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International Subcontracting Involving LDCs

by Professor Dr W. König, Göttingen *

An increasing number of LDCs for which international subcontracting has been an accepted practice can be seen to be progressively tied to the internationalization of production and marketing.

The general question regarding international subcontracting is whether this practice constitutes a means of improving the international division of labour through a better world-wide allocation of resources and thus leads to a profitable situation for both developed and less developed countries (LDCs). Various terms such as off-shore assembly, contract manufacture, in-bond processing companies and run-away plants are frequently used to refer to a relatively new feature in international trade and investment which, applied to industrial cooperation between developing and developed countries, has been of rapidly increasing importance in recent years. International agencies, such as the United Nations Industrial Development Organization (UNIDO), which are providing technical assistance, have coined the corresponding practice "international subcontracting" (IS). Involved are business relationships between principals in industrial and subcontractors in developing countries which have been emerging mainly as a result of substantial differentials in labour costs between these two groups of nations. A good deal of these relationships takes place within international corporations, i.e. between parent companies and their affiliates, and often subcontractors are located in a so-called industrial free zone.

Characteristics of IS

International subcontracting is readily understood as an arrangement whereby a relocation of productive processes outside the country of the principal takes place. In reality, however, this practice is not easily defined and identified because it includes a wide range of business relationships. Crucial in all cases is a dependency of the subcontractor upon the principal which may indeed take various forms and range from technical advice to foreign direct investment together with the supply of all materials to be used. Generally speaking, since the subcontractor becomes active upon the order of the principal, usually entailing

precise technical specifications, he cannot be considered a full-fledged entrepreneur. The demand for his products is to be considered a derived demand, leaving the corresponding marketing effort entirely up to the principal.

Against this background various data about the nature and scope of IS are:

Since the productive processes involved could also be carried out in the country of the principal, the comparative advantage of the host country occurs in terms of "intangible" inputs, i.e. mainly labour, and leads in many cases to simple processing and assembly.

The cost and availability of labour being a major motive, IS provides the only chance for those LDCs to industrialize that, possibly because of a lack of natural resources and the narrowness of their domestic markets, cannot do so otherwise.

Semi-industrialized countries with a relatively high wage level within the developing world will also qualify as locations for subcontracting in those activities in which the skill requirements are high.

Since IS implies the specialization and division of productive processes, it favours the vertical integration of companies and thus may be actively sought by multinational corporations, but, on the other hand, foreign ownership of subcontracting firms will be a less critical issue to principals than the observation of high standards of quality and other specifications imposed upon the subcontractor.

In summing up the foregoing, two points deserve to be made. First IS is applicable in one way or another to a wide range of actual and potential industrial business relationships between developed and developing countries. Second, the actual form it takes will, in each case, depend upon

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the nature of inputs required and the degree of industrial development as well as wage levels of the host economy. By implication, IS expresses not only a division of labour between industrial and developing countries but will also be shaped along the line of comparative advantage within the developing world, permitting most of these nations to be involved.

Expectations of Host Countries

Independent of whether or not the subcontractor is a local or foreign investor, acceptance and promotion of his production activities by host governments constitute, in most cases, an important element of recently adopted outward-looking development strategy. This strategy is usually based upon the notion that manufacturing for export will provide an incentive for industrialization generally and particularly for the diversification of the domestic economic structure as well as of the international supply of the countries concerned. Among the expected benefits are an increase in job opportunities, opening of alternative, possibly more stable, sources of foreign exchange and with it a rise in the capacity to import.

For small countries without any significant industrial experience, this strategy becomes viable only through IS. However, also semi-industrialized developing nations are increasingly opting for this device in the context. The reason is that a conversion of high cost import substitution into export industries, however logically postulated, is difficult to accomplish in the short and medium run because the step towards international competitiveness is too great.

Barring the rather exceptional cases in which excess capacity of existing firms normally supplying the local market provides the ground for IS, the initiation of this practice is thus bound to constitute for all types of developing countries an entirely new dimension to their general economic structure. Countries adopting it, have realized that it might permit, for the first time, the introduction of significant economies of scale and directly lead, without marketing costs, to substantial manufactured exports on the basis of their comparative cost advantage. Therefore, it can make an important contribution by reducing unemployment and strengthening the trade balance, within the context of industrial promotion

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efforts. In addition, most of these countries have substantiated their favourable view towards IS by pointing to the possibilities of obtaining from abroad technologies that are in line with the domestic factor endowment.

Issues Raised In Countries of Principals

If a principal in IS has the option of keeping production at home, much of the benefits accruing to the host economy of the subcontractor, e.g. in terms of employment and trade balance effects, would appear to constitute corresponding costs to the country of this principal. However, the emergence of this practice has to be seen in the light of pressing domestic and international competition and a corresponding search for possibilities to cut down on production costs and to rationalize production techniques. In principle, therefore, a convergence rather than a conflict of macro-economic interests between the two types of countries can be expected.

Many industrialized countries have, in fact, stipulated tariff and other provisions which constitute incentive measures to IS. In the United States for example, provisions for tariff item 806.30 have for years allowed goods made of metal to be sent abroad for processing and returned duty free, except for foreign value added, for further processing in the US. Provisions for tariff item 807.00 have also provided special tariff treatment for all articles assembled abroad in whole or in part of fabricated components which are the product of the US.

In recent years, however, organized labour in industrialized countries has laid a number of charges against offshore production and maintained, with particular reference to IS, that a supposed exportation of jobs through so-called run-away plants should not be permitted to have official support. Changes in this direction seem to be expressed, for example, by the fact that the Trade Reform Act of the US will greatly affect the above-mentioned tariff items. Also the Overseas Private Investment Corporation (OPIC) of the US, for some time now, will not assist with loans and investment guarantees and insurance, if it determines according to specific guidelines, that a proposed investment concerns a "run-away" industry.

Motives of Principals

The impact, however, that official measures adopted by industrialized countries would make on the amount of IS as such appears to be relatively negligible in the light of the weight of business considerations behind it. Generally speaking, the most important motive for subcontracting

relationships to be established between industrialized and developing countries is, as was suggested before, the availability and cost of labour in the LDCs. To be sure, in each case there might be important additional considerations referring to whether or not the subcontracting firm is a foreign affiliate, receives its materials from the principal, and sells its production to associated enterprises. But a cost saving aspect will always be of prime importance and, in the case of many products involved, the pressing need is the shortness of their durability leading to rapidly increased competition.

Clearly indicative of the potential of cost saving are such estimated labour cost data collected at a UNIDO sponsored meeting on industrial free zones in October 1974 which, among others, stated estimated labour costs per hour, including fringe benefits, as between US \$ 0.15 and 0.21 for Mauritius, Haiti, Colombia, the Philippines and Korea.

It should also be realized that even if labour costs rise much faster in developing than in industrialized countries, the absolute wage differential between these nations could still increase. In some host countries and for certain product groups such increases could be as much as over ten times higher¹.

Location Decisions and Free Zones

The decision to go ahead with IS will require the principal to carefully evaluate an increasing number of possible sites for his offshore production. His choice is eventually bound to depend on transport costs involved and the business climate in the host economy. Transport costs usually play only a minor role in total cost considerations, but in a number of cases a particular geographic location might be decisive for principals, like the Mexican northern border zones which gave rise to the so-called twin plant concept with the involvement of both sides of the border. Also of importance can be, in the context, the time element in implementing product specifications.

The business climate or more specifically, when subcontracting involves international companies, the foreign investment climate, will comprise a wide array of pertinent aspects ranging from infrastructure facilities and labour laws to political stability. Corresponding official operating conditions are important in that increased competi-

¹ For corresponding data on the US and a number of developing countries involved in IS with the US, see US Tariff Commission, Economic Factors Affecting the Use of Items 807.00 and 806.30 of the Tariff Schedules of the United States, Washington, D.C., September 1970, p. A-90. On its p. 171, this publication reads "Productivity of workers in foreign establishments assembling or processing products of US origin generally approximates that of workers in the same job classifications in the US."

tion among actual and potential host countries has led to a certain minimum of incentives as the going price for the attraction of IS.

When IS involves to a high degree the supply and reimportation of materials by principals this price is usually to be defined in terms of waiving the application of pertinent import and other regulations leading to the creation of a kind of foreign enclave either as bonded plants or industrial free zones. The latter have proven to be effective devices for reconciling much of the interests of all parties involved. Several countries have been operating such zones quite successfully for some time, notably India, Ireland, Korea, Malaysia, the Philippines, Singapore, and Taiwan. Many more countries intend to follow suit.

About 80 p.c. of export manufacturing in free zones is accounted for by the electronics industry involving a good deal of typically multinational corporations. As for foreign capital participation, the zones have the advantage of permitting host governments an easy control over foreign investment activity, on the one hand, and, for the foreign investor, on the other, to be able to operate under clearly established rules of the game.

The success in initiating and operating a zone, however, rests greatly with the set of promotional incentives offered to local and foreign investors; the quality of its administration; and its relation with the rest of the host economy over time. As concerns the latter, an industrial free zone is not an end in itself, but should be conceived as part of an overall industrial development program for the country or region in which it is located and thus, when it has become obsolete, would have accomplished its role.

Effects of IS

The most obvious impact IS will make on the economies of the countries involved is in terms of interdependent effects on income distribution, employment, value addition and the trade balance. In most cases these effects will be relatively more significant for host economies than for the countries of principals, even if the latter had had the option of keeping the production at home. For example, US imports under tariff items 806.30 and 807.00 of US \$ 4.2 bn in 1973², with a dutiable value (i.e. value added abroad) of US \$ 3 bn, constituted only a relatively small percentage of total imports. By contrast, the US \$ 650 (285) mn³ of that amount accounted for by Mexico — where in mid 1974 a total of 665 in-bond plants employed 74,000 people — was a considerable percentage of its exports and at the same time made up one

third of the total of manufactured exports of Latin America to the US. Such US imports from the developing world increased in only five years from US \$ 395 (177) mn to as much as US \$ 1,523 (827) mn in 1973.

Transactions of this kind are bound to have a considerable impact on small countries. In Haiti, where the corresponding value was US \$ 28 (8) mn in 1973, assembled products had already accounted for 25 p.c. of the country's total exports back in 1971, then giving employment to 10,000 out of 50,000 wage earners in urban centers; in Barbados, 21 assembly plants had provided jobs for about 20 p.c. of the workers in manufacturing in that year⁴. As for income distribution, corresponding effects will be readily realized and detected if the assumption can be made that the usually unskilled local labour force employed would be jobless in the absence of subcontractors.

These obvious effects of IS, however, which were understood to be positive to developing countries, might be reinforced or offset in varying degrees by a number of accompanying benefits and costs the importance or even occurrence of which is relatively difficult to determine: forward and backward linkages, however rudimentary, affecting the domestic industrial structure; transfer of technology mainly in terms of management techniques and when local materials are substantial inputs; learning effects; impact on local entrepreneurship; and amount of subsidization materializing through host countries' incentive measures.

In conclusion, international subcontracting is, in principle, a mutually beneficial practice within the scope of industrial cooperation between developed and developing countries. Among the many forms it may take, the most advantageous arrangements for the developing nations are those under which provision is made for an intensive use of local materials. But each LDC should carefully determine, according to its stage of development and factor endowment, which type of export manufacture should actually be attracted in order to achieve a proper place within this highly competitive international division of productive processes.

Although its approximate net cost or benefit to a developing country is not easily determined mainly because of difficulties in evaluating the weight of incentive measures, international subcontracting is to be considered an important, and in many cases the most important, device of a development strategy aimed at export-oriented industrialization.

² Unpublished data provided by the US Tariff Commission.

³ Locally added value in brackets ().

⁴ Jan F. Van Houten, "Assembly Industries in the Caribbean". In: Finance and Development, Juni 1973, p. 22.