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Outsourcing with debt financing

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Abstract This paper investigates the effect of capital structure on a firm's choice between vertical integration and outsourcing. We model the production decision in a Principal-Agent framework and show that suppliers use debt as a strategic instrument to collect the surplus from outsourcing as their wealth constraint or limited liability ensures them more attractive compensation schemes. Investigating the buyer's capital structure, we find that outsourcing with risky debt is more likely to occur for high values of the outsourcing surplus.

Keywords Outsourcing · Capital structure · Incentives · Uncertainty

JEL Classifications D81 · G32 · G33 · L23 · L24

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