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UNIDO'S ACTION IN THE FIELD OF
INTERNATIONAL SUBCONTRACTING^{1/}

prepared by

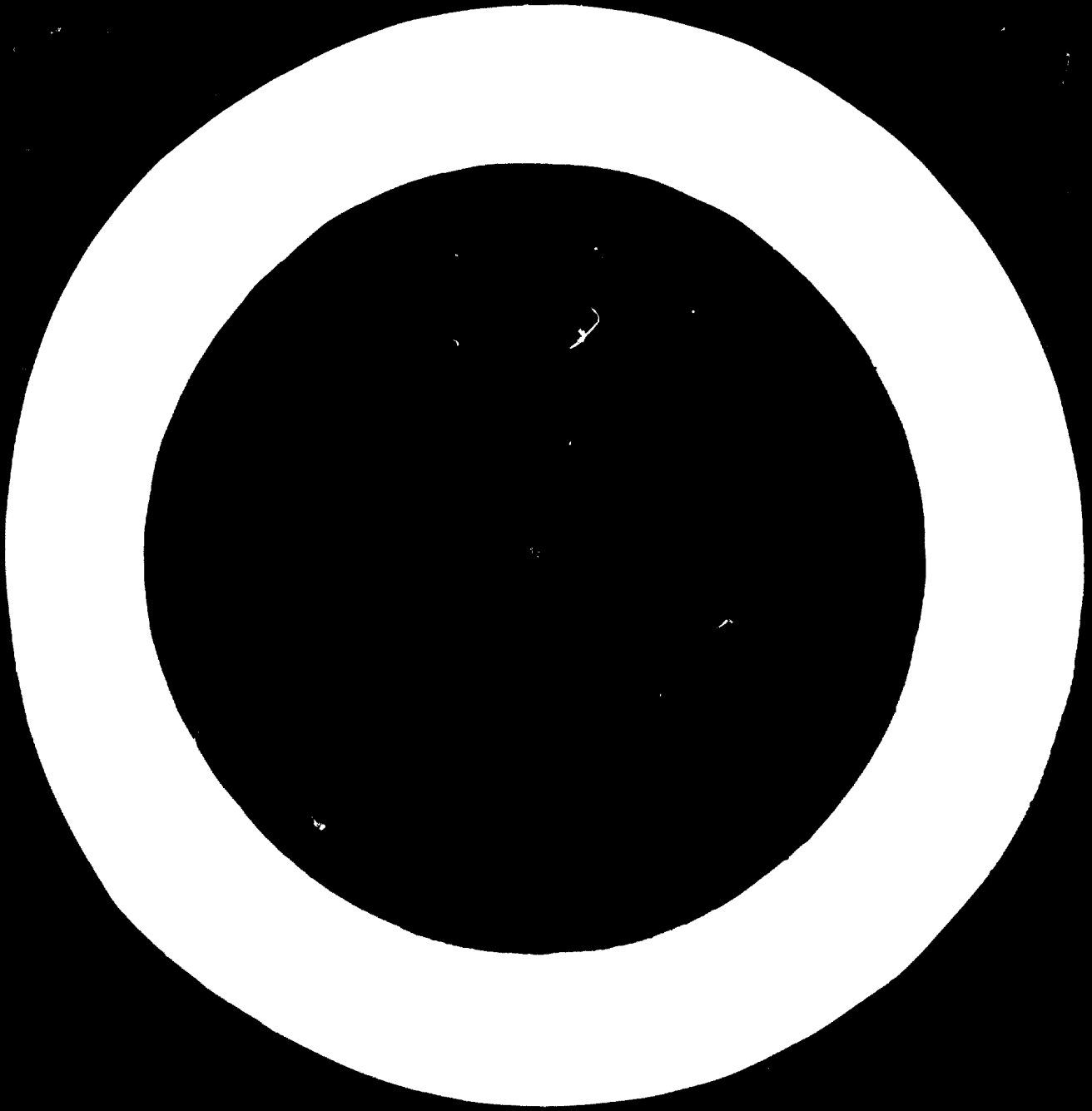
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Introduction

The importance of export oriented industries in the industrialization process of developing countries has been analysed in a paper presented by UNIDO at the Third Session of UNCTAD which took place in Santiago, Chile, in April-May 1972.^{1/}

It showed that, with the exception of six countries (Hong Kong, Taiwan, India, Yugoslavia, Mexico, Republic of Korea) which represent alone nearly 60% of export of selected manufactured goods from developing countries, the progress made by the remaining developing countries in expanding export of manufactures have been very limited and not compared with the increase of industrial production.

The need for export oriented industry in a strategy of industrialisation of developing countries have been widely accepted as an addition to the possibilities offered by import substitution industries. In order to help manufacturing enterprises of developing countries to increase their capability of entering into world trade, two types of separate yet complementary action are proposed by the two UN organisations dealing with trade of manufactured goods, UNCTAD and UNIDO.

UNCTAD, in the past recent years, has exerted major efforts towards the establishment of preferential tariff system for goods originated from less developed countries to be exported in industrialized countries' markets. Similarly assistance has been made available to provide these producers with marketing and market intelligence. Also governments' involvement in export promotion has been substantially increased and efforts were geared to the establishment of export incentives and the creation of export promotion institutes.

UNIDO has complemented these programmes which were concentrated towards market accessibility with solutions and assistance for a set of obstacles originating from the products themselves.

These obstacles were represented by the insufficient level of sophistication and quality frequently encountered in products from developing countries, the inexistence of an efficient commercial and after-sales servicing; coupled with some reluctance of consumers in the industrialized world in accepting goods with trademarks from developing countries.

International industrial co-operation between enterprises can help developing countries to overcome these obstacles and implement an export oriented strategy of industrialization. Such co-operation can take many forms from licensing to joint ventures. This document will concentrate on International Subcontracting, as not only an agreement to manufacture parts and components but also to transfer the production for manufacturing or assembling finished products under the specifications and the trademarks of a principal contractor.

This type of international co-operation between firms offer an in-built solution of technology and knowhow problems. It is in fact the interest of the principal contractor in transferring to the subcontractor all possible information and helping him with technical and managerial assistance so that the production of the latter is in accordance with his requirements. As to the problem of market, the components or products manufactured under a subcontracting agreement are channelled to the consumer through the pre-existent distribution channels of the main contractor. This constitutes a definite advantage for the subcontractor who can concentrate on the manufacturing operations without direct involvement in market and after-sales techniques.

This sort of agreement is an increasingly common practice in the business world especially when the increasing cost of labour in industrialised countries, on the one hand, and sufficient level of productivity achieved in developing countries, on the other, provide a strong stimulus and the necessary elements for the reciprocal involvement.

The Concept of International Subcontracting

Subcontracting, also called contract manufacturing, can be defined as a contractual arrangement between two firms by which the subcontractor executes an order to produce, manufacture or assemble parts, components or finished products according to the requirements or technical specifications of the main contractor.

The basic structure of subcontracting is the mutual dependency of the two partners. The contractor substitutes his own manufacturing process with the production of the subcontractor and relies for the continuity of his own production on the performances of his partner.

The degree of dependency of the subcontractor is however greater as he is in debt for the know-how, technology and access to the market to the contractor. This dependency varies considerably whether the subcontracting agreement covers the production of only parts or components or if it contemplates the assembling or manufacturing of finished products with the contractor's trademark.

In the first case the subcontractor will not acquire the necessary know-how to produce an independent base while in the second case he will receive a considerable amount of technical information useful to either improve his existing production or create his own market.

Manufacturing through subcontracting agreements based on cost savings and transfer of production have been the constant and growing feature especially between North America and Western Europe or between Western and Eastern Europe, and between Japan and surrounding Far East Asian countries. Presently there is a definite trend to involve, to a greater extent than previously, developing countries in these opportunities. The existence in these countries of a large stock of underutilized, yet sufficiently skilled manpower, constitutes an appeal to European, Japanese and North American manufacturers who have increasing difficulties in supplying their products at competitive prices and with a stable delivery schedule. These requirements meet with the need for manufacturers in developing countries to utilize excess production capacity, mobilize local labour force and raw materials and have access to sophisticated techniques and markets which otherwise would be difficult to reach.

However, international subcontracting and similar types of industrial co-operation, are not a panacea and without a careful approach, disadvantages and risks could offset the advantages of such agreements.

From the viewpoint of developing countries' manufacturers, several problems may have to be faced. For instance, the impact of business cycles which in case of a downward cycle, slowing the demand, would be immediately reflected on the volume of orders passed to subcontractors abroad. These fluctuations would be easily absorbed by the contractor but will have extensive negative repercussions on the subcontractor, particularly in those cases where extra investment and labour were involved.

Particular attention should also be given to the conditions set for subcontracting work. As offers for subcontracting activities are usually greater than demand, the weaker bargaining position and the high competition between possible subcontractors, leads to prices and conditions which are frequently established at an uneconomical level.

But, of all the problems confronting subcontractors, the situation of dependency often created by such agreements, is particularly serious. This occurs when a small firm is entirely dependent on one sole contractor who takes all or most of his output. The potential subcontractor in a developing country should be advised not to unduly concentrate his activities with one single main contractor but diversify his output among several contractors or maintain independency on a larger portion of his production.

From the point of view of the contractor, however, the situation is unfavourable when the output of the subcontractor does not conform to the specifications and when inferior quality and raw materials, inadequate finish, high rates of reject, delayed and erratic deliveries, offset the advantage of setting up a production agreement with a firm in a developing country.

In a growing number of cases, however, positive results have been achieved and this was secured by thoughtful and detailed negotiations and careful appraisal of economic, financial and technical conditions for the manufacturing, thereby establishing mutual confidence between partners.

In such a case, international subcontracting and transfer of production in developing countries may represent a successful means to accelerate industrial development and in many cases the first step to the establishment of joint ventures and creation of investment opportunities.

Before illustrating the UNIDO action in this field, it would be useful to propose for discussion some topics of general interest such as:

- (a) The necessity for a developing country to analyse the benefit of international subcontracting and transfer of production and the way they meet the country's requirements. This enables a selection among the various proposed arrangements and/or investment on the basis that they correspond with national priority policies such as the mobilization of labour, utilization of local raw material, improvement of local technology. Those requirements can be complementary but are often alternatives (Singapore concentrates now on co-operation for high technology products while South Korea is looking for labour intensive processes).
- (b) Discuss the aspects of financial and legal guarantees in case of disruption of contract (see Mr. Bernard's report on "Automobile Subcontracting with the Developing Countries").
- (c) Ways and means of organizing co-operation and improving contacts either on a bi-lateral or multi-lateral level through channelling them through national organisations or in international bodies.
- (d) The need of conformity of technical standards to facilitate negotiations.
- (e) The necessity for the developing countries to establish a strategy to upgrade the level of work of subcontractors and enable them, after a certain preparatory period, to acquire technical independence from the contractor and establish their own production and market.

UNIDO's Involvement in International Subcontracting

The growing importance of International Subcontracting and the wish expressed by several developing countries to receive UNIDO's assistance in this field has led the organization to the conclusion that it could play a role both as an adviser and as a promoter of contacts between potential partners of developed and developing countries in view of facilitating contract manufacturing. Consequently, UNIDO, starting in 1971, has developed an International Subcontracting Programme with two main components - advisory and promotional. These activities are in fact very closely linked and usually performed jointly by UNIDO's experts and staff members during missions to developing countries.

- (a) Advising Role - UNIDO's action in this field is exerted both at the level of government as well as of individual manufacturers.

In the first case, UNIDO is in a position to provide assistance to improve conditions for industrial co-operation and in particular, international subcontracting. In particular, advice is available on incentives to facilitate interfirm agreements such as fiscal reliefs and tax holidays, drawbacks and temporary import regulations for parts and components, the creation of export processing free zones, establishment of pre-shipment quality control institutions etc. Further to this, UNIDO would provide assistance in investigating the conditions for the creation of national organizations such as subcontracting exchanges which could play an active role in fostering and promoting interfirm relationships at national level and/or at interregional or international level.

In the second case, direct assistance to manufacturers can be provided in the form of management and technical assistance, fellowship and training of labour and general information on the requirements to be met for international subcontracting. Whenever possible tailored information connected with practical enquiries or cases, can be provided upon request.

Other programmes of UNIDO such as industrial information, training, management clinics, quality control, investment promotion, product adaptation, are involved whenever necessary.

(b) Promotional Role - In addition to the advice to governments and firms of developing countries, it has been felt that there was some need for UNIDO assistance in promoting direct contacts between potential partners in industrialized and developing countries. The programme was set on a very practical approach concentrating on identifying specific products and specific offers by industrialists in developed countries interested in subcontract components and transfer production abroad. It responded to a need and involved firms interested in getting in touch with each other. Its immediate objectives are the following:

- (i) to identify, in the industrialized countries, manufacturing processes which could be subcontracted in developing countries;
- (ii) locate specific firms interested in subcontracting a portion of their operations in developing countries;
- (iii) establish a co-ordinated network to identify potential subcontractors and ascertain their willingness and their capability to participate in such agreements;
- (iv) assist the parties to create the prerequisite of these business negotiations.

No exhaustive preliminary surveys were organized on the potential available for such arrangements in industrialized and developing countries. To meet the objectives of the programme, two simultaneous actions were launched in order to establish workable contacts with organisations and producers. The following developing countries agreed to participate in the programme's activities: Argentina, Brazil, Cameroon, Chile, Colombia, Cyprus, Ghana, Greece, Guatemala, Hong Kong, India, Iran, Ivory Coast, Korea (Republic of), Lebanon, Malaysia, Malta, Mauritius, Morocco, Pakistan, Peru, Philippines, Senegal, Singapore, Thailand, Tunisia, Turkey, Uruguay.

In these countries points of contact were established with an organisation or an office either in the private or public sector, with the central position in respect to the manufacturing sectors and capability in identifying for the programme the firms interested in production co-operation agreements. This identification was made on a pragmatic basis with case by case investigations based on definite subcontracting offers.

Certain criteria were adopted for identifying prospective subcontractors:

- (a) The potential subcontractors were identified among local manufacturers already operating in the field covered by the offer. This guaranteed more rapid negotiations and the possibility to compare on the spot experiences, samples and receive quotations.
- (b) The local manufacturer normally had certain excess capacity of production. By this criteria it was not only possible to achieve prompt implementation but also guarantee the subcontractor against the risk of heavy dependency on the contractor's decisions as only a minor and under-utilized part of its operations would be involved in the international contract.
- (c) Local manufacturers guaranteed, in principle, the necessary quality level of production and reliable deliveries, protecting the programme from the loss of confidence which might have been caused by recommending unsuitable firms.

As a result of this investigation it was possible to identify and select 320 potential subcontractors located mainly in Asia, North Africa and Middle East countries. It is expected that as a result of a recent expansion of the programme's operations, firms from Latin America will be included in the operations of the programme.

These firms encompass a large number of industrial products especially in the automotive and automotive parts industries, metalworking, textile and garments, electrical and electronics, optical, furniture, rubber and plastic, chemical and pharmaceutical industries. For each firm detailed information is available on their production, available capacity, labour costs, lists of products they would be ready to produce under a subcontracting agreement and detailed description of machinery. A roster of these firms has been created.

In industrialized countries, the programme's objectives were explained, with the help of field experts, to the business communities and specific firms in the following industrialized countries: Austria, Belgium, France, Federal Republic of Germany, Luxembourg, Netherlands, Switzerland, Denmark, Norway, Sweden, Finland and U.K. Numerous contacts were established in the course of several missions with public and private organizations such as development and investment banks, federations and chambers of industry, sectoral organizations, followed by interviews with as many industrialists as possible. Those industrialists were contacted on the basis that they operated in industrial sectors such as automotive parts and components, textiles and garments, furniture, metalworking and electrical industries, where subcontracting is a common practice. As a result of this activity the programme is in direct contact with a part of the manufacturing sector of Europe. If financial and staff requirements are met, the same action will be undertaken in North American countries, Japan and Australia.

In order to facilitate further the contacts between interested manufacturers, UNIDO has established co-operation agreements with FINCOM (Foreign Trade Company of CSSR), the Ministry of Economic Co-operation and the Association of Importers and Exporters of the Federal Republic of Germany, the Centre for Promotion of Imports from developing countries of the Netherlands. Through these agreements, UNIDO will be advised of subcontracting requirements to be processed and will in return identify suitable subcontractors in developing countries. Further agreements are anticipated with similar organizations in Austria, Hungary, U.K. and Canada.

So far several firms mostly from the Federal Republic of Germany, Austria, Belgium and Netherlands, and to a limited extent from U.K., Finland, Sweden, Norway and France have made some 60 offers for subcontracting or transferring part of their production in developing countries. These offers encompass a very large number of products but are largely concentrated in the field of metalworking, garments and furniture. Some of them were originated from large European firms and covered products such as machine tools, fabrication, films, cameras and lenses, small diesel tractors, injection moulding machines, sporting guns, automotive and truck parts.

The method of processing enquiries and offers is the following:

- the offer is either identified by field experts or sent directly to UNIDO by interested firms from developed countries;
- upon receipt the description with all available details of the offer is introduced to potential subcontractors in developing countries. Subcontractors are informed either directly, if they are registered in the UNIDO roster, or via the local contact point in each country;
- replies, quotations and eventually samples from interested subcontractors are screened by UNIDO. Whenever necessary further clarification or information is requested, and then UNIDO sends to the firm placing the enquiry all the relevant material. It is normal that from this stage onwards, the contractor enters directly into negotiations with prospective partners, and further UNIDO action is generally not required.

In order to stimulate further possible offers and, in general the active interest of manufacturers in developed countries, the information assembled in the roster is statistically processed and distributed to organizations and firms of industrialized countries which are in contact with the Programme.

This information concentrates mainly on capacity available.

Concerning the results of processed offers, in several cases such as those concerning small tractors, machine tools, automotive parts, sporting guns and several garments and furniture enquiries, negotiations are concluded or in an advanced stage, the co-operation agreements are expected to be finalized soon. It is obvious that the great difficulties inherent to international subcontracting such as distance, different governmental policies, different approach, non-standardized technical measurements and requirements, political factors have played a negative role in several cases which failed to reach a positive conclusion.

At this early stage no systematic analysis has been done of the operations. Information will be collected on these factors and UNIDO will try to identify, in spite of the great variety of conditions of each negotiation, a set of guiding principles to usefully advise the negotiating parties.

Future Orientation of UNIDO's Activities in Subcontracting

So far the main activity of UNIDO has been concentrated on establishing workable contacts at the level of industrial organizations and industries in both developed and developing countries.

At this stage a set of questions are raised and it would be very useful to have the views of the participants.

- (1) It is apparent that there is a striking difference between the bargaining power of the partners. This has been underlined in many documents presented to this meeting. The necessity therefore exists to advise the weaker party and assist him to gain knowledge and information on the requirements and foreseeable consequences of international manufacturing agreements. By improving the position of less advanced parties, it would be possible to reach more satisfactory and durable contracts and benefit indirectly the more advanced partner. As said previously, it seems that UNIDO's advice to manufacturers of developing countries could be increased and may cover such aspects as the economic and financial, legal and technical requirements of international manufacturing agreements. Such assistance could be extended, upon request, at all stages of negotiation.

- (2) The question should also be raised whether it is necessary to extend the role of national organizations which so far acted as contact points for UNIDO, and limited themselves to the identification of prospective subcontractors for particular enquiries. Such an extended role could englobe a more active representation of the country's potential for subcontracting and production agreements. If this action is considered useful, UNIDO could supply expert advice to local institutions so as to help them to set criteria for selection of subcontractors, to investigate the potential for subcontracting and production agreements of the local industry and represent this potential with manufacturers and organizations of industrialized countries and by this promotional activity elicit interest and originate new industrial co-operation proposals. The same representation could then be envisaged for similar related fields such as promotion of investments and transfer of technology requirements.

If this is the case, UNIDO assistance could be provided through the country programming.

- (3) Furthermore it might be worthwhile to consider useful, on the part of industrialized countries, establishing a national machinery to act as a counterpart of developing country's organizations. It might be advisable, in such cases, to establish an organized action in order to, on the one hand, investigate the needs of local manufacturers for transfer of labour intensive production and the country potential for investment, transfer of technology, licensing in developed countries. The same organization could process directly, or through the UNIDO Programme, all the enquiries related to the above mentioned fields.
- (4) It might also be advisable, at this stage, to maintain the direct promotional activity of UNIDO so as to take care, on the one hand, of the enquiries which require a multi-national approach, and, on the other hand, to cope with the requirements of developing countries which have not, at present, the necessary local machinery. UNIDO's promotional activity will also allow the constant analysis of results of negotiation and accumulate experience from them so as to advise interested parties whenever necessary. UNIDO will, furthermore, be in a position to act as a centre of discussion and evaluation for the reference for interested countries and organizations.
- (5) Another subject for discussion could be the necessity of securing better liaison among existing national machinery and possibly envisage the creation of a central international point of contact under the auspices of UNIDO. At this stage, however, it is not clear whether this organization is needed and if it should limit itself to the requirements of international subcontracting and transfer of production or cover a sort of general co-operation programme between industrialized and developing countries.

It is not certain whether this set of questions will definitely be clarified in the present meeting but discussion will provide preliminary indication and possibly establish a set of priorities and orient UNIDO's action further in this field.





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