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D00215



United Nations Industrial Development Organization
Organisation for Economic Co-operation and Development -
Development Centre

Distr.
LIMITED

ID/WG.41/1
CD/PME(69)12

20 November 1969

ENGLISH

Expert Group Meeting on the Role and Promotion
of Subcontracting in Industrial Development

Paris, France, 6-11 October 1969

THE ROLE OF LARGE INDUSTRY IN THE
PROMOTION OF SUB-CONTRACTING 1/

by

C. Sicard
General Management Consultant
Louvain-la-Neuve, France

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THE ROLE OF LARGE INDUSTRY IN
THE PROMOTION OF SUB-CONTRACTING

A definition of the role of large industry in the promotion of sub-contracting must give a clear outline of the responsibilities of the small sub-contracting business and of the large firm placing the order and, perhaps even more pertinently, must relate the matter to an economic context, since the relations of big firms to sub-contractors are quite different in a liberal economy and in a controlled economy.

For the sake of clarity, it seems advisable to consider the matter under the following heads:

- (a) To recall the advantages of sub-contracting for the two partners involved - the big firm, on the one hand, and the sub-contractor on the other.
- (b) To indicate the conditions for the proper functioning of sub-contracting in a liberal economy.
- (c) To consider the different degrees of intervention (or even interference) by a large firm in the affairs of its sub-contractors, in a controlled economy.

1. Review of the role and advantages of sub-contracting in the organization of industrial production

Sub-contracting is justified from the economic point of view, by the fact that certain manufacturing operations can be carried out more rapidly and more economically in relatively smaller firms than in the firms placing the orders.

There are, in fact, two types of sub-contracting:

- structural sub-contracting;
- cyclical sub-contracting.

In contrast to the latter type, where big firms sub-contract only to enable them to surmount a peak period or, more rarely, to overcome a temporary inability to produce, sub-contracting is practised on a permanent basis, illustrating the division of labour between the ordering firm and its sub-contractors in the context of job specialisation. It therefore corresponds, at any given moment, to some degree of integration of production in the ordering firm.

Cyclical sub-contracting is justified when a firm finds its production lines temporarily saturated (or out of action) but is nevertheless anxious to meet the demand, either so as not to lose potential business or to fulfil contractual obligations.

Structural sub-contracting, on the other hand, appears a priori to be a less obvious necessity. Various arguments are generally put forward to justify it, e.g.:

(i) In general, the existence and expansion of small and medium-sized businesses is essential for a country wishing to keep its economy on a liberal and competitive basis; a certain number of small businesses may, with time, become large firms providing increased competition for the other large and longer established concerns. This is the principle upheld in particular by the United States, which has even set up a large agency like the S.B.A. (Small Business Administration), for the encouragement of small and medium-sized firms.

(ii) In a more immediate context, the advantages of sub-contracting derive from the following factors:

- Management

To avoid the need for large firms to increase their size even further, in as much as management becomes increasingly top-heavy and costly as a business grows.

- Specialisation

A large firm cannot master all techniques, and must therefore relinquish the manufacture of certain specialised components to outside firms.

- Critical mass

Apart from the need for specialisation, there is a phenomenon of "critical mass". For specialised operations requiring a high critical mass (whether in manufacture or in research), a sub-contractor specialised in a particular manufacturing process will be able, by working for several big enterprises at the same time, to attain a larger-scale production in its speciality than each ordering firm would be able to do on its own.

The three factors listed above tend to lower manufacturing costs and raise the quality of products. There is one further point worth mentioning, which relates neither to product quality nor to production costs, but has to do with a bottle-neck arising within the ordering firm namely, the restriction of investment possibilities.

- "Investment" bottle-neck

A large enterprise has constantly to meet increasing demands for funds to finance its own growth. It should normally have discovered enough opportunities for investment in fields where it is irreplaceable to be only too happy that in certain spheres where its

intervention is not really warranted, others invest in its place. This is a matter of the "natural" division of labour between the large and the small enterprise, in which the latter can essentially find a place in all spheres where it encounters no problems of critical volume.

Arguments in favour of limiting sub-contracting

Having put forward the arguments in favour of sub-contracting, we must now point out that when a large enterprise limits its recourse to sub-contracting, it does so for the following reasons:

- Lack of investment opportunities

When a large enterprise finds itself in a slowly expanding market where investment opportunities are consequently limited and profit margins small, it tends to take back into its own hands the manufactures assigned to sub-contractors, so as to increase its own level of activity.

- Security

The need for "security" of supplies is the argument most commonly put forward to justify a tendency not to use sub-contracting, particularly when the difficulty is enhanced by long distances between the locations involved.

- Dependence

Just as a small business tries to secure a wide range of customers, so a large concern has, for obvious reasons, to try to maintain its independence and take care that none of its suppliers or sub-contractors acquires too prominent a position. Accordingly, a large concern is often obliged to keep in its own hands certain manufactures which a simple economic calculation would suggest should be assigned entirely to outside firms.

2. Conditions for the proper functioning of sub-contracting in a liberal economy

Having briefly recalled the role and advantages of sub-contracting, we shall now here to indicate the necessary conditions for the proper functioning of sub-contracting in a liberal economy.

As we see it, these conditions are as follows:

- A climate of complete confidence between the ordering firm and the sub-contractor. This condition is essential, since no contractual obligations can have as positive an effect as a real atmosphere of trust.

- **Scrupulous integrity in business relations.**

This condition follows from the previous one, but is worth stating explicitly because sub-contracting cannot fulfil its role if this condition is not fulfilled. Smaller enterprises must be perpetually scrupulous in matters of production quality, delivery dates (respecting commitments) or prices; while the ordering firm must suppress any tendency to dominate or coerce.

The ordering firm should not merely confine itself to the strict observance of its commitments but should show understanding for the management problems of the sub-contractor.

- **Good management in the ordering firm.**

Sub-contracting can only be practised on a lasting basis to the satisfaction of both parties if the ordering firm has a high standard of management.

If the big firm is run well:

- Relations between it and the sub-contractor can be established on a rational basis (i.e. the ordering firm is thus aware of the reasons why it is employing sub-contractors as its decision can be based on objective data).
- The sub-contractor can run his business efficiently, on the basis of planning ahead.

If the ordering firm is badly run, it will inevitably involve its sub-contractors in its inefficiency, and relations between the two parties are bound to deteriorate (difficulties in observing prices or trying to meet impossible delivery dates by the ordering firm, decline in quality consequent on meeting such extraordinary requirements, etc.).

To sum up, then, integrity, a thorough understanding of each other's interests and good management are the essential conditions for the proper functioning of sub-contracting.

If these conditions are not fulfilled, the position of sub-contractor will be untenable for the small business and it will be the big firm which will suffer in the long term; instead of basing its development on a rich, sound industrial structure, a large firm surrounded by declining businesses, will have to undertake all sorts of secondary tasks which will absorb its financial resources and overload its management.

3. Varying degrees of intervention by large firms in the management of sub-contractors in developing countries

In a developed country with a liberal economy, ordering firms and sub-contractors are sufficiently numerous to ensure that observance of the above conditions alone will lead to the smooth functioning of sub-contracting.

On the other hand, in the developing countries, the situation is quite different; potential sub-contractors are very few and those which do exist generally lack the necessary technical or managerial know-how. A point to stress here is that while the number of potential sub-contractors is small, there are equally few ordering firms, which makes the position of sub-contractor a highly risky one for the small or medium-sized business.

Accordingly, insofar as in developing countries sub-contracting is not more advantageous than integration for large firms, it becomes necessary to ask them to play for a while, a role which is not normally theirs in a competitive economy. The large firms will, of course, benefit from their efforts, but only in the very long term.

The key point here is that sub-contracting, instead of facilitating the development of the big firms, will for a time have the opposite effect, since instead of unloading certain manufacturing processes on sub-contractors, a big firm will, on the contrary, have to train the small firms; as for production costs, the sub-contractors' low level of technical development and productivity will mean that the results obtained are generally not as good as they would be in the workshops of the big firm. Lastly, the big concern will run very great risks as to the quality of production, which, of the three considerations of quality, price and delivery time, is generally the determining factor for deciding to transfer a particular manufacture to an outside concern.

Thus, to urge big firms in the developing countries to help in expanding sub-contracting is tantamount to asking them to act for a while against their own interests - asking them in fact to make an infrastructural investment. In our view, this sort of investment should essentially be the responsibility of the public Authorities, which can of course make use of the big firms (paying them suitably) as an instrument of industrial development policy.

As it is thus a matter of the division of responsibility between the State and large industry in establishing and training small and medium-sized businesses, there does not appear to be any obvious and clear-cut dividing line between what should be the responsibility of the public Authorities and what should be left to the large enterprises. This demarcation of responsibilities is even less clear if the big business is itself State-owned.

The essential aspects where intervention would be appropriate are the following:

- (a) General training of the entrepreneur and, in particular, training in business management.
- (b) Financial aid for equipment of the sub-contractors (problem of investment financing).
- (c) Financial aid towards operating costs.
- (d) Know-how.
- (e) Technical assistance.

The State can, of course, act either directly, or through the large enterprises, particularly those in which it has a capital holding. However, it seems expedient to keep their roles separate and, for the sake of clarity, to leave each full discretion in its own particular field, the State bearing the cost of the action which it wants the large firms to carry out in the small ones(1).

The responsibility for training the entrepreneur and improving his knowledge of management techniques should normally be assumed directly by the State. The firms themselves can certainly help in this by encouraging their staff to take advantage of the instruction offered.

Financial assistance (loans for equipment and operating expenses) should likewise be borne by the public authorities and may be administered through the medium of specialized agencies; here the range of feasible policies is very wide, but it is not the purpose of this paper to dwell on the various lines of action open.

On the other hand, in all matters involving know-how and production problems, responsibility for action may and should be assumed by the large enterprises, which are indispensable in this respect. The techniques for transferring know-how are well known (licensing contracts for instance); in particular, they include a training period in the large firm for the transferee and technical assistance to the small firm acquiring such know-how.

In conclusion, we should like to make it clear that with the market situation obtaining in the developing countries, it would seem quite impossible for sub-contractors to become independent for a long time to come; for them to do so would presuppose conditions which cannot be fulfilled:

(1) The State will eventually recover its initial "outlay" through the taxes levied on the enterprises.

-- Firstly, a relatively "atomic" market, enabling a small or medium-sized business to get a wide range of clients. This sort of market, of course, implies the existence of a fairly large number of concerns placing orders.

-- Secondly, a high level of technical skill in the small and medium-sized firms enabling them to negotiate with an ordering firm on a not too unequal footing.

As a result, in the very large majority of cases in developing countries, the sub-contracting firms will in fact closely approximate to a decentralised workshop of a big firm.

In conclusion, we feel it is important to stress that for the large enterprises in the developing countries, sub-contracting is a liability rather than a dynamic factor. The large enterprises will therefore not tend to develop sub-contracting spontaneously, but will have to be very firmly encouraged to do so, for sake of general industrial development and eventually, in the long term, in their own interest.

The assistance to be given to small and medium-sized sub-contracting firms is well known (training of managers, transfers of technology, financing investments, financing stocks, etc.); the division of responsibility between the State and the large concerns will depend on the specific structure of each country and in the last analysis on the prevailing economic philosophy.

Attention should, however, be paid to the fact that a small or medium-sized enterprise engaged in sub-contracting in the developing countries will find itself in a position of extreme dependence on large firms.





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