To internationally subcontract or not?

Yue Wang's conceptual model of international subcontracting provides an analytical framework for supply chain managers choosing between outsourcing, subcontracting and vertical integration.

International subcontracting delivers a win/win for both the supplier and the buyer. The supplier, usually a developing country firm, gets an influx of hard currency and technological know-how and the buyer, usually a firm from a developed country, gets it all done cheaper. Essential features of international subcontracting include the 'quasi-integration' relationship between subcontracting parties in which developing country subcontractors depend on principals from developed countries. The subcontractor provides products or services on agreed terms, conditions and specifications, making it impossible or very difficult to sell them to other customers. Also, the principal usually provides specialised physical equipment and/or ongoing technical assistance to ensure product quality. Taking into account these three characteristics, this article builds a transaction cost model for studying the choice of international subcontracting which lies somewhere between a market outsourcing arrangement and vertically integrated multinational enterprises (MNEs).

SUBCONTRACTING VERSUS OUTSOURCING

Subcontracting is a kind of long-term contract that aims to facilitate the sourcing of products or components with buyer-specific requirements. This clarification is important because the term 'subcontracting' is often misunderstood as an exclusive portrait of a buyer-supplier relationship and therefore the distinction between common outsourcing and subcontracting is blurred. Relationship-specific assets, an investment made to support a given transaction and the value of which will be lost or significantly reduced in alternative transactions, is an important driver for the development of long-term contracts and explains the choice of subcontracting over outsourcing. To protect themselves from exposure to transaction costs arising from making asset-specific investments, both parties have incentives to form a long-term subcontracting arrangement.

SUBCONTRACTING VERSUS VERTICAL INTEGRATION

Vertical integration through acquisition of foreign firms has a number of disadvantages compared to engaging international subcontracting. First, the assets you want from an acquired firm are hard to separate from the ones you don't, often forcing the buyer to enter unrelated fields or to expand suddenly in size. Second, there are the inherent management problems of buying a firm with already established organisational routines and corporate culture that must be managed at considerable geographical distance. Third, it's difficult to assess the true value of a company's assets due to the fact a supplier may tend to exaggerate the value of its assets. Subcontracting allows foreign principals to gather information on the value of an overseas subcontractor's assets without financial exposure.

Fourth, high exit costs in an equity relationship jeopardises the buyer's flexibility. In contrast, a subcontracting arrangement allows buyers to get out of a contract relatively cheaply. Finally, impediments to acquistions arise from governmental and institutional barriers. Many developing countries discourage and restrict the foreign equity control of local companies while pervasive anti-trust legislation in developed countries also acts against acquisitions.

When making the choice between subcontracting and building new plants (greenfield) in low-cost countries, the following two things need to be considered.

First, relocating low value-added operations to greenfield plants may achieve cost reduction in labour and other production factors, but requires additional knowledge in managing labour and production in another country, and familiarity with local cultures and environment. Greenfield investments are therefore good for companies that aim to develop foreign markets for their products, but not for companies simply seeking to lower costs. Second, even when the buyer firm plans to develop the foreign market in the future, subcontracting may still be preferable as it allows the acquisition of knowledge of the local market in the meantime.

A subcontractor is more dependent when the principal has stronger bargaining power, such as when buyer commitments are confined to specific physical capital to manufacture a product but the subcontractor has to invest in special-purpose equipment and employ skilled workers to meet orders.

THE NATURE OF THE SUBCONTRACTING RELATIONSHIP

International subcontracting relationships range in terms of the degree of interdependence and bargaining power between principals and subcontractors. In a loose subcontracting relationship the principal does not rely on a particular subcontractor or subcontractors for supply and the subcontractor also has a broad customer base. The principal only needs to provide minimal technical assistance to the subcontractor and the subcontractor does not need sophisticated machinery and skills to perform their job. The frequency of orders has little impact on the relationship since both sides are loosely tied to each other and the exit costs are low.

A subcontractor is more dependent when the principal has stronger bargaining power, such as when buyer commitments are confined to specific physical capital to manufacture a product but the subcontractor has to invest in special-purpose equipment and employ skilled workers to meet orders. However, such an unbalanced subcontracting relationship may not be unstable. Although buyers from developed countries have more leverage, they know stable long-term relationships make life easier and business more profitable.

The situation where a principal is more dependent on a subcontractor is less common and usually occurs when the overseas subcontractor is the gatekeeper of crucial know-how such as in the aerospace and shipbuilding industries. In this case, a local subcontractor's bargaining power stems not from the transaction characteristics, but from the foreign buyer's strategic purpose in developing the local market with that supplier's help.

When the principal and the subcontractor are mutually and heavily dependent on each other, the situation demands equal collaboration. Subcontracting of this type requires highly specialised investments from both sides which balance out the relationship. In such a subcontracting relationship, the principal typically contracts out the assembly of a final product and any principal commitment has a high degree of asset specificity since complete assembly requires the highest integration of contract-specific physical facilities, like assembly lines, tooling and testing equipment. Moreover, the principal will incur human asset-specific investments in the form of managerial training and technical assistance. For subcontractors, end-product assembly for a particular overseas buyer will require specific investments in both human capital and physical assets. Therefore, principals and subcontractors commit a similar level of asset-specific investments, which supports an equal collaborative relationship.

To conclude, few international subcontracting studies have looked at the phenomenon from a management perspective. The proposed transaction cost analytical framework investigates the choice of international subcontracting over its market and hierarchy alternatives. It also allows the examination of the specific nature of a range of subcontracting relationships and helps international firms' supply chain managers make a strategic choice between outsourcing, subcontracting and vertical integration with overseas suppliers.

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