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Strategies for sustainable upgrading in global value chains: the Tunisian textile and apparel sector

Jan Grumiller, Shamel Azmeh, Cornelia Staritz, Werner Raza, Hannes Grohs, Bernhard Tröster

This policy note presents policy recommendations for a sustainable development strategy for the Tunisian textile and apparel (T&A) sector in the context of the ongoing negotiations on the Deep and Comprehensive Free Trade Agreement (DCFTA) between Tunisia and the EU. Against the backdrop of economic crisis and decreasing apparel exports to the EU, support for the T&A industry could be an important way to help reinvigorate the economy. A sector development strategy should primarily focus on functional and product upgrading potentials, linkage development as well as on export market and product diversification.¹

Overview of the Tunisian textile and apparel sector

The T&A sector can be roughly divided into four stages: (i) raw material supply, including natural (e.g. cotton and wool) and synthetic or man-made fibers (e.g. polyester, nylon and acrylic); (ii) yarn and fabric production and finishing (textiles); (iii) apparel production; and (iv) distribution and sales channels at the wholesale and retail levels. In contrast to the labor-intensive apparel sector, textile (yarn and fabric) production is more capital and scale intensive which explains why textile production has partly remained in developed countries or shifted towards middle-income countries whereas apparel production has been also relocated to low-income countries (LICs) (Staritz 2012).

T&A represents a classic example of a buyer-driven global value chain (GVC) which is characterized by decentralized, globally dispersed production networks, coordinated by lead firms which control activities that add “value” to products (e.g., design, branding), but outsource all or most of the manufacturing process to a global network of suppliers (Gereffi 1999). Although buyers are not directly involved in production, they yield significant control over manufacturers and stipulate often detailed product and production specifications. The strategies of buyers, in particular their global sourcing policies in terms of costs, quality, lead times and flexibility, as well as compliance, importantly shape production and trade patterns and upgrading prospects in the global T&A sector.

Upgrading dimensions include most importantly process, product, functional and end market upgrading with functional upgrading, which means moving to higher value added activities within GVCs, being of specific importance. The functional upgrading trajectory² from cut-make-trim (CMT) to free on board (FOB) and further to original design manufacturing (ODM) and original brand manufacturing (ODM) also represents the main categories of apparel suppliers (Gereffi 1999; see Staritz 2011 for more details).

Two distinct T&A value chains serve the European market. The first can be thought of as the regional supplier network

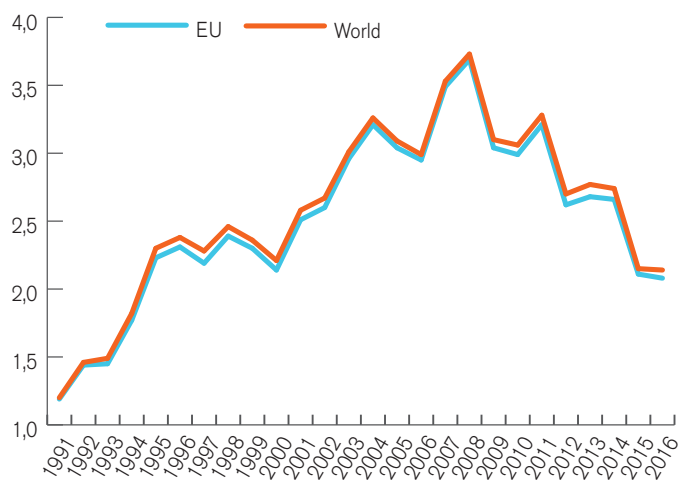
in which apparel production is relocated to geographically close countries but a substantial share of the textiles and accessories used in production come from EU countries. The exporting countries in this network enjoy secure and predictable preferential access to the European market through free trade agreements (FTAs). The other global network is more geographically distant and does generally not include the use of European textiles and accessories. While regional suppliers in North Africa, Eastern Europe, and Turkey, enjoyed substantial market share in the 1980s and 1990s, more recent developments in the industry including the phasing out of the Multi Fibre Arrangement (MFA) end of 2004 and the resulting liberalization of trade in apparel are reflected in the growing share of Asian producers in recent years.

Tunisia has a long history in the industry and of trading in T&A with a number of European countries. The roots of the current export-oriented industry can be traced to the 1970s and 1980s when the Tunisian government adopted a semi-liberal economic policy and pursued deeper integration with the European economy as a way to achieve economic development. This close relationship led to the Association Agreement with the EU that entered into force in 1998 and offered Tunisia preferential access to the EU market. In addition, the government supported the T&A sector with industrial policies such as tax and other financial incentives.

Today, Tunisia has a relatively large apparel industry consisting of around 1,000 firms of different sizes employing around 160,000 workers. In 2016, Tunisia's apparel exports amounted to USD 2.1 billion, accounting for more than 15% of total Tunisian exports (Figure 1; UN Comtrade 2017). Tunisia exports almost exclusively to the EU, in particular France and Italy (more than 60% of total T&A exports). The ownership pattern of the industry is mixed and it is estimated that around 50% of the industry are wholly or partially foreign-owned with European investors being the main group of foreign investors. In terms of the activities performed, it is estimated that around 80% of the industry performs CMT activities while 20% produce on a FOB basis in which they handle sourcing of inputs and logistics, with few firms also

supplying ODM where they are also in charge of design and product development. The FOB firms are the large firms, Tunisian and foreign, while small and medium enterprises (SMEs) tend to export on a CMT basis due to lack of capabilities and also limited access to working capital. In terms of buyers, Tunisian firms generally sell to high-end brands in the European market.

Figure 1: Tunisia's exports of apparel (HS61+HS62), billion USD



Source: UN Comtrade 2017

In terms of products, woven apparel accounts for a larger share of Tunisian exports to the EU (71% compared to 29% for knitted products in 2015). Men's trousers are the main export item from Tunisia to the EU accounting for 21.3% of total apparel exports in 2015 followed by women trousers that accounted for 11% (Eurostat 2017). Within these products, Tunisia occupies a generally higher than average position with regard to unit value of its exports compared to all EU imports, which is also related to its role in the fast fashion segment. In terms of product diversification, Tunisia has a relatively undiversified export composition in comparison to other regional and global apparel exporting countries (ibid.).

In contrast to apparel, Tunisia has limited textile production capacities. As EU FTAs generally stipulate double transformation rules of origin (RoO)³, this means that for exporters to benefit from duty-free access to the European market, they need to use fabrics produced either in the EU or in other countries within the Euro-med region, which includes Turkey. This has led to the development of a sourcing network in which fabrics are shipped from Europe to Tunisia to be processed and exported back. Today, the EU remains the main supplier of fabrics to Tunisia but its share has declined whereas Turkey's share has increased (UN Comtrade 2017).

Tunisian T&A exports (Figure 1) and its market share in the EU have declined in the context of the MFA phase out, competition from Asian exporters, the economic crisis in 2008 and the Arab spring (e.g. due to increasing labor costs) (UN Comtrade 2017). The key challenges for the Tunisian T&A sectors include (i) the high dependency on the EU market and on a small number of markets within the EU; (ii) a small textile and accessories industry, which complicates the sup-

ply chain; (iii) limited sourcing capacities of Tunisian firms, which increases production costs since it makes them dependent on suppliers nominated by buyers, or, to meet RoO, Turkish suppliers; (iv) low diversification of export products; and (v) limited linkages to the local market. Given the important role of the T&A sector in the Tunisian economy, a sustainable industrial policy strategy for the T&A sector could be an important way to help reinvigorate the economy.

Policy recommendations for a sustainable development strategy

Based on field research as well as a GVC- and SWOT-analysis, a sector development strategy should focus on 11 intervention areas.

1. Develop a framework for strategic industrial strategy

The challenges facing the Tunisian apparel industry are complex and have contributed to the overall decline of the industry in recent years. A key part in this decline is the lack of a coherent overall strategy for the sector. Despite the number of institutional actors in Tunisia working on different elements of industrial policy, the work of those actors seems fragmented without an overall strategic direction. A number of the industrial policy tools are enterprise-driven which limits the overall strategic orientation of these tools and fails to address the lack of information about new processes, new products, new markets, etc. for most of the domestic enterprises. While preferential access to the EU market in addition to proximity to this market have enabled the industry to survive and expand in previous decades, this lack of strategic direction and coherence is proving a more serious constraint in today's more competitive market.

2. Leverage the subcontracting system in the industry for industrial upgrading

The Tunisian industry is diverse in terms of size and capabilities as well as functions performed. An overall strategy should recognize that different firms have very different positions in GVCs. Small firms operate mostly on CMT basis with very limited capacities in logistics, supply chain management, or access to finance for working capital, while some of the large firms are FOB or even ODM producers with capacities in areas such as input sourcing, logistics, storage, design and product development. This means that programs to develop the industry need to focus on different areas for different types of firms. The fact that small firms export both directly and through large Tunisian firms creates the possibility for a dual strategy, which targets small firms directly, but also leverages the subcontracting system that is increasingly important in the industry. While building FOB capacities through functional upgrading at the hundreds of small firms is potentially possible, a more realistic strategy might be to develop and improve FOB capacities at a larger number of medium and large firms and supporting small firms to enter subcontracting relationships to these larger firms through supporting them particularly in process and product upgrading. Additionally, there could be further direct support for small firms to diversify their client base in terms of larger Tunisian firms to

subcontract to but also developing direct buyer relationships on CMT basis where possible. Hence, a multi-dimensional strategy would be required that focus on (i) large and medium firms, (ii) small firms directly, and (iii) small firms through subcontracting relationships with large firms.

3. Invest in design and branding capacities for large and medium firms

Some of the large firms in Tunisia are collaborating with their buyers in the areas of design and product development and few already supply on an ODM basis. In these higher value-added functions as well as for branding, a more pro-active strategy could be developed to build capacities and to encourage Tunisian firms to expand their roles in GVCs. However, a shift to ODM and even more to OBM also importantly depends on buyer strategies and might be difficult in the context of existing buyers. The push toward export market diversification could create however more space in new end markets and buyers for selling on ODM or even OBM basis by Tunisian firms. Hence, in collaboration with firms and existing support organizations such as the Centre Technique du Textile (CETEX), capacity building in the areas of design, product development and branding should be strengthened. Barriers to upgrade to these functions in existing value chains should be identified and upgrading opportunities in these activities should be taken into account and proactively explored in export diversification strategies.

4. Invest in sourcing and supply chain management capacities with a focus on regional sourcing

One of the areas where Tunisian SMEs lack capacities is the area of sourcing and supply chain management. This weakens the position of Tunisian firms as it leaves them dependent on their buyers and on suppliers nominated by the buyers with little ability to develop alternative sources of supply. This suggests the need to develop joint and individual capacities in this field. For instance, the Tunisian Export Promotion Agency (CEPEX) was working with some firms on joint sourcing from new sources and organized a trip to Egypt in this context. Such joint efforts could be expanded to overcome the barriers created by the small size of most firms. In addition to leveraging the subcontracting system for small firms, strategies to develop sourcing capacities of these firms could be explored and particularly the possibility of joint sourcing capacity building among a number of small firms examined. Medium and large firms on the other hand should be supported to develop new sourcing linkages possibly on a regional level.

5. Invest in improving access to capital for the industry

Access to finance is an important barrier facing the industry and particularly for SMEs. This includes access to working capital, which is needed for firms to move from CMT to FOB. It also includes access to investment capital with some interviewees reporting that the majority of commercial banks have stopped lending to the industry following the problems the industry faced in recent years. The Tunisian government has taken up the issue of access to finance in the measures it adopted to support the industry in 2017. It is not very clear, however, how effective the implementation of these mea-

asures will be. While policies to improve access to working capital should be part of the strategy to support functional upgrading from CMT to FOB, there is also a need to think of investment capital sources for the expansion of firms, investments in new technology, and moving into new segments within the industry that is important for all upgrading paths.

6. Boost efforts for market diversification

As long as the Tunisian apparel industry is dependent on a small number of markets within the European Union, the industry will face threats posed by market or trade shifts. This could include shifts in the sourcing policies of major buyers in those markets or growing competition from other suppliers. While it is natural for Tunisia to focus on the European market as its main market, there is a need to go beyond the Italian and the French markets and to target other markets within the EU. Furthermore, there should be serious efforts to open up new export markets in the region, in Sub-Saharan Africa, and in other emerging markets. The barriers to selling in the domestic market should be removed and Tunisian firms should be encouraged to also move into design, branding and retailing in the domestic market. Market diversification is a key focus area of the Tunisian government and industry at the moment, with organizations such as CEPEX focusing on new markets within the EU and markets outside the EU. The interviews in Tunisia, however, showed that there is weak coordination of these efforts and many in the industry feel they have little say in shaping the direction of these efforts. A more coordinated market diversification strategy is needed, which is based on a decision-making process involving all actors and based on a comprehensive analysis of these potential markets. A specific focus should be given to regional and emerging country markets given their larger potential to upgrade to ODM and OBM production.

7. Support product diversification

In addition to concentration in a small number of markets, Tunisian exports are also concentrated in a relatively small number of products. Although in some of these products Tunisia occupies a high value-added segment, this concentration remains a threat to the industry as it leaves it subject to shifts in markets and in sourcing decisions of buyers or to shifts in trade policy and preferences. Product diversification should thus be an important objective of the industry. The question about value versus volume needs to be part of the analysis. Some firms in Tunisia interviewed for this study have highlighted how the decline in Tunisian market share was linked to the country losing its position in intermediate value products where the volume tends to be higher, and that this loss cannot be offset by supplying higher end markets. Hence, the strategy for the industry should not only focus on market diversification but also on product diversification, which might be interlinked with the former. This should include an analysis of value versus volume of different segments and of overall benefits to the economy.

8. Support of a national textile and accessories industry

The limited textile industry in the country is also an issue that should be examined in more detail, as it increases production

costs and lead-times. Considering that most firms in Tunisia are small enterprises, the absence of domestic textile capacities makes these firms more dependent on their buyers or on large Tunisian firms, and also makes it difficult for such firms to fully exploit the advantage of proximity to market. A national textile industry would however not only address competitiveness and upgrading challenges of the industry but also increase the economic benefits of the apparel export sector in terms of broader linkages, value added, employment and skills. Since it is unlikely that the EU will grant Tunisia single transformation in the DCFTA – but even with single transformation RoO – the expansion of the textile sector should regain strategic importance in order to benefit from lower lead times, input costs and an expansion of value added activities. The reduction of lead times due to the availability of local fabrics could particularly benefit the important fast fashion segment of Tunisia's apparel sector. Given limited state and industry capacities, developing the domestic textile sector will need to adopt a long-term and gradual trajectory. In a first phase, the focus should lie on developing a domestic industry for finishing services and accessories firms, before more ambitious projects for the development of more technologically advanced textile production can be envisaged.

9. *Boost efforts to promote regional value chains*

While arguments for regional integration especially in North Africa are frequently made, there is still little progress in achieving such integration. Issues related to political factors, logistics, and business networks, limit trade and joint production in the region. In the apparel sector, however, considerable scope for promoting cooperation and joint production between the three major exporting countries in the region (Morocco, Egypt, and Tunisia) exists. CEPEX, for instance, is assisting Tunisian firms to build up sourcing networks in Egypt that has a larger textile industry than Tunisia. There is also space for learning in terms of market and product diversification. The ongoing efforts, however, seem largely ad-hoc and there is little institutional-level work in relationship to this. A higher ability to export regionally could also help firms to expand into new markets. A strategy would need to include the promotion of linkages with regional producers by reducing regulatory and logistical barriers for further cooperation and by building business networks between the sectors.

10. *Promote social upgrading and environmental sustainability*

While economic upgrading is very important for Tunisia overall, it is crucial to address social and environmental factors in the industry. This is not only important from a development perspective but also from a competitiveness perspective, as many buyers take social and environmental compliance more seriously and have developed their own codes of conducts in the context of pressures in consumer countries and the recent tragedies in Asian supplier countries. Buyers' codes of conducts or industry-wide certification schemes can have an important role to improve compliance, but impacts of such schemes depend on the extent to which the core sourcing policies of buyers in terms of prices, lead times, flexibility and short termism are aligned with demands in these schemes. Otherwise, there is the danger that they add another lay-

er of costs and responsibilities on the supplier firm without helping them to fulfill them through actual support or higher prices or less flexible and short-term sourcing relationships (see Plank et al. 2014).

The issue of water pollution in particular needs to be treated as an urgent issue. The pollution of areas such as the Monastir Gulf is having a negative impact on agriculture, fisheries, and tourism, all of which are important sectors for local livelihoods and for the Tunisian economy in general. Labor issues should also be dealt with in a proactive manner. While recent political developments in Tunisia in this area and in particular growing labor unrest is often seen negatively by firms and buyers, in the framework of economic upgrading the promotion of better social and labor relationships is a complementary process which does not only expand the social benefits of the industry, but is conducive to productivity growth and innovation.

11. *Use development cooperation in strategic policy areas*

EU development cooperation has traditionally played an important role in supporting the T&A industry in Tunisia. Its role should be continued, but it should focus on areas where such assistance will be most useful. Through targeted industrial policies, the Tunisian industry would be able to upgrade its operations and to increase its share in the total value-added, which will have positive economic and social impacts on Tunisia and on EU-Tunisian economic relations. EU development cooperation could support such a process in a number of ways.

An important overall area where development cooperation could make an important contribution is capacity building at the strategic level of industrial policy. While Tunisia has a number of dedicated industrial policy agencies, there is a need for stronger analysis of the position of Tunisian firms in global and regional value chains and on potential markets for diversification and paths for upgrading. Choices for market diversification, for instance, need to be based on a solid understanding of potential markets and GVCs and this understanding needs to be updated regularly through constant monitoring and analysis of market trends. This requires strategic analysis capacities in Tunisia and development cooperation could be an effective way to build such capacities. EU assistance to Tunisia on diversification within the EU market could also be useful. EU assistance could also be very useful in developing an industrial strategy for the sector that outlines in more detail specific policies and implementation tools. In particular, there is a need to develop a better understanding of the subcontracting system in Tunisia and what are its implications for issues such as value distribution, internal linkages, working conditions, and potential for upgrading. The development of a national textile and accessories industry could also be supported by EU development cooperation, both in terms of providing technical advice and financial support as well as in terms of encouraging textile companies from the EU to invest in Tunisia. These companies should be incentivized to link up with local firms to ensure technological transfer and to supply local firms with textile inputs.

Social upgrading and environmental degradation are other areas where there is a responsibility of European buyers to ensure better standards in their sourcing locations including Tunisia. There is a need for stronger pressure from EU policy-makers in this regard and need for EU support in dealing with this issue.

Conclusion

Tunisia has a long history and tradition in the T&A industry. The modern sector in the country grew in the second half of the 20th century as a result of national industrial strategies on the one hand and important shifts in T&A global and regional value chains on the other hand. In this context, Tunisia emerged as an important supplier to the EU benefitting from proximity and from preferential access to the EU market. The industry grew as a result and became an important employer and an important source of foreign exchange through exports. Starting in the mid-2000s, however, the industry began to feel the pressure of growing Asian competition in the European market and a downward trend in the market share of Tunisia in the EU market began. These difficulties were intensified in the aftermath of the political revolution in 2011 and growing economic and social pressures.

From the EU perspective, Tunisia is a strategic partner in the Middle Eastern and North African (MENA) region. The country has long-standing cultural and economic ties with a number of EU countries. Over the past few years, Tunisia has been rightly considered a success case of democratic transition. The country, however, is facing serious economic difficulties especially in terms of rising domestic costs and growing competition in its traditional export markets. Providing support for the T&A industry with a focus on economic, social and environmental upgrading could be an important way to both stabilize the economy and put it on a sustainable development trajectory for the future. While EU development cooperation agencies have provided such support in the past, there is a need to develop new programs and tools that address the current challenges facing industrial development in the country in general, and in the T&A industry in particular.

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Disclaimer:

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- 1 This policy note builds on the results of two comprehensive studies conducted by the Austrian Foundation for Development Research (ÖFSE). It particularly builds on Grumiller et al. (2018a), which analyses the DCFTA with regard to its potential macroeconomic effects based on a structuralist Computable General Equilibrium (CGE) model and its implications on the Tunisian textile and apparel as well as olive oil sectors, and Grumiller et al. (2018b), which focuses on policy recommendations for a sustainable development strategy for the two respective sectors based on a Strengths-Weaknesses-Opportunities-Threats (SWOT) analysis.
- 2 An assembly or CMT manufacturer is responsible for sewing apparel and may be responsible for cutting the fabric and sourcing simple trim (buttons, zippers, etc.). The buyer provides product specifications and the fabric. The apparel factory is paid a processing fee rather than a price for the product. A FOB or OEM supplier purchases (or produces) the textile inputs and provides all production services, finishing, and packaging for delivery to the retail outlet. The customer provides the design and often specifies textile suppliers. An ODM is involved in the design and product development process, including the approval of samples and the selection, purchase and production of required materials. The last upgrading step in this trajectory is OBM, where suppliers develop their own brands and are thus also in charge of branding and marketing (Gereffi 1999).
- 3 Single transformation means that only the sewing stage has to be conducted in the beneficiary country in order to access preferential market access; all inputs can be imported. Double transformation, in contrast, means that at least two production stages have to be conducted in the beneficiary country, which includes for example sewing and fabric production. Triple transformation demands three production stages in the beneficiary country, which includes for example sewing, fabric production and yarn production.