



TOGETHER
for a sustainable future

OCCASION

This publication has been made available to the public on the occasion of the 50th anniversary of the United Nations Industrial Development Organisation.



TOGETHER
for a sustainable future

DISCLAIMER

This document has been produced without formal United Nations editing. The designations employed and the presentation of the material in this document do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations Industrial Development Organization (UNIDO) concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries, or its economic system or degree of development. Designations such as “developed”, “industrialized” and “developing” are intended for statistical convenience and do not necessarily express a judgment about the stage reached by a particular country or area in the development process. Mention of firm names or commercial products does not constitute an endorsement by UNIDO.

FAIR USE POLICY

Any part of this publication may be quoted and referenced for educational and research purposes without additional permission from UNIDO. However, those who make use of quoting and referencing this publication are requested to follow the Fair Use Policy of giving due credit to UNIDO.

CONTACT

Please contact publications@unido.org for further information concerning UNIDO publications.

For more information about UNIDO, please visit us at www.unido.org



D00882



United Nations Industrial Development Organization

Distr.
LIMITED

ID/WG.47/9
12 December 1969

ORIGINAL: ENGLISH

Expert Group Meeting on Industrial Co-operation
between Developed and Developing Countries
for Exports

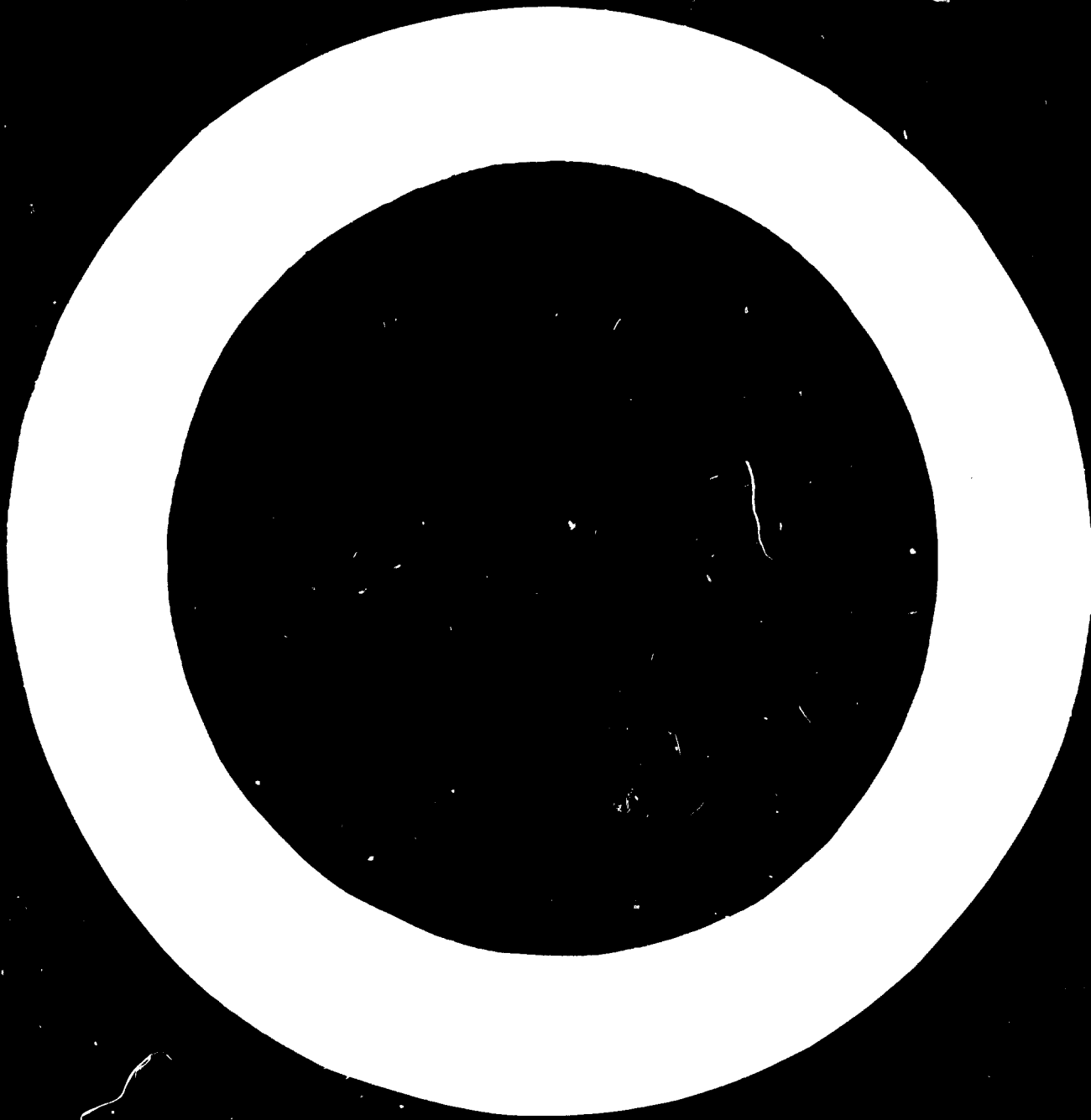
INTERNATIONAL SUBCONTRACTING IN THE DEVELOPING COUNTRIES 1/

Prepared by the UNIDO secretariat

1/ This document has been reproduced without formal editing.

id.69-6362

We regret that some of the pages in the microfiche copy of this report may not be up to the proper legibility standards, even though the best possible copy was used for preparing the master fiche.



INTERNATIONAL SUBCONTRACTING
IN THE DEVELOPING COUNTRIES.

Among all forms of industrial co-operation between developed and developing nations, international subcontracting is a prominent one if only because it generates export income and contributes directly to the elimination of the balance of payments constraints on economic growth. And yet, although being a familiar feature of the business relations between industrialized countries, international subcontracting activities are still a novelty and an unexplored field for most industries in the developing countries.

International subcontracting, also called "contract manufacture" is still a rather elusive concept that has not yet acquired legal tender in the economic literature. It can be defined as a buying/producing arrangement between partners established in different countries whereby the main contractor orders products or components from a subcontractor who manufactures or transforms them according to the design and specifications imposed by the buyer and under the technical responsibility of the latter. It is this special relationship of substitution and subordination between partners which makes subcontracting clearly distinguishable from the usual purchasing and production processes.

Apart from the division of labour considerations and socio-political arguments in general, subcontracting agreements are concluded as pure commercial or financial deals. Commercial subcontracting can take either of the three following forms: 1) "economic subcontracting" covers all cases where it is considered more economic or a means of reducing costs to have a number of parts entering into a finished product or operations needed for its manufacture, done outside the firm; 2) "specialized subcontracting" refers to all cases where work is given to outside firms because of the highly specialized skills required; 3) "capacity subcontracting" takes place in emergency situations or in all cases where the main contractor's order backlog exceeds his own manufacturing capacities.

Financial deals by contrast are less concerned with the cost saving implications of the activity but use subcontracting as a form of payment in kind to recuperate suppliers' credits or to settle foreign trade balances. This financial version of subcontracting is more likely to be practised by Centrally Planned Economies.

The present paper sets itself a number of limitations. It approaches the problem of international subcontracting in a somewhat "one way sense" in that it concerns itself only with the case of developing countries acting as exporting subcontractors and not with the case of subcontracting orders placed by developing countries in industrialized countries.

To sum up, we will review briefly the experience of developing countries in international subcontracting and assesses the macro and micro economic advantages which the system carries but also the drawbacks that should be considered by the potential subcontractor. After focusing some attention on the different barriers that will have to be overcome, this paper concludes with suggestions for a number of possible promotional techniques.

1. PRESENT STATE OF INTERNATIONAL SUBCONTRACTING IN DEVELOPING COUNTRIES

Although domestic subcontracting is gaining importance, it is generally acknowledged that the experience of developing countries in international subcontracting is rather limited. To quantify the matter is virtually impossible. For one reason, foreign trade statistics do not distinguish between conventional and subcontracting sales; this makes it rather difficult to gauge the exact importance which subcontracting assumes in the foreign trade bill. For another, national industrial surveys and censuses have not been devised to collect data on subcontracting.

The evidence available permits to describe the main characteristics of international subcontracting involving developing countries as follows:

- (a) It is widespread in Singapore; increasingly practised in Latin America (Argentina, Brazil, Chile, Colombia, Mexico and the Central American Common Market), the West Indies and certain countries of Asia (Israel, Taiwan, India, Pakistan, Thailand and South Korea); and less developed in the rest of Asia and Africa (except for Mauritius, Morocco, Tunisia, and the UAR). On the main contractor's side, the bulk of the subcontracting orders are placed by American and Japanese firms and to a lesser extent by European Common Market and EFTA countries.¹ Apart

¹ There are however a few examples of British, German and Dutch confection firms who have subcontracting agreements with manufacturers in Singapore and Morocco. A Swiss firm is reported to have a subsidiary in Mauritius drilling micro-jewels on a subcontracting basis.

from the inter-C.M.E.A subcontracting activities, it does not appear from the information presently available, that Centrally Planned Economies have entered into any such agreements with developing countries.

- (b) In most cases of international subcontracting performed by firms in developing countries there exists some financial, technical or commercial kinship between the main contractors abroad and the subcontractor at home; this implies that subcontracting also happens to be a corollary of foreign investment. Indigenous firms, which are locally owned and managed, are less engaged in international subcontracting.
- (c) The range of products being subcontracted in developing countries is far more specialized and restricted than for domestic subcontracting. The most prominent sectors are the car and tractor industry, electrical equipment and textile confection. The main subcontracted products or processes are:
- automotive parts and components
 - bus and truck assemblies
 - trailers and railroad cars
 - shipbuilding
 - parts and components for construction industries
 - assemblies of integrated circuits and transistors
 - furniture, television, radios, boilers
 - surgical instruments
 - drilling of micro-jewels
 - luminous sign-boards for advertising
 - dresses, swimsuits and general confection
 - detergents and cosmetics
 - pulp
 - fruit
- (d) Virtually all subcontracting agreements are of the "economic type". Many of the products or manufacturing processes are labour-intensive. Availability of raw materials plays a role in only a few instances. Skills, by contrast, proved extremely important in attracting subcontracting orders from abroad.
- (e) The list of countries and products seems to point out that international subcontracting is determined less by the level of industrialization, but far more by its pattern and structure, some industrial sectors obviously more suited for it than others.

- (f) Unlike domestic subcontracting where the assistance extended by the main contractor is largely limited to providing drawings and specifications, international subcontracting agreements generally carry considerable assistance in the field of management, know-how, training or finance.

2. THE CASE FOR INTERNATIONAL SUBCONTRACTING

International subcontracting is not an end in itself. Foreign exchange having a higher than face value for the generation of economic development, an important purpose of these manufacture agreements is to help alleviate the balance of payments' difficulties. International subcontracting offers an opportunity of defining and exploiting comparative advantages. In addition to the advantages derived from domestic subcontracting, it extends the following benefits for the developing countries:

- (a) It contributes to the diversification of export products and helps prevent a lop-sided export structure with excessive dependence upon foreign exchange earnings from one or just a few products.
- (b) It creates additional outlets which allows exploitation of economies of scale and greater scope for specialization. Specialized international subcontracting in manufacturing or transformation processes in which a country enjoys a definite comparative advantage may prove in certain instances to be more efficient and realistic than certain projects of "straightforward" substitution of imports. The rationale for this contention is that international subcontracting requires few linkages (for example, cutting of imported diamonds) whereas import substitution is only efficient to the extent that the locally added value component is high and that diseconomies of scale can be avoided.
- (c) Furthermore, specialized subcontracting affords the developing country to be competitive. No marketing costs are involved because the main contractor sells the product as his good under his trade mark. One hardly needs to be very perceptive to realize that the marketing costs are often a major prohibitive factor for the exports of developing countries.
- (d) International subcontracting on a regional level can promote economic integration. It also fosters the development of complementarity in international trade as opposed to an increase in competition. For example, some American data processing hardware is equipped with

integrated circuits subcontracted in Japan and Singapore; this lessens the competitive pressure on the finished product markets.

- (e) As pointed out earlier, international subcontracting normally carries considerable technical and financial assistance. It also implies production or manufacture processes under strict specifications which often are implemented under the control of the main contractor; this, to be sure, conveys an excellent learning opportunity and provides manufacturing and export know-how.
- (f) Often being a first nucleus of foreign investment the subcontracting activity may have a multiplier effect and act as a catalyst in attracting additional capital both to widen the scope of locally added value and to diversify the range of products.
- (g) Subcontractors catering for the needs of foreign companies normally deal with partners that are financially more stable and secure than local prime contractors and succeed better in avoiding arrears in payment and bad debts.
- (h) In countries where export incentives are granted, the subcontractor may get advantages which, working for the national market, he would not normally be entitled to. To be sure, this additional income accruing to the private entrepreneur is in fact obtained at the government's expense and thus is not directly a net contributor to national income.

3. THE DRAWBACKS OF INTERNATIONAL SUBCONTRACTING

But international subcontracting is no panacea. In the final analysis as to whether a country should get involved in it at all, due attention should be paid to the many problems which the subcontractor may have to face. These problems lie on several levels:

- (a) To begin with, the prices at which subcontracting orders are obtained may be highly uneconomical due to fierce international competition, even with other developing countries, and the disparate bargaining position between the subcontractor and the large foreign contracting company.
- (b) It is generally true that the buy/make issue for the main contractor is decided mainly on the basis of minimal cost and/or minimal risk criteria. The subcontractor often obtains subcontracting orders for items whose production is less profitable for the main contractor or more risky.

- (c) International subcontracting unless permanent arrangements are made, tends to be an unstable activity owing to competition, changing economic and business conditions, changing technologies and designs, etc. For example, it has not passed unnoticed that many subcontractors have been phased out after heavy investments in new moulds which soon proved obsolete due to technical changes.
- (d) The foreign contractor may impose delivery demands and requirements which cannot be met by the subcontractor in the developing country. This may result in additional costs and waste (rejected products).
- (e) Considering the overall framework of national planning and resource allocation it should be realized that subcontracting for exports generally requires more specialized skills and technologies than when working for the domestic market. Those resources are scarce by the very nature of early industrialization and have a higher value than the market price may indicate. The policy makers should find out whether international subcontracting is the domain where those resources contribute at best to the economic development of the country.
- (f) For the entrepreneur, international subcontracting is not necessarily more profitable than domestic subcontracting. Tariff and non-tariff barriers and transportation costs imply that the exporting subcontractor may have to operate with a lower added value (and less profits) than when producing for a protected local market. Governments are well aware of this fact and tend for macro-economic reasons and indirect social benefits to support exports via incentives.

4. BARRIERS TO INTERNATIONAL SUBCONTRACTING

If a firm in a developing country decides after a thorough economic analysis to embark upon international subcontracting, a number of barriers will have to be overcome. Sure enough, those restraints are not conspicuously different from the ones that limit international trade in general.

(a) Lack of confidence

The single most important factor which deters main contractors looking for partners in developing countries is a genuine lack of confidence in quality, standardization, reliability, and delivery performance. Fear

of plagiarism may also constitute a serious deterrent. For instance, a case has been reported where a large international can-maker fears to subcontract the making of stamping dies lest it gives rise to copying; the laws against plagiarism are often only partly effective.

(b) Lack of information

It is well known that lack of market information continues to be an important hurdle in the process of the international division of labour. This applies both to the demand^{and} supply aspects of the problem, and certainly be sure, holds even more true for subcontracting than for conventional trade. It is a startling fact that managers of sizeable companies in developing countries had to admit they had not yet really given any serious thought to the possibility of embarking upon international subcontracting.

(c) Lack of adequate capacities

Despite existence of considerable under-utilized productive capacities in many developing countries, the manufacturing techniques are mostly geared towards the domestic market and are not necessarily suited for the generally more stringent requirements of the international contractors. Simple, non-costly adjustments may not be appropriate to warrant improved export proficiency. An industrial structure once established is in the nature of things, long-lived, and not easy to modify. A new productive set-up with different plants and equipment may be needed to start international sub-contracting. This is actually what is mostly done in cases of long term subcontracting agreements.

(d) Tariff and non-tariff barriers

Tariff and non-tariff barriers such as quota restrictions and administrative practices are well-known and will not be developed here at length. However, mention should be made of a peculiar type of private restrictions often imposed on potential subcontractors which are subsidiaries of foreign companies. Most international corporations have for a number of reasons an internal distribution policy that is sharply circumscribed and they generally are loath to authorize their subsidiaries in the less-developed countries to compete with the parent company in the home market.

(e) Transportation barriers

Transportation constitutes a natural barrier to international subcontracting and imposes a further profitability squeeze on the manufacturer. Countries remote from the subcontracting demand and not richly endowed with material resources which are scarce on the world market, can only overcome the transportation barrier if they concentrate on low weight/high value items.

(f) Lack of government incentives

Many governments have evolved incentive packages for the promotion of export-oriented industries. These incentives can analytically be broken down into governmental initiative or "entrepreneurship" and financial inducements.¹ However, although international subcontracting is not excluded from the benefits of these incentives schemes no special measures have been issued to cope with the particular approach which the promotion of international subcontracting requires.

5. AVENUES FOR PROMOTIONAL ACTION

UNIDO is presently undertaking research to find out in which sectors international subcontracting is practiced and on what terms. Both the experience of the developing and the industrialized countries is being analyzed. It is hoped that this will provide leads to identify subcontracting opportunities and partners and that it will also pave the way for the formulation of technical assistance projects in this specific field.

The following are suggestions for actions that the countries themselves could undertake.

(a) Identification of subcontracting potentials

A first logical step for any country wanting to embark upon international subcontracting is to make a systematic survey of the economy and to identify resources or manufacturing capacities which could be harnessed for subcontracting purposes. The consecutive step is to look for potential partners.

¹ Governmental and semi-governmental "entrepreneurship" is defined to include the whole gamut of activities - falling short of direct or indirect assistance in cash - which covers promotion and assistance in the development of exports. By contrast, in the category of financial inducements, cost-reducing measures are distinguishable from straight income increasing devices.

(b) The search for partners

The promotional machineries that have been set up thus far to identify main contractors or partners are of two types:

1. "International Subcontracting Exchanges" or clearing houses are basically intended to publicise the requirements of main contractors and the manufacture capacities offered by sub-contractors. For instance, in the Scandinavian countries the Sveriges Mekanförbund has quite successfully established an "International Subcontractors Exchange" which monthly publishes lists of free capacities that are available for subcontracting work and also lists of the type of capacities that are required.

Since no formal industrial communication systems or directories of products exist in developing countries, it is easy to visualize that the scope for similar "Sub-contracting Exchanges" may be considerable. They could be organized on a regional basis and supported by technical assistance provided by international organizations. However, the experience reveals that the action radius of these Exchanges is rather geographically restricted. They are also biased to the promotion of "one batch" operations (f.e. 50.000 units of a particular product) or short-term deals and they have only exceptionally resulted in long-term co-operation agreements.

2. The Subcontracting Exchanges are complemented by the traditional export and investment promotion machineries and techniques involving action at home and abroad. Special efforts are displayed for the promotion of long term deals. The approach here is very much similar to the investment promotion techniques; it requires detailed preparation of projects, feasibility studies, long-term negotiations with partners, finance institutions, local authorities etc.

(c) Governmental Action

1. The Governments should consider adapting their incentive schemes to make subcontracting attractive to the main contractor abroad. We have in mind the whole gamut of export incentives which either lower manufacturing costs or increase the income accruing to the subcontractor. It is also conceivable that the governments in developing countries impose international subcontracting

activities on foreign companies wishing to establish themselves in the country or applying for incentives. Subcontracting may thus offer an interesting alternative to secure export revenue in cases where the internal distribution policies of the applicant company restrict the export of finished products.

2. Governments should envisage to promote international subcontracting in their negotiations of bilateral trade agreements because it affords payment in kind. One of the major reasons underlying the decisions of the US automotive industry to subcontract in Canada are balance of payments considerations.
3. Finally, Governments should be particularly concerned about the international image of their manufacturing industries. - This to be sure, is nothing specific for subcontracting and also applies to exports in general. - They should evolve incentives and regulations to promote the improvement of quality, quality control, strict application of specifications, standardization of output, shortening of delivery dates, etc. The creation of design and quality control centres and the granting of productivity awards for subcontracting activities could be instrumental in securing the required confidence.

6. CONCLUSION

International subcontracting holds out many promises for developing countries because of three main reasons. To begin with, it can be successful even if the rest of the economy is still unbalanced; it has high learning effects and, finally it affords to be competitive in exports since marketing costs are borne by the main contractor. This paper has considered the problem from the developing countries point of view, but no doubt also the industrialized countries may derive many benefits from this form of industrial co-operation both on pure commercial and financial grounds.





13.3.74