

## DEALING WITH CRISIS: USING SUBCONTRACTING FOR THE DEVELOPMENT OF THE CROATIAN LEATHER MANUFACTURING AND PROCESSING INDUSTRY

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### Abstract

As literature suggests, subcontracting presents an important source of support of various kinds to small and medium-sized companies from large ones as well as an important source of efficiency and competitiveness. It is considered as an instrument of industrial and economic development and employment creation in developed and developing countries, and particularly in labour intensive industries. A reduction of demand, a change in consumption patterns, a global shift from production and economic crisis have increased the interest of many researchers analyzing subcontracting relationships mostly in textile and clothing industry. This paper is investigating the role of subcontracting in the case of the Croatian leather manufacturing and processing industry with an aim of getting better insight into its contribution to the development of this sector. Therefore, for the purpose of this paper, a two-phase research study, including a qualitative approach, was used: 1) the first phase on the sample of companies operating in the Croatian leather manufacturing and processing industry which intended to find out overall perception of benefits and limitations of subcontracting for the Croatian footwear and leather manufacturing companies; 2) the second phase on the group of the Croatian footwear and leather manufacturing companies, focusing on the success of subcontracting in dealing with global crisis. The findings of the study confirm that positive relationships between subcontracting and business performance was found as well as some areas for improvement.

**JEL Classification:** L67, M11

**Keywords:** subcontracting, Croatian footwear and leather manufacturing industry

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## 1. INTRODUCTION

While adapting to the demanding EU market, exposed to the increasing competition from the Far East, and very inconsistent market susceptible to ever-changing fashion trends, Croatian leather manufacturing and processing industry has recognized the necessity for implementation of new strategic approaches. Those new strategic approaches have focused on a cost management strategy combined with adequate service and quality management level. Literature (Buxey, 2009) suggests that subcontracting is the strategy for companies in the textiles, clothing, and footwear industry for adapting to the pressures of globalisation. Namely, the production in the textile, clothing, and footwear industry is transferred to cheap offshore locations, generally via subcontracting, and in order to survive, local factories focus on quality and customer service. In general, Anić et al. (2008) have seen the textile and clothing industry as a declining industry.

The main characteristics of the Croatian leather manufacturing and processing industry are: labour intensiveness, export character, insufficient investment in technologies and high regional concentration (75% of companies are located in the Northwest of Croatia). It participates in the Croatian manufacturing industry with 1,22% companies, 3,89% employees and 1,84% revenue (CCE, 2012.).

The fact that most of the revenue in investigated industry is realised through the system of subcontracting, that, according to INTRASTAT, does not record value of used materials, given on disposal to be manufactured, in invoices issued, but added value only, can partially explain disproportion between participation in the number of employees and revenue. The domination of small companies in this industry is evident (93,8% of companies have less than 50 employees), but, although there are only eight medium and big size companies, they should also be taken into account because their revenue is significant. Analysing the situation in this industry, a slight increase in the number of companies and in total revenue is observed from 2008 to 2012 (Table 1), and this paper is an attempt to find out whether subcontracting business model have helped Croatian companies to deal with global crisis which started in 2008.

**Table 1** Number of companies, employees and total revenue of Croatian footwear and leather industry 2008 - 2012.

Indicator	2008.	2009.	2010.	2011.	2012.
Nr of companies	124	124	127	129	130
Nr of employees	8.538	7.692	8.781	9.026	8.547
Total revenue	2.364.973.135	2.182.539.018	2.556.027.748	2.957.739.973	3.000.752.156

Source: CCE, 2012.

Kimura (2002) points out that in labour intensive industries, subcontracting has been regarded as an important source of efficiency and competitiveness. It is interesting that although there is a growing interest to examine subcontracting as the special form of co-operation among companies (Furlan et al., 2007) or as a specific form of outsourcing (Heshmati, 2003) in the world, and the importance of subcontracting as the form of the export of the Croatian leather processing and manufacturing industry's output, there has been little academic investigation into the area of subcontracting in the Republic of Croatia. There is only worth mentioning work of Anić et al. (2008), which compares subcontracting and full manufacturing business models employed by the Croatian textile and clothing manufacturers.

Therefore, in this paper we try to obtain the better insight into the benefits and limitations of subcontracting for the Croatian footwear and leather manufacturing companies, and into the contribution of subcontracting in their dealing with global crisis.

The paper begins with the literature review where the definitions of the concept of subcontracting, main types of subcontracting, as well as motives for subcontracting are presented. Then, research methodology, short review of the situation in the Croatian leather manufacturing and processing industry, and an analysis of the research findings are given. For the purpose of this paper, a two-phase research study, including a qualitative approach, was used: 1) the first phase included in-depth interviews carried out on the sample of 10 companies that are working as subcontractors in the Croatian leather manufacturing and processing industry; 2) the second phase included more detailed in-depth interviews with two companies in the Croatian footwear and leather manufacturing industry. Finally, an integrated conclusion, summarising the results, developing managerial implications and providing suggestions for future research is provided.

## 2. LITERATURE REVIEW

The role of subcontracting, as an important source of support of various kinds to small and medium enterprises from large firms, as well as an important source of efficiency, emerges from the decentralisation process of large companies that started in the 1970s and that has been widely discussed by the literature (Cagliano and Spina, 2002). Accordingly, literature review suggests the wide range of definitions of the concept of subcontracting. According to the UN official definition (UNECE, 1995), subcontracting relationship exists whenever a business (subcontractor) acts for the account of another (main contractor) undertaking in the process of working and making a specific product to plans and technical specifications supplied by the main contractor, who has final economic responsibility.

Subcontracting can be considered as an inter-firm alliance contributing to enhancing common members' interests (Kooli et al., 2010, p. 374). It is an important option among strategies for aggregate production and capacity planning. "Subcontracting is a means of reallocating production requirements among firms to achieve production smoothing. It usually lowers total production costs, and hence, increases producers' profits" (p.1362). Subcontracting is traditionally regarded as an opportunity to pay a fixed-cost or premium for items produced by an outside supplier. Watts and Kleiner (1995) consider subcontracting as the procurement of an item or service which is normally capable of economic production in the prime contractor's own facilities and which requires the prime contractor to make specifications available to the supplier.

There is an interesting approach of Sousa and Voss (2007), who investigate subcontracting as a particular case of outsourcing. The authors observe it as a type of manufacturing outsourcing, an arrangement in which the client outsources manufacturing-related processes (manufacturing per se as well as product design processes), resulting in the subcontractor plant performing all or part of the manufacture of the client's product.

Taymaz and Kilicaslan (2002) think that there are significant differences between traditional and new approaches to subcontracting. Traditional approaches consider subcontracting as a relationship between two firms, the parent and the subcontractor, while new approaches like the network and cluster approaches look at a group of firms cooperating (and competing) within a complex web of supportive institutions. Externalities generated by this form of cooperation and competi-

tion are internalized by the network so that the collective efficiency and flexibility is enhanced.

A number of researchers point out the advantages of subcontracting. According to Anić et al. (2008, p. 331), the main idea behind advocating the development of subcontracting was based on the benefits a small subcontractor derives from a large parent company in the form of guaranteed markets, secured raw materials, and technical assistance. Taking advantage of the small size, subcontractors can produce multiple items in small quantities. On the other hand, large companies (parent companies), start with subcontracting model for the following purposes (Watanabe, 1971): to economize capital and labour, to take advantage of lower wages in small companies, to take advantage of the subcontractor's specialised technology, and to serve as a buffer against business fluctuations.

Kongmanila and Takahashi (2010, p. 99) pointed out two main reasons why large companies prefer to outsource production process through subcontractors: to enjoy flexibility by utilizing production capacity of subcontractors, and because of cost reduction. Subcontracting networks occur when a manufacturer sells products to a specific buyer for a considerable period of time, while the latter specifies the design of the products and supervises the production process (Ghauri et al., 2008, p. 741).

Small and medium enterprises can have multiple benefits from the subcontracting relationship with large firms (Bala Subrahmanya, 2008, p.25; NASEP, 1997):

- subcontracting enterprises can produce multiple items in small quantities effectively taking advantage of the small size of the organization,
- subcontracting enterprises let their parent enterprise develop products, cultivate markets and sell products. This allows them to concentrate on manufacturing activities alone and specialize in specific engineering fields.
- subcontracting enterprises can ask their parent enterprise to instruct or advice on technologies and production management, lend facilities, train human resources, and provide with information.

Although the literature considers subcontracting as basically positive business model, there also some disadvantages of subcontracting. For example, Cagliano and Spina (2002, p. 1383) find that although subcontracting seems attractive and profitable, companies that are involved in the model of subcontracting show relatively low levels of strategic planning, employee involvement and performance measurement. In contrast, they excel in production practices.

Kooli et al. (2010) warn that an organization might suffer from the opportunism of its partner. Moreover, the role of information in coordinating activities between the two partners, involved in the model of subcontracting, becomes very important as it reduces the problem of uncertainty and complexity.

Andreff (2009, p. 24) points out that overall impact of subcontracting on host countries is less controversial than in home countries since it is basically positive, even though all the revenues from this business model do not remain in host countries. However, although foreign multinational companies support local suppliers in setting up their production facilities, by providing technical assistance to raise product quality, and by training employees and managers, at the same time they have an impact on competition in local markets. They could be more productive than local firms, may increase imperfect competition in the local market and reduce the market share of local firms forcing them to exit their activities. There is insufficient transfer of capital, technology and knowledge via subcontracting business model (Urošević et al., 2009).

Andreff (2009, p. 28) suggests that the likelihood of positive effects of the subcontracting on the host country's economy depends on specific factors, such as: depth of technological gap between foreign multinational company and host country, extent of vertical linkages between multinational company and local firms, nature of competition in a specific industry, etc.

Anić et al. (2008, p. 331) considered some disadvantages of employing subcontracting business model. Firstly, its success depends on the exact predefined standards. Moreover, most subcontractors have no possibility to differentiate their offer except through geographical proximity and/or low prices. In such a way, subcontractors are in an adverse position on their way towards the full manufacturing model. Subcontracting does not contribute to the development of modern industry, but it keeps up old fashion production structures. Urošević et al. (2009, p. 112) add that the parent firms determine prices of products, insist on the export of equipment from their host countries, and engage the part of subcontractor's production capacities. Thus, we cannot rely on the stability, continuity and no riskiness of subcontracting business model. Kaufman et al. (2000) point out that from a strategic perspective, and because product designs remain under the control of clients, subcontractors avoid investing in client-specific processes in order to prevent dependency on a few clients. Thus, subcontractor plants have their operations organized specifically to routinely provide manufacturing services to a range

of clients and they tend to employ general assets and skills in order to meet diverse client specifications.

### 3. METHODOLOGY

The objective of this study is to understand benefits and limitations of the subcontracting strategy and its contribution in dealing with the crisis of the Croatian leather manufacturing and processing industry. Therefore, given the exploratory nature of the research it was felt that a qualitative approach, using qualitative in-depth interviews, was appropriate. Such approach will produce the qualitative data necessary in an exploratory study, where scientific explanations are desirable and the researcher is uncertain of the nature of the construct to be employed. Eisenhardt and Graebner (2007) point out that a qualitative approach is particularly suited for gaining a better understanding of collective and individual perceptions, and open or semi-structured interviews are suitable means to gain such perceptual data with respect to a given phenomenon of interest.

For the purpose of this paper, a two-phase research study, including a qualitative approach, was used:

- 1) the first phase - on the sample of ten companies that are working as subcontractors in the Croatian leather manufacturing and processing industry which intended to find out overall perception of benefits and limitations of subcontracting for the Croatian footwear and leather manufacturing companies;
- 2) the second phase – with two companies operating in the Croatian footwear and leather manufacturing industry, focusing on the success of subcontracting in dealing with global crisis.

At the methodological level, the research was carried out by means of a qualitative study companies. Information was gathered using a questionnaire, specially developed for this specific industry, which was followed up with direct interviews with the owners. Pre-survey telephone calls were made at each company to identify whether they would be prepared to participate in the survey.

The sample (in the first phase) consisted of large Croatian companies with more than 250 employees, and with more than 20 years of the existence on the market. Their parents firms are mostly from Germany (59%), Italy (35%), Austria (29%), and France (24%).

Concerning two companies that were included in the second phase of the study, they differ in their ownership. The company A (for the reason of anonymity we did not use their names in the text) is completely in the Croatian ownership, while the second company, named company B, is half Italian and half Croatian ownership. Moreover, both companies are middle sized companies (50-250 employees) and are completed production facility. However, company A operates 23 years on three locations on the Croatian market, while company B operates less than 10 years on one location on the Croatian market. Both companies are producing high quality products in high price range. As their comparative advantages they state: closeness of the main markets, production flexibility that is reflected in the capabilities of small-series production with no additional cost, experienced and skilled, even too low educated labourers, and specialisation for certain demands regarding special constructions or specific processing inquired by parent company. Some of the questioned companies also consider reliability of the Croatian companies as one of the advantages as well.

The questionnaire design is based on the discussion pointed out in the theoretical part of the paper. Moreover, two different research instruments were used in each phase of the study. Namely, questionnaires were adapted to the particular research interest in each phase of the study.

Each interview lasted on average about 30 minutes and was transcribed verbatim, and thematically content analyzed.

## 4. RESULTS

In accordance with the research methods, the analyses, as well as the results, first refer to the first phase of the study on the sample of ten companies, and then to the second phase of the study conducted through in-depth interviews with two companies. What follows is a short discussion of investigated themes and some interpretations.

### ***4.1. The perceptions of investigated companies about benefits and limitations of subcontracting***

The findings of the interview among companies, that are working as subcontractors in the Croatian leather manufacturing and processing industry, revealed that they were of the same opinion regarding benefits of subcontracting for their business.

Subcontracting has brought significant financial stability and improved internal relationships in the companies. Moreover, their organizational schemas were adjusted to subcontracting business model. There were rationalizations in all departments that are not directly related to production, while their business volume was enlarged.

Subcontracting business model brought some improvements in the level of knowledge of the companies, as it resulted in the increase of education level. Namely, after introducing subcontracting, companies (subcontractors) have continually experienced internal education programmes in order to increase their efficiency. Also, education has been conducted to coordinate subcontractors' processes to those of the parent firm. Both of the companies investigated in the second phase, emphasized that help provided by parent company was priceless in process of turning low educated into a highly skilled labourers.

Respondents agree that subcontracting business model helped them with the working capital and to independently participate in the international market.

#### ***4.2. The perceptions of investigated companies about the success of subcontracting in dealing with crisis***

In subcontracting system, mostly every subcontracting company performs one function (eg: production, sales or marketing, etc.) for which is highly specialized. So when it comes to the problem (in this case crisis), it is much easier to deal with problem in only one function than in the entire business process. In a period of crisis, it is necessary to initiate optimization processes, and mentioned processes are different in each business process, apropos, cost are reduced in different ways. For example, production mostly makes decisions for productivity increase, marketing insists on efficiency increase, while sales needs to find new target markets with the same operating costs.

Respondents agreed that it is more effective when each subcontracting company has responsibility for only one function and that in subcontracting system they operate more effectively and efficiently than companies that deal with all business functions/processes at once. In subcontracting companies, each company has its own management that deals with only one function for which is highly trained. That is how subcontracting leads to business risk dispersion. In a period of financial crisis it leads to dispersion of negative effects caused by crisis. Further more, each company covers costs of the mentioned process out of own sources, what disperses

financial burden as well. Such system gives much more strength to struggle any disorder. Nor less important is the fact that different governments applied different measures to struggle with the global crisis, and, companies involved in subcontracting systems in several countries, took benefits of each one of them

Respondents agree that subcontracting help them to overcome global financial crisis that started at the year 2008 because they are in charge for only one function for which are highly trained and they do not disperse their concentration on other business functions.

## 5. CONCLUSION

The increasing market competition with the growing trend of globalisation forced companies to improve their business strategies. This paper presents an attempt to prove that the implementation of subcontracting, as one of the new strategic approaches leads to lower costs, increasing quality and service efficiencies. Moreover, the goal of the paper was to find out whether subcontracting has helped the Croatian footwear and leather manufacturing companies in dealing with global crisis. The main reason why the authors of this paper decided to choose the footwear and leather manufacturing industry to explain benefits and limitations of subcontracting lies in its strongly export-oriented towards EU market, mainly in the form of contract processing.

The paper contributes to a better understanding of the theoretical and operational implications of subcontracting for small and medium companies in leather processing and manufacture of footwear and leatherwear in the form of guaranteed markets, secured raw materials, and technical assistance. On the other hand, there are two main reasons why large companies prefer to outsource production process through subcontractors: to enjoy flexibility by utilizing production capacity of subcontractors, and because of cost reduction.

The results of the study conducted among companies that are working as subcontractors in the Croatian leather manufacturing and processing industry proved that subcontracting business model has brought significant financial stability in the company and improved internal relationships, increased overall level of knowledge, and conducted rationalizations in all departments that are not directly related to production. Additionally, respondents agree that subcontracting is efficient strategy in a period of crisis because subcontracting company performs one function (eg: production, sales or marketing, etc.) for which is highly specilaized. So when it

comes to the problem (in this case crisis), it is much easier to deal with the problem in only one function than in the entire business process.

Several managerial implications for the Croatian leather manufacturing and processing industry might be derived from the findings of this paper. Firstly, the study shows that the main reason for employing subcontracting business model is the lack of working capital and impossibility to independently participate in the international market. Moreover, it gives directions for the Croatia Chamber of Economy's Leather Processing Industries Association to help Croatian manufacturers in dealing with crisis and entering EU market.

One of the Interview findings was also that most of the companies in Croatian footwear and leather manufacturing industry, eight out of ten, see their further development in overtaking the tasks with higher value added in order to increase incomes and keep up with expected wages growth, rather than develop its own brand, what is opposite to the main stream opinion in Croatian contemporary economy.

Positive tendencies within last eight, recessional, years, unlike most of the manufacturing industries, give us the right to conclude that contemporary main stream opinion is about to be modified.

Business performance can be indeed improved through the system of subcontracting, what this paper also researched and proved.

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