Piracy in Somalia costs billions

For every $120 million seized by pirates in Somalia, the cost to the shipping industry and the end consumer is between $0.9 and $3.3 billion, according to research by Tim Besley (LSE and the IGC Steering Group), Thiemo Fetzer (LSE) and Hannes Mueller (Barcelona GSE). This money is enough to employ well over a million Somalis for a whole year.

The study examines the effect of pirate attacks on shipping costs. It looks at shipping routes whose shortest path takes them through regions where pirates are known to operate and finds that the increase in attacks in 2008 led to around an 8% increase in shipping costs. The study uses this estimate to get a sense of the loss to society caused by piracy.

Personnel from RFA Fort Victoria board a boat suspected of use by pirates near Somalia. © Crown copyright 2011.

For centuries, piracy has posed a threat to trade at sea. Setting to one side the romanticised image of pirates in fiction, modern day pirates are organised bandits that thrive in areas where law and order is weak, either because particular states provide safe havens or because of poor international cooperation to police them. Beyond the costs to people's lives, this may have repercussions for worldwide trade.

Yet despite the long-standing importance of piracy, little is known about its economic costs. The issue has been brought into sharp relief by the upsurge of piracy in the Gulf of Aden between Somalia and Yemen. The waterway is part of the important Suez Canal shipping route between the Mediterranean Sea and the Arabian Sea in the Indian Ocean with 21,000 ships crossing the gulf each year, at one point it is only 20 miles wide. The gulf is earning the nickname 'Pirate Alley' due to the extent of pirate activity in the area. This poses a threat to one of the world's busiest shipping routes.

The paper aims to do three things.

- First, it models the frequency of piracy attacks in Somalia as a means of generating monthly forecasts of such attacks.
- Second, it matches the piracy forecast to data on around 24,000 shipping contracts. It works out the closest navigable sea distance between each origin and destination port for which a ship has been chartered. This allows the study to compare the cost of shipping on a monthly basis and to see what effect a surge in piracy has on these costs.
- Third, it uses these estimates to examine the cost to society of Somali piracy.

It estimates that shipping costs for some goods rises by around 8% when pirate activity increases in Somalia. The estimates also suggest that it is around 14% cheaper to charter ships through the Gulf of Aden during the summer monsoon (July-August) than in spring (March-April), when there is more piracy. And this seasonal pattern in shipping prices is absent prior to the upsurge in pirate activity in the region during 2008.

These extra shipping costs are mostly due to the increased security measures that are needed to repel pirate attacks and risk premiums paid to crew and insurance. The authors argue that these constitute a 'welfare cost' as labour and resources are allocated from other more productive sectors of the economy productive to guard services. The study develops a model to compare this cost to the shipping industry through pirate attacks to a tax on shipping which would finance the same transfer to pirates. This allows the authors to calculate the welfare loss caused by piracy. The main estimate suggests that the resource costs incurred in an industry worth $120 million a year to Somali pirates is between $0.9 and $3.3 billion.

To put this in context, the research looks at how many Somalis could be hired for one year using the additional resources that it estimate are expended by the shipping industry in response to the threat of piracy. Using wage data from the Somali Food Security and Nutrition Analysis Unit (FSNAU) presented it estimates a yearly wage of around $900. This means that the extra spending due to piracy could finance one year of employment for well over 1 million workers at the going market rate. The authors are quick to note that this does not mean that such a transfer scheme would be realistic or that it would prevent piracy, but it does illustrate the scale of losses to the industry relative to the reality of the Somali economy.

Piracy has always posed a particular problem because of the difficulty of securing international agreement over whose responsibility it is to deal with the problem and how the costs are shared. Private solutions to increase security such as carrying guards aboard ships are inherently less efficient than a government or policing body providing security for all.

While the international community has now attempted to introduce naval patrols to combat Somali piracy, this is extremely expensive and requires international diplomacy between a number of states. In the end, the study argues that the most promising long-term solution would seem to be to restore a functional Somali state that can deny pirates safe haven, thereby dealing with the problem at its source.

Ideas for Growth

While pirates are unique to the sea, the problem of bandits is common to many developing countries. A traditional problem in countries with weak institutions is that companies bringing goods to market face the threat of kidnap and theft. The consequences of this failure to establish and enforce property rights is a core theme in development policy.

This study shows that the costs of banditry are far more than the costs to private companies of having an effective state that enforces taxes and redistributes wealth. It estimates that piracy is at least ten times more costly. While many private companies are loathe to pay taxes in developing countries to governments they consider corrupt, the study points out that this may be the lesser of two evils, adding a reference to the late American economist and social scientist Mancur Olsen. It notes 'pirates are roving bandits while the state is a stationary bandit and hence is in a better place to organise extraction at lower costs.' However it closes by saying: 'without a return to strong law and order in Somalia, it seems unlikely that these welfare costs will disappear any time soon.'

The IGC is based at LSE and in partnership with Oxford University. Follow @THE_IGC on twitter.

January 14th, 2013 | Economics | 1 Comment