

## Chapter 4.3

# Strategic Management of International Subcontracting: A Transaction Cost Perspective

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### ABSTRACT

Research on international subcontracting has been policy-oriented and industry-focused. There is a lack of understanding of the phenomenon from strategic management and international business perspectives. This article conceptualizes international subcontracting as a type of relational contract formed by buyers and suppliers from different countries, aiming to facilitate the sourcing of products or components with buyer-specific requirements. It builds a transaction cost model for studying the strategic choice of international subcontracting as an intermediate governance structure, sitting between arm's length outsourcing arrangement and vertically integrated multinational enterprises (MNEs). A set of propositions are developed to aid future empirical research and to provide managers with some guidelines for organizing supply chain across borders. The

model also allows managers to examine the complex nature of a range of subcontracting relationships and identify the specific mechanisms that can be used to preserve and manage the dyadic principal-subcontractor exchanges.

### INTRODUCTION

International subcontracting is an important phenomenon in international business (IB) studies (Casson, 1990) and has been an effective means of accelerating industrial development since 1960s, fostering the specialization among countries that reflects comparative advantages (Germidis, 1980). Through such measures as the establishment of free trade zones, developing countries encourage local firms to undertake subcontracting jobs for foreign firms to earn hard currency and to accumulate technological

know-how (Hamada, 1974). Firms from developed countries are frequently attracted into subcontracting arrangements to exploit low labour and production costs in developing countries. The studies of international subcontracting are mainly policy-oriented (Cohen, 1975; Riedel, 1975; Sengenberger & Pyke, 1991) and geography or industry-focused (Kashyap, 1992; Lawson, 1992; Rogerson, 1995). Few have examined why firms from developed countries choose to use subcontracting arrangements in the first place. Moreover, despite some classifications of international subcontracting activities according to functional or market criteria (Gereffi, 1993; Holmes, 1986), the nature of subcontracting relationships remains unexplored due to the lack of theoretical underpinning of international subcontracting as a form of international business organization. Grounded on transaction cost theory (Buckley & Casson, 1976; Hennart, 1982; Rugman, 1981; Williamson, 1975, 1979, 1985), this article aims to provide a firm-level analytical framework for analysing the subcontracting choice and the nature of subcontracting relationships, complementing the existing literature's emphasis on studying international subcontracting as a macro-economic phenomenon. The framework will also aid managers in choosing strategically between outsourcing, subcontracting, and vertical integration when organizing their supply chain.

Although "transaction costs differ depending on both the nature of the transaction and on the way that it is organized" (Coase, 1937, p. 386), transaction cost economics (TCE) as formally developed by Williamson (1975, 1979) is not mainly concerned with the transaction itself, but with the contractual arrangements (the ways) through which transactions are organized (Cheung, 1983). Contractual or institutional arrangements, normally referred to as governance structures, are "the institutional matrix within which transactions are negotiated and executed" (Williamson, 1979, p. 239). Drawing upon the legal concept of generic contracting forms (Macneil, 1974, 1978) and relat-

ing them to the nature of transactions, Williamson (1979) matched the transactions to the contracts. By so doing, he provided a framework 'to assess the efficacy of alternative means of contracting' (Williamson, 1990, p. 8) and illustrated which governance structure (including the firm, the market and intermediate contracts) has the lowest cost under given circumstances.

Despite the criticisms (some are highly theoretical and sometimes obscure or even mistaken on what they are criticising) (e.g., Conner & Prahalad, 1996; Ghoshal & Moran, 1996), empirical studies show Williamson-type of transaction cost-comparative contracting approach has more predictive power than other major IB theories such as resource-based view (RBV) in informing the choice between different forms of governance structures for organising firm interdependence (e.g., Hennart, 1991; Reddy, Osborn, & Hennart, 2002). Much of the RBV (Barney, 1991; Peteraf, 1993; Wernerfelt, 1984) and its closely-related competence perspective (Foss, 1996; Knudsen, 1995) entail ex post rationalizations for success and has been remiss in predictive respects (Williamson, 1999). This article therefore employs TCE as an analytical framework for examining the choice of international subcontracting.

## **THE CONCEPT OF INTERNATIONAL SUBCONTRACTING**

There is a great deal of ambiguity on the definition of subcontracting in the existing literature (Hovi, 1994). However, there are some essential features about the international subcontracting as a form of investment. First, international subcontracting involves two independent units located in different countries, reflecting a type of cross-border inter-firm relationship. But the fact that a firm is legally independent does not necessarily mean that it will be economically independent. The relationship between subcontracting parties is defined as "quasi-integration," in which subcontractors from

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