

DEVELOPMENT CENTRE STUDIES

INTERNATIONAL SUBCONTRACTING

A NEW FORM OF INVESTMENT

Edited by
DIMITRI GERMIDIS



DEVELOPMENT CENTRE
OF THE ORGANISATION
FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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PREFACE

The present volume constitutes both the last publication of the research programme on technology and industrialisation, and the first publication of the new research programme on "Foreign investments and their impact on development".

In fact, international sub-contracting (ISC) appears on the one hand as a "new form" of investment, and on the other as an instrument of third world industrialisation, to the extent that certain conditions are fulfilled.

In this synthesis report, and taking into consideration the case studies, Mr. Germidis summarises these conditions as follows :

- creation of ripple effects within the economy where the international sub-contracting takes place ;
- international competitiveness of the sub-contracting activity through the transfer of technology from the principal to the sub-contractor ;
- durability and adaptability of the international sub-contracting agreements towards truly joint venture investments ;
- lastly, diversification of the agreements.

Empirical observation shows that there is a great deal to do in this area, both on the side of the principal and on the side of public authorities, especially those in the developing countries.

To-day, the successful experiences of international sub-contracting, particularly those in South Korea, Singapore, Brazil, etc., have aroused the interest of several developing countries hoping that ISC may contribute effectively to their industrial development. For that reason, these countries demand within such international organisations as UNCTAD or UNIDO a larger share of local value added in the products manufactured by the affiliate of multinational firms.

International sub-contracting is the activity which most clearly brings out the interdependence and the complementarities between the North and the South. In fact, it permits the continuation of several industrial activities in the North while contributing to the industrialisation in the South. Furthermore, it provides the time necessary for the industrialised countries to proceed with the required adjustments for industrial redeployment.

A "new form of investment", ISC is the typical manifestation of a weak financial engagement by a foreign investor-entrepreneur accompanied by a reinforcement of contractual obligations. It is precisely this tendency which characterises the "new forms of investment".

This collective work, co-ordinated by Mr. Dimitri Germidis, will certainly contribute to a better understanding of the unity of interests of the partners and, therefore, will stimulate and reinforce North-South industrial co-operation, at a time when such co-operation becomes increasingly necessary.

Part one

INTERNATIONAL SUB-CONTRACTING AND INDUSTRIALISATION
OF THE THIRD WORLD : PROBLEMS AND PERSPECTIVES

by

Dimitri Germidis

INTRODUCTION

A. Background and objectives of the research project

Despite the difficulties they may present for principals and subcontractors, international subcontracting agreements are generally claimed - according to a traditional approach - to be an effective means of accelerating industrial development since they foster a certain complementarity of production lines on the basis of a specialisation which reflects comparative advantages. Moreover, they have positive effects on the balance of payments of LDCs and, above all, they allow a mobilisation and better utilisation of these countries' manpower resources.

The analysis of international subcontracting (ISC) can be linked to the manner in which the master concepts in development strategy have evolved (1). Models based on the "import substitution" process are less well-regarded than they were 15 years ago. The results produced by the introduction of such models are inhibited by the limited size of domestic markets. If the momentum is not to be lost, there will have to be a change in income distribution. Reform along these lines may not be easy to carry through in some of the developing countries. This accounts for the success of another industrialisation concept, in which emphasis is placed on "export promotion" and foreign demand is made a substitute for domestic demand. It is precisely here that ISC appears to be an acceptable approach. On the one hand, it is in line with attempts to bring about a new international division of labour. On the other, it should be instrumental in strengthening industrial structures in the developing countries. If its scope were broadened, a large number of local firms could be mobilised for subcontracting work. Furthermore, ISC lends itself to the use of medium-sized and small production units.

The development of international subcontracting should also contribute to the dissemination of scientific and technological knowledge to the less developed countries. Work done by subcontractors has to conform to strict technical specifications and if goods, regardless of their origin, are to be of uniform quality, technological standardization is necessary.

At the same time, international subcontracting could induce a flow of foreign capital and thus act as a catalyst in attracting other investments which would allow both an increase in local value added and help to diversify the product range. Subcontracting agreements should be a first step towards the creation of joint ventures. In this case technology transfer accelerates and the network of subcontracting firms becomes viable.

1) See C.A. Michalet, "International subcontracting", roneoed report, Development Centre.

Finally, the introduction of "regional" assumptions opens up other subcontracting possibilities, notably the specialised industrial subcontracting practised by subsidiaries of multinational corporations, which can - in a dynamic perspective - lead to "regional joint ventures". In this respect one should not lose sight of the technical and political difficulties which this tendency could come up against.

On the basis of these initial assumptions and apart from its "survey" function, the research had three objectives :

- i) to identify the conditions under which certain types and modalities of subcontracting (which also remained to be identified) can lead, in a dynamic perspective which goes beyond the resolution of short-term problems, to the effective industrialisation of the developing countries concerned. The role of the public authorities should be especially shown in this respect ;
- ii) to measure the scale and nature of technology transfers (be it in the form of machines - new or secondhand - or know-how, notably in the fields of organisation and marketing, etc.) according to the types of subcontracting arrangements and the nature of the sectors under study ;
- iii) to explore the opportunities offered by "regional" subcontracting, notably by subsidiaries of multinational corporations, for the strengthening of regional co-operation between the LDCs and, through this, for regional economic integration.

B. Organisation and implementation of research

After the research project had been prepared and discussed in a group of experts, the Development Centre proposed a methodological framework which included a series of indicative questionnaires intended for businessmen (principals and subcontractors) and government officials.

A pilot study was carried out in Tunisia (by Dean Michel Falise), where international subcontracting is the mainstay of current industrialisation policy ; other case studies were then undertaken.

The choice of countries obeyed certain criteria such as the development level and structure of the "subcontracting" economy, the sectors affected by subcontracting, the types of subcontracting agreements, the origin of the principal and, finally, the possibilities of local collaboration. The major constraint was of course the Centre's limited financial resources for this study.

Finally, in addition to Tunisia, the study was able to cover Morocco (Prof. A. Hanaut and Prof. C. Berthomieu), Haiti (J-R. Estimé), the Philippines (L. Bacungan and Dean F. Bacungan) and Sri Lanka (Dr. P. Nugawela).

The studies for the last two cases were based on specific experiences. Thus, for the Philippines, the authors presented the "Progressive Car Manufacturing Programme of the Philippines" (PCMP) as an example of government policy to promote

"industrialising" subcontracting (1), with respect to Sri Lanka, international subcontracting was studied in association with the creation of free zones within which subcontracting should take place.

Lastly, two "regional" reports have been prepared ; one concerns the Caribbean (Prof. J. Crusol), the other South-East Asia (Dr. S. Watanabe). The aim of these two analyses was to enable us to assess the possibility of making international subcontracting a means of economic integration.

On completion of the research work, an evaluation meeting was held in Haiti (from 29th November to 1st December 1978) by the National Development and Planning Board (which has since become the Plan Secretariat) with the assistance of the Development Centre. Other international organisations such as the OAS, the local UNDP and UNIDO took an active part in this meeting.

The present synthesis is based on the discussions at this meeting as well as the case studies.

1. TYPOLOGY - FORMS OF INTERNATIONAL SUBCONTRACTING

The multitude of definitions, the fluidity of the concept and the evolving nature of the related activities make it essential to give a type classification of the different forms of international subcontracting. This is all the more necessary in that a reasonably standard language is needed in order to make comparisons between the various case studies.

Of all the definitions (2) of simple subcontracting, we feel that the one adopted by UNIDO (3) is the most explicit : "a subcontracting relationship exists when a firm (the principal) places an order with another firm (the subcontractor) for the manufacture of parts, components, sub-assemblies or assemblies to be incorporated into a product which the principal will sell. Such orders may include the treatment, processing or finishing of materials or parts by the subcontractor at the principal's request".

In addition to the subcontracting activities covered by this definition, there is however the possibility of subcontracting the manufacture of finished products to be marketed as such by the principal without any need for prior assembly.

1) This case study of the Philippines undertaken by F. and L. Bacungan is not included in the present publication, because, due to its volume, it was published (Oct. 1979) directly by the Faculty of Economics of the University of Philippines. However, the reader will find here a summary description as well as an evaluation of the Progressive Car Manufacturing Programme (PCMP) of the Philippines in the study of S. Watanabe dealing with ISC in the Asean countries (see part four).

2) See the report by C.A. Michalet in Part two.

3) UNIDO : "Subcontracting for modernising economies", United Nations, New York, 1974.

The subcontractor's room for initiative varies according to whether he carries out a simple piece of commissioned work on raw materials or components (and sometimes even machines) supplied by the principal, or whether he himself takes responsibility for purchasing raw materials, making or adapting the production machinery, choosing manufacturing processes, designing the product required (although admittedly this very rarely occurs) and so on.

But what factors should be taken into account in order to "internationalise" this definition ? On the basis of observed practice, two essential factors can be considered in turn :

- the geographical location of the firms in the subcontracting relationship ; the principals and the subcontractor are situated in two different countries ;
- the foreign origin of the principal, which may be a subsidiary of a multi-national corporation or a firm under "foreign" control. It goes without saying that in this case the principal and the subcontractor are situated in the same geographical area, i.e. the country of the subcontractor.

If one of these two criteria is met, subcontracting can be regarded as an international activity.

In addition, it is possible in some cases to take the destination of the product manufactured by the subcontractor (export or re-export) as a third factor which will give subcontracting an international dimension. This is where we see the first divergences of views between authors.

Indeed, such a conception brings multi-national corporations into the picture as operators of international subcontracting.

The discussions at the Haiti meeting confirmed the growing importance of the MNCs in the development of international subcontracting, at least in some of its forms. This importance differs according to the type, level and structures of the subcontracting country's economy, its policy towards industrialisation (policy of import substitution or export promotion), its attitude towards foreign investors, etc.

This much said, the differences that appear between the type classifications suggested by C.A. Michalet, C. Berthomieu, A. Hanaut and S. Watanabe (the other *rapporteurs* having more or less adopted Michalet's type classification) make it essential to begin by briefly describing these and then finding a common denominator, or at least certain similarities.

But first of all, let us make the conventional division (formulated by UNIDO) of international subcontracting into three forms according to the principal's motivations :

- i) Speciality subcontracting. The contractor entrusts the subcontractor, on a permanent basis generally, with the execution of certain manufacturing operations. The subcontractor has specialised machinery and equipment, or has developed specialised technologies, with or without the assistance of the main contractor ;
- ii) Economic or cost-saving subcontracting. The contractor's main motivation for such an arrangement is that the subcontractor's costs for certain operations (production or processing) are considerably lower ;

- iii) Complementary or intermittent subcontracting. This form of subcontracting is used when the main contractor's production capacity is at times insufficient owing to sudden surges in his orderbooks.

While implicitly accepting the functional criterion, on which the above classification is based, Michalet's type classification is founded on the various strategies adopted by principals.

Michalet distinguished four archetypes of international subcontracting relationships (1) :

Type A : Between two independent units in countries at different levels of development - the "pure" form of international subcontracting.

Type B : Between the subsidiary of a multinational corporation and a local firm.

Type C : Between two subsidiaries of different multinationals in the same country.

In both cases B and C, there may be some supply to the local market.

Type D : Between a parent company and a subsidiary or between two subsidiaries of the same multinational corporation in different countries.

Types A and D are forms of "direct" international subcontracting in which the output of the subcontractor is exported in full to the principal. Types B and C represent the forms of "indirect" international subcontracting in which the subcontracting relationships occur through a subsidiary of the multinational corporation which subcontracts work to a local firm or another multinational corporation affiliate.

S. Watanabe (2) also distinguishes four types of international subcontracting :

- i) Across-border commercial subcontracting :

this takes place between independent units located in different countries and concerns the manufacture of finished products exported (without assembly of finishing) either via the principal or direct by the subcontractor. As defined here, this form of international subcontracting comes under Type A in C.A. Michalet's classification.

- ii) Across-border industrial subcontracting :

this takes place between two units located in two different countries and concerns the manufacture of intermediate products (components or sub-assemblies) which are assembled at the principal's own plant. Insofar as these two units are independent, such subcontracting is again of C.A. Michalet's Type A.

Where the two units belong to the same multinational corporation (which Watanabe does not regard as a real case of international subcontracting), this form of international subcontracting is akin to Type D in Michalet's classification.

1) See the report by C.A. Michalet in Part two.

2) See the report by S. Watanabe "International subcontracting and regional economic integration in the ASEAN countries : role of the multinational corporations", in Part four.

iii) Within-border industrial subcontracting :

which takes place between a subsidiary of a multinational corporation (the principal) and a local firm ; the two units are located in the same country and the subcontractor manufactures components ; this is Type B in Michalet's classification.

iv) Within-border commercial subcontracting :

the operators are the same as in the preceding case (within border industrial subcontracting), but the products manufactured under contract are finished goods ; this is again C.A. Michalet's Type B.

The methodology of A. Hanaut and C. Berthomieu is broadly based on that of S. Watanabe (they use the same terminology) and it is not difficult therefore to find "equivalences" with C.A. Michalet's methodology.

However, the following comments are necessary :

First, since A. Hanaut and C. Berthomieu did not come across any case of within-border international subcontracting, as defined by Watanabe, in Morocco, they excluded this particular category. Secondly, they propose extending C.A. Michalet's Type B to cover the case where the principal is not an MNC subsidiary but an independent foreign (or foreign controlled) firm located in the subcontracting country. Lastly, they introduce special types of international subcontracting which have the common characteristic of being encouraged in various ways by the public authorities in the subcontractors' country, as opposed to the forms of spontaneous international subcontracting between private decision-making centres (1). This applies to the subcontracting of contracts (in connection with a public procurement contract between firms of different nationalities, i.e. a case of within border industrial subcontracting) and compensatory subcontracting (2) (in the category of across-border industrial subcontracting and C.A. Michalet's Type A).

The following table is an attempt at a composite presentation of all these types of international subcontracting.

-
- 1) For more details of the types of international subcontracting mentioned here, the reader is referred not only to the report by A. Hanaut and C. Berthomieu on Morocco, but also to their article "La sous-traitance internationale peut-elle être un facteur d'industrialisation ?" (Can international subcontracting be a factor of industrialisation ?), published in the International Labour Review, n° 3/1980.
 - 2) In the case of a public contract or a foreign investment authorisation, the public authorities impose subcontracting for part of the exportable output with a view to compensating for sales in the host country.

Table 1

COMPOSITE TYPES OF INTERNATIONAL SUBCONTRACTING

Other type classifi- cation	Watanabe				Berthomieu/Hanaut (main types used in addition to those proposed by Watanabe)		
	Across border commercial ISC	Across border industrial ISC	Within border industrial ISC	Within border commercial ISC	ISC of contracts	Across border compensa- tory ISC	ISC between an independent foreign firm and another firm (2) in the same country
Michalet's type classifica- tion (1)							
A	X	X				X	
B			X	X	X		X
C							X
D		X					

1) A detailed description of these type classifications will be found in the experts' reports in Parts two and three.

2) National firm or MNC subsidiary.

X Indicates that the types of international subcontracting proposal by Watanabe and Berthomieu-Hanaut and those proposed by Michalet are "equivalent".