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Law, social responsibility, and outsourcing[☆]

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ABSTRACT

Previous research into law and corporate social responsibility mostly assumes that the vertical structure of production is exogenous. Here, we allow a brand to choose between vertical integration and outsourcing. With outsourcing, the brand avoids some liability and responsibility, but loses direct control over the producer's infringement of law or code of conduct. Infringement increases with production, so the brand tailors production to guide the producer's infringement. The elasticity of demand for the product affects the degree to which, under outsourcing, the brand will increase production to induce the producer to reduce cost through infringement. If the demand is sufficiently elastic relative to the social harm caused by infringement, the optimal policy is to reduce avoidance such that the brand chooses vertical integration. However, if the demand is sufficiently inelastic relative to the social harm, then the optimal policy is to increase avoidance such that the brand chooses outsourcing.

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1. Introduction

Unilever is one of the world's top consumers of palm oil and palm kernel oil, which it uses to manufacture soaps, cleaners, margarine, and ice cream. As a corporation, it has committed to procuring all agricultural raw materials from sustainable sources by the year 2020. However, palm kernel oil derivatives may be shipped over long distances and difficult to trace. Unilever is addressing the challenge by vertical integration: “investing € 69 million in a palm kernel oil processing plant in Indonesia and considering similar joint venture investments in processing crude palm oil derivatives elsewhere *to help us achieve traceable supplies*” (Unilever, 2013, 42) [emphasis added].

Rana Plaza, an eight-storey building in Bangladesh, was designed for shops and offices, but illegally extended and converted for industrial production. In April 2013, the building collapsed, killing over 1000 workers. Factories in Rana Plaza manufactured clothing for clients including Benetton and Joe Fresh. The Institute for Global Labour and Human Rights called on Joe Fresh to protect workers in contract factories. Nobel Peace Prize winner, Muhammad Yunus, asked global fashion brands to treat Bangladesh workers *as their own employees* (BBC News, 2013; Forbes, 2013).

Here, motivated by the above examples, we study the distribution of legal liability and social responsibility across vertically related organizations. Issues of liability and responsibility arise in any chain of production, especially those that transcend international borders (Lyon and Maxwell, 2008; Kitzmueller and Shimshack, 2012; Lee and Tang, 2018).

In the strategic choice between vertical integration and outsourcing, a brand faces a fundamental trade-off. Under vertical integration, the brand bears the full brunt of legal liability and corporate social responsibility, but the brand fully controls the harmful actions that give rise to liability and responsibility. We call the harmful actions, such as clearing virgin forest, using unsafe factories, and imposing excessive overtime, “infringement”. By contrast, under outsourcing, the brand only bears *vicarious* legal liability and social responsibility – to the extent that it is responsible for infringement by the producer. However, with outsourcing, the brand cannot directly control the producer's infringement.

This paper contributes to understanding of the vertical structure of production and policy towards liability and responsibility for social harms caused by production in three ways. First, we show that, under outsourcing, the brand tailors production to guide the producer's infringement. Infringement reduces production costs, and so, increases with the scale of production. The brand sets production scale so as to maximize profit given that the producer will then choose infringement conditional on the scale of production. The producer ignores the penalty on the brand, and hence, conditional on production, infringement is higher under outsourcing.

Second, we analyze how the brand's choice between vertical integration and outsourcing depends on the degree to which it can avoid liability or responsibility for the producer's infringement. The higher the degree of avoidance (equivalently, the lower the

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