Contracting in the Fog of War ... Private Security Providers in Iraq: A Principal-Agent Analysis

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1 Introduction

This paper will look at the phenomenon of outsourcing security tasks to private security providers/contractors (PSPs/PSCs) in Iraq after the invasion of coalition forces in March 2003. As a general premise it will be assumed that if something as highly important as providing security is privatized, it is the special interest of the outsourcing party to hold the executing party as close as possible to its own goals, leading partially to problems of accountability. The theory of Institutional Economics seeks to solve these problems putting the contractual relationships in the focus of interest. The principal-agent setting which is part of this approach will be used to examine the question what kind of contractual hazards could be expected in such a deeply destabilized environment as contemporary Iraq and what possibilities does the principal have to enforce the agent's compliance to the negotiated contract.

To answer the question the paper will (1) briefly outline the principal-agent setting and notions relevant to the examination; (2) introduce the Iraq-scenario in order to mark out the case study's background and its key players; before (3) applying the theoretical assumptions to the case of Iraq; and (4) drawing some conclusions. The examination period of time covers March 2003 to December 2005. Primary sources are official reports and documents of various US institutions and organizations. No less important has been information gathered by the author in background interviews with managers of Private Security Providers currently operating in Iraq. These interviews took place in London and Paris in spring 2005. As the selection of sources shows, the focus of this paper clearly lies on the American engagement in Iraq, as the United States took and takes the lion's share of actual fighting and reconstruction efforts.

2 Theoretical Framework

One of the main aims of Institutional Economics is to reduce different interactions to its common principles in order to enable general assumptions for effective collaboration between different parties (Jost 2001: 10, 34). The
theory's premises are bounded rationality, saying that the human behavior is unintentionally rational but limited, due to incomplete information (Williamson 1990: 34). Furthermore, opportunism, meaning seeking one's self interest, including calculated efforts to mislead, is regarded as inherent of the human being (Williamson 1999: 377). The principal-agent setting is used as a method of displaying the relationship between an ordering party (principal) and a performing party (agent) in which both are assumed to act as rational actors and thus according to their self-interest. Due to the fact that incomplete information is assumed in this relationship, knowledge asymmetries are unavoidable. The problems and uncertainties arising from this fact can be classified on the basis of the temporal positioning of the underlying information asymmetries. ‘Hidden information’ describes, therefore, the hazards before the contract is made (ex-ante), whereas ‘hidden actions’ focus on the ex-post effects of information asymmetries (Arrow 1985: 37–51).

This paper deals primarily with the question of the hazards and the enforcement of already agreed-on contracts and thus ex-post considerations take wider space. However, in order to create a complete picture, it is also useful to look at the period before the actual conclusion of a contract, at least theoretically. In the case of hidden information, the principal can not observe all relevant facts ex-ante and can therefore not decide comprehensively what price would be appropriate for the needed goods or services. This causes an effect named adverse selection, which has been firstly described extensively by Akerlof (1970: 488–500). He showed that under circumstances where the principal is partly unable to distinguish and judge the quality of a service he will always stick to the cheapest offer. Therefore, the average price may sink extensively until high-value agents cannot compete anymore and are excluded. This finally leads to a partial market failure since in the end only low-quality agents will offer their services.

Ex-post, i.e., after principal and agent have signed a contract, the actions the principal wants the agent to perform are relatively costly for the latter (they require him time, effort or other resources) (Bergen/Dutta/Walker 1992: 4). Furthermore, the principal can control the agent's activities only incompletely and only under positive information costs, which may lead the agent to use his discretionary freedom to undertake “hidden actions” (Jost 2001: 27). Doing this, the agent has two basic choices to maximize his own utility, which both lead to inefficiencies for the principal. He can work with unnecessarily high budgets due to alleged unfavorable exogenous effects, and thus raising the price, or he can reduce his efforts again due to exogenous effects, but still demanding the same payment for his services, i.e., lower his costs.

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1 This paper follows Herbert A. Simon’s and Oliver E. Williamson’s concept of bounded rationality.