The International Organization of Production in the Regulatory Void (with Philipp Herkenhoff)

Abstract:

Over the last decades the internationalization of the value chain has allowed firms to exploit cross-country differences in environmental and labor regulation (and enforcement) in ways that are frequently criticized as ‘unethical’ and have triggered a large number of NGO campaigns and consumer boycotts. How do potential ‘unethical’ cost savings on the one hand and the threat to reputation and sales on the other interact with the international organization of production? In this paper we introduce North-South differences in regulation, a cost-saving ‘unethical’ technology and consumer boycotts into a standard property rights model of international production. Contracts are incomplete, so that a firm has limited control over both investments and (un)ethical technology choices of foreign affiliates and suppliers along the value chain. We show that international outsourcing and unethical production are linked through a novel unethical outsourcing incentive, for which we also provide empirical support: a high cost advantage of ‘unethical’ production in an industry and a low regulatory stringency in the supplier's country favor international outsourcing (as opposed to vertical FDI). We also provide a microfounded model of investment and pricing under incomplete contracts when the production technology is a credence characteristic of the final good and an NGO investigates firms and may initiate a consumer boycott.