Make versus Buy? Ethics in Knowledge-based Outsourcing

1 Overview

The ‘make versus buy’ decision has always been a key operational lever for firms. Knowledge-based outsourcing – which includes R&D, engineering design, operations and supply chain analytics, and information technology – is booming; its market is upwards of one trillion dollars by recent estimates (Gartner Research 2016). Although the potential rewards of knowledge-based outsourcing are high (cf Carson and John 2013), managing outsourcing relationships is challenging for several reasons that include incomplete contracts, moral hazard and adverse selection (see Section 2).

Our dynamic model of knowledge-based outsourcing integrates all the three major impediments – incomplete contracts, moral hazard and adverse selection, under both perfect and, more realistically, bounded rationality. Models incorporating both moral hazard and adverse selection are quite rare even in static models due to analytical complexities, let alone in dynamic, multistage models with incomplete contracts such as ours. In addition to the classical profit-maximizing firm unconstrained by ethics, we model an ethically-constrained (but otherwise profit-maximizing) firm that honors its contractual obligations irrespective of legal restraints. We prove that under bounded rationality, the ethically-constrained firm can obtain strictly greater profits than the unconstrained profit-maximizing firm, even when (i) the unconstrained firm has access to a superset of the ethical firm’s strategies, and (ii) the ethical firm is unable to reveal its ethical commitment to its contracting partner. Thus, a commitment to ethics, while of course being morally desirable, can be a superior business strategy to the unbridled profit-maximization of classical economics. Moreover, as we show, a commitment to ethics directly undercuts the three major impediments to knowledge-based outsourcing – incomplete contracts, moral hazard and adverse selection.

To summarize, a commitment to ethics (i) can be a superior business strategy to unbridled profit maximization, and (ii) provides a novel explanation for why knowledge-based outsourcing is booming.
2 Knowledge-based Outsourcing: The Case for Ethics

Knowledge based outsourcing faces three key impediments: (i) **Incomplete Contracts**, which fail to provide adequate legally enforceable consequences for every possible contingency, are ubiquitous in knowledge-based outsourcing; cf Taylor and Plambeck (2007), Williamson (1985). By denying adequate legal recourse, incomplete contracts can lead to disputes, renegotiation of terms, financial losses and the souring of relationships. Several factors – such as *relationship-specific investments* (investments that are valuable primarily within a specific relationship) and complex end products with qualitative, hard-to-measure performance dimensions – exacerbate the problem of incompleteness in knowledge based outsourcing contracts. (ii) **Moral hazard**, the predilection of one party in the contractual relationship to shirk effort when the effort is unobservable to the other party, is endemic in all knowledge work (Carson and John 2013). (iii) **Adverse selection**, uncertainty regarding the contracting partner’s traits, such as his ethical norms, is especially acute in knowledge-based outsourcing given its global reach (see Banerjee and Duflo 2000).

What explains the boom in knowledge-based outsourcing despite the above formidable impediments? An implicit but ubiquitous assumption in the extant contracting literature, leading to the above impediments, is that *all* firms are unconstrained profit-maximizers, indifferent to ethical considerations. We challenge this assumption and relax it by modeling a fraction of firms that are committed to (and constrained by) *ethics*; after all, often managers (and firms) are ethical.

We define *ethics* in contractual relationships as *commitment to the contractual agreement under any non-contractible outcome, when violating the agreement could improve one’s own profits at the expense of the other*. Ethical firms are also profit-maximizing; however, they lexicographically prefer ethical behavior to profit maximization.

3 Managerial Implications

Prior researchers have made the case for ethics purely on normative grounds that are silent on the impact of a commitment to ethics on the firm’s own profits. Managers are inevitably confronted with an ethical dilemma whenever a conflict is perceived between profit-maximization and ethics – after all, maximizing profits is axiomatic for survival in business.
Our research establishes that such perceived conflicts are misplaced. As we prove, a commitment to ethics offers several benefits: *(i)* It can be a superior business strategy to unbridled profit-maximization, in fact accruing higher profits. *(ii)* It facilitates knowledge-based outsourcing by directly undercutting impediments such as incomplete contracts, moral hazard and adverse selection. *(iii)* It ensures an enduring reputation for ethics and fairplay in the marketplace, which is desirable to all managers. In contrast, any reputation for ethics acquired through opportunistic imitation by ethically-unconstrained firms is fickle.  

*(iv)* Finally, as we show, it shields managers from the adverse effects of bounded rationality, which is pervasive, especially in swiftly evolving landscapes such as knowledge-based outsourcing. To summarize, it is in managers’ self-interest to be ethical and promulgate a culture of ethics within the organization.

**References**


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1 The classical model of reputations *(cf Kreps et al 1982)* arises as a special case of our model.