changes from being an involuntary burden (tax) to a voluntary burden (entrance fees, etc.) and the validity of the prices is entrusted to the judgement of the market (consumer—the people who purchase

the entry tickets). Each consumer has their own yardstick as regards the threat of terrorism, and they will judge whether the cost added (the expense for counterterrorism measures) to the entry ticket is expensive or inexpensive based on their yardstick. If, however, the perpetrator of terrorism is caught at the concert venue, this will prevent anxiety spreading across society (positive externality) and the counterterrorism security will then have the characteristic of non-rivalness and non-excludability. From the economic viewpoint, it is desirable to remain on alert through the combination of both the private goods and public goods (PMSCs and the military/ police).

### **3. Waterborne Security by the PMSC – A New Type of Counterterrorism**

PMSCs offer various services (security, consulting, logistical support, etc.) that require specialized knowledge, and many of the services are land-based. Conversely, there have been PMSCs that specialize in maritime activities focusing on the security for offshore oil platforms. Moving into the 21st century, there has been an increase in demand for ocean-based PMSC activities specifically for counter-piracy operations. The areas of concern were the waters off Somalia, the Indian Ocean and the West African waters where there has been a rapid surge in the activities of pirates, in addition to those areas that are traditionally prone to piracy such as Southeast Asia. In Japan, the “Special Measures Act for Security of Japanese Vessels in Pirate Infested Waters” was enacted in November 2013. This means that Privately Contracted Armed Security armed with rifles are entitled to board and guard the vessels registered in Japan in pirate-infested waters, as designated by government ordinances.

Nonetheless the danger of terrorist attacks is rising fast at sea (both surface and under water, including dams, rivers, lakes and marshes) and the number of PMSCs (includes private security companies that do not necessarily possess a specialized knowledge of military affairs) in this area is also growing rapidly. There is danger that not only ocean vessels/port facilities (commercial, tourist, etc.) and offshore excavation equipment can become a terrorism target, but small-sized ships can also become an operational base for drones. Nowadays, drones with a cruising range of nearly 2,500 km are available for the public and some have remote control capability through satellite communication system (Inmarsat satellite). The operation of such drones does not require special skills, and automatic flights are possible by setting up the flight profiles beforehand. These drones do not just carry and drop explosives and chemical weapons but they can also carry out surveillance and reconnaissance by having a built-in high performance camera. That is to say, drones are useful not only for offshore terrorist attacks (including on the high seas) but also for intelligence gathering in preparation for large scale terrorist attacks. As regards such maritime terrorism, there is also an aspect of the aforementioned cost-imposing strategy, and most of the costs are sunk costs and raising of anxiety among the general public, as described in the Prospect Theory.

As a part of their counterterrorism measures involving surface and under water surveillance, PMSCs carry out the detection and the collection of suspicious objects, such as smuggled goods and explosives that are rigged under vessels or bottoms in the vicinity of the harbor, in addition to their normal warning and surveillance activities. Although the surface and under water security is the duty of the navy and marine police organizations (harbor police and coast guards), PMSCs are also starting to provide these types of services to vessel owners, shippers and port operators. This is in order to correspond to the increasing demand in small-to-mid-sized harbors that are inadequately maintained, and developing nations that lack effective law enforcement authorities. The performance of consumer-use sonars is improving, while they are becoming cheaper. Some submergence terrorism detection device for civilian-use are light enough to load on to small vessels, and the sonars of such devices have the ability to detect whether the moving object in the water is a fish or a suspicious frogman, and in the case of the latter they will track it automatically. Moreover, in order to deal with strikes by drones, there are detection systems available

on the markets that are a combination of phased array radar, an infrared optical equipment and radio jamming unit. This type of radar has the ability to detect from a maximum distance of 20 km, and the radio jamming unit prevents the aircraft from receiving the location information of Global Positioning Systems (GPS). PMSCs are now able to offer counterterrorism services using such devices for general consumers.

#### 4. Comprehensive Risk Management – the Economies of Scope

Apart from the security and vigilance, anti-terrorist measures include hostage negotiations, dealing with the press, treatment of injuries, mental care of the victims (including their families) and obtaining terrorism insurance. (Ever since the September, 2011 terrorist attacks in the United States, many insurers and reinsurers are applying a terrorism exclusion clause to their policies). When an incident occurs in an advanced country, in many cases the security authorities will deal with the situation. However, when a multinational company encounters terrorist attacks in a developing country where they have expanded, it is necessary for them to cope by themselves and in turn forces them to receive help from the PMSCs, as they did when the Algerian gas plant siege by terrorists occurred in 2013. In order to meet the demands of such clients, some major PMSCs are pursuing diversification and multinationalization as a part of their comprehensive risk management efforts, and this is also in part a pursuit of the “economies of scope” (to achieve greater managerial efficiency through the diversification of their business operation). For example, as regards terrorism insurance, rather than having a non-life insurance company deal with the planning and designing of the products, conducting risk assessment, retailing and fund management by themselves, it is more effective for a PMSC who has a specialized knowledge of terrorism to take the lead in the product design and risk assessment. Hereafter, the business categories of the PMSCs will be split into companies that excel in specific fields, and major comprehensive risk management companies that will oversee several categories and pursue diversification. However the services offered by the PMSCs, as can be seen in counterterrorism measures, are highly specialized. Even a major PMSC company will not be able to maintain a high level of expertise in all areas, and therefore they cannot avoid cooperation with PMSCs who are specialists in particular areas. In such cases the economies of scope will be achieved through methods such as merger, cooperation, affiliation and financial contribution.

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