Abstract

A firm who decides to assume an international configuration of its productive activities faces two questions: (i) the choice of the form of international production organization, namely the choice between to engage in foreign direct investment (IDE) or subcontracting; (ii) the choice of the place where to subcontract or the country where to produce. The present work develops these questions, focusing on the effect that the presence of asymmetric information has on the multinational firm (MNE)'s decision. Through the development of a moral hazard model, we conclude that the presence of this information asymmetry in the subcontracting relationship affects the MNE's expected profit due to the agency cost, but it might not have influence in its choice, since IDE involves fixed costs and the subsidiary is less efficient than the subcontracted firm. Concerning the choice of the place where to subcontract, the presence of adverse selection, characterized by the fact that foreign firms have an information advantage relatively to the MNE with respect to its true production costs, can justify some empirical evidences such as, MNEs subcontract in several countries and the fast production relocation between countries. Finally, we show that the presence of adverse selection influences the decision to relocate or not its production, and that foreign government can benefit by sending a signal of the amount of subsidy that is able to grant.