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Research Report

ASSESS_TTIP: Assessing the claimed benefits of the Transatlantic Trade and Investment Partnership

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ASSESS_TTIP: Assessing the Claimed Benefits of the Transatlantic Trade and Investment Partnership

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The current negotiations on a transatlantic Free-Trade Agreement between the US and the EU (TTIP) have raised substantial public interest. Several studies have highlighted the positive economic effects of TTIP. A new ÖFSE report shows that these claims are overstated and neglect crucial adjustment costs and the social costs of regulatory change.

I. Introduction

The United States (US) and the European Union (EU) are currently negotiating a free trade agreement: the Trans-Atlantic Trade and Investment Partnership (TTIP). Trade flows between the EU and the US, which both account for almost half of world GDP, have a substantial influence on the world economy. Including trade within the EU, exports and imports of the potential TTIP member states represented more than 43 % of world trade in 2012 (World Bank data). The US is still the EU's single most important trade partner, accounting for almost 20 % of extra-EU exports in goods and services and more than 15 % of imports in 2012, even though the bilateral EU-US trade as a share of world trade has lost some importance in recent year. Also the level of Foreign Direct Investment (FDI) between the EU and the US is exceptionally high. The bilateral FDI stock stood at €2,400 billion in 2011 (European Commission 2013, p9), annual FDI inflows from the US to the EU amounted to roughly €80 billion in the same year.

With average tariff rates between the EU and US already standing at a very low 3%, trade and investment between the two economic areas are already very open. Trade liberalization in the conventional meaning of the term is thus only a minor issue in the negotiations. Several recently published studies nevertheless say that TTIP would deliver substantial benefits both to the EU and US, and also to global economic growth. Most prominently, the European Commission estimates the potential economic stimulus because of TTIP at €120 billion for the EU economy, €90 billion for the US economy and €100 billion for the rest of the world.ⁱ But how are these benefits of TTIP derived?

In the debate, a few selected studies, mostly commissioned by the European Commission, have set the tone, suggesting that effects are positive on both sides of the Atlantic. The studies are from Ecorys (2009), CEPR (2013), CEPPI (2013)ⁱⁱ and Bertelsmann/ifo (2013).ⁱⁱⁱ A new ÖFSE report

critically assesses these findings and their underlying methodologies.^{iv} In addition, some issues are explicitly addressed that are frequently neglected by trade impact assessments, but are nevertheless important from a policy-oriented point of view. Besides, some ex-post evidence on experience with other trade liberalization ventures, in particular NAFTA is provided. In a nutshell, we see limited economic gains, but considerable downside risks.

II. Results of our assessment

1. The estimated economic effects are small:

All of the four scrutinized studies report small, but positive effects on GDP, trade flows and real wages in the EU. GDP and real wage increases are however estimated by most studies to range from 0.3 to 1.3 %, even in the most optimistic liberalization scenarios. These changes refer to a level change within 10 to 20 years (!), annual GDP growth during this transition period would thus amount to 0.03 to 0.13 % at most. Unemployment in the EU will either remain unchanged (by assumption), or will be reduced by up to 0.42 %-points, i.e. roughly 1.3 million jobs, again over a 10-20 year period. This amounts to an annual reduction of 65.000 – 130.000 unemployed persons. In our view, this overly optimistic estimate rests upon questionable assumptions. Unsurprisingly, total EU exports are predicted to increase by 5 – 10 % because of TTIP. Since tariffs on transatlantic trade in goods are already at very low levels, roughly 80 % of the economic effects depend on the elimination of Non-Tariff-Measures (NTMs), i.e. the removal or harmonization of regulations, administrative procedures or standards. NTM reduction is thus key to arriving at positive effects. According to three studies, TTIP benefits will however come at the cost of reducing bilateral trade between EU Member States. In a deep liberalization scenario, intra-EU trade could fall by around 30 %.

Table 1: Overview on central findings

	Ecorys (2009)*	CEPII (2013)	CEPR (2013)	Bertelsmann/ifo (2013)
Main Findings (different scenarios, percentage changes compared to baseline scenario within forecasting period)				
EU GDP	0.32 - 0.72	0.0 - 0.5	0.02 - 0.48	0.52 - 1.31++
US GDP	0.13 - 0.28	0.0 - 0.5	0.01 - 0.39	0.35 - 4.82++
EU bilateral exports	not specified	49.0+	0.69 - 28.0	5.7 - 68.8++
EU total exports	0.91 - 2.07	7.6+	0.16 - 5.91 (extra-EU only)	not specified
EU real wages	0.34 - 0.78	N/A	0.29 - 0.51	not specified
Unemployment rate in EU-OECD countries (avge. %-points)	unchanged (assumption)	unchanged (assumption)	unchanged (assumption)	- 0.42 (deep liberalization)

Source: Ecorys (2009), CEPII (2013), CEPR (2013), Bertelsmann/ifo (2013)

* Findings for ambitious and limited scenarios only; + Reference scenario only ++ Derived from BMWT/ifo (2013), aggregated to EU-27 level

The reason for this is that these EU countries' exports will be substituted for by cheaper Extra-EU imports. In addition, diversion effects in global trade from TTIP could be harmful for developing countries – one study expects negative real GDP change of 2.8% for Latin America and 2.1% for Sub-Saharan Africa, as well as 1.4% for LICs. This could indicate a potential violation of the EU's commitment to Policy Coherence for Development.

2. Macroeconomic adjustments costs could be substantial:

Adjustment costs are mostly neglected or downplayed in the TTIP studies. This refers in particular to macroeconomic adjustment costs, which can come in the form of (i) changes to the current account balance, (ii) losses to public revenues, and (iii) changes to the level of unemployment.

Ad (i): Trade agreements by their very purpose lead to changes in trade as well as capital flows. If, for instance, imports rise disproportionately vis-à-vis exports immediately after trade liberalization, a trade deficit might emerge. Strong FDI inflows might lead to a structural drain on the current account due to profit repatriation. Short-term speculative capital in- and outflows might lead to balance of payments problems. While for the EU in toto this will arguably present no major problem, for individual member states such occurrences might prove problematic.

Ad (ii): The elimination of all or most of the remaining tariffs due to TTIP will unavoidably lead to losses for the public budgets of the EU and its member states. During the transition period of 10-20 years the lower bound for these public revenue losses will be at close to 2 % of the EU budget, i.e. €2.6 billion p.a. Thus, the EU will receive less income from its traditional own resources, a loss that only gradually might be compensated for by an increase of its GNI resources. We would thus estimate cumulated income losses to be in the order of €20 billion over a period of 10 years, also depending on tariff exemptions and phase-in periods for sensitive goods.

Ad (iii): All four studies reject the idea that TTIP will lead to permanent unemployment. Either employment is assumed to remain constant (by three studies), or estimated to be reduced by TTIP. Any persons in import-competing sectors who lose their jobs because of TTIP are assumed to be reemployed instantaneously, i.e. with only negligible effects on their incomes and costs to the public budgets due to retraining expenses etc. According to one study (CEPR), between 430.000 and 1.1 million workers will be temporarily displaced. The economics literature however suggests that (i) most displaced workers will earn lower wages in their new jobs, (ii) retraining expenses particularly for less-skilled workers might be substantial, and (iii) a fraction of the displaced workers, in particular older and less-skilled persons, will in all likelihood remain unemployed for a long time, thus inferring substantial costs on national unemployment benefit schemes and social spending. These adjustment costs will be generally higher during times of economic crisis and low levels of labor mobility. Both of these conditions apply to the current situation in the EU. EU unemployment is at record heights. Labor mobility in the EU is generally low, though somewhat rising recently as a response to the economic crisis. A rough calculation yields annual expenses for unemployment benefits of between €0.5 – €1.4 billion during a TTIP implementation period of 10 years. Thus a cumulative €5 – €14 billion might be necessary to finance a part of the adjustment costs on the labor market, with additional costs for re-training and skills-acquisition not included in this amount. To this amount, a further loss of public revenue from foregone tax income and social security contributions between €4 - €10 billion has to be added.

3. The social costs of regulatory change can be substantial, but have been neglected:

Another type of costs ignored refers to the regulatory change resulting from TTIP. All studies, but particularly the Ecorys study, assume that a reduction of NTMs is welfare-enhancing. This ignores that NTM such as laws, regulations and standards pursue public policy goals. They correct for market failures or safeguard collective preferences of a society.

As such they are themselves welfare-enhancing. The elimination or alignment of an NTM thus will imply a social cost for society. This applies equally to NTM elimination, harmonization and mutual recognition. Firstly, harmonization of NTMs, e.g. technical standards, will imply both a short-term adjustment cost for public institutions and for firms required to align their administrative procedures, production processes and products to the new standards. Secondly, mutual recognition of regulations and standards will increase information costs for consumers, since the latter will be confronted with a more complex and potentially less transparent multiplicity of permissible standards, e.g. on consumer goods and services. Thirdly, the elimination of NTMs will result in a potential welfare loss to society, in so far as this elimination threatens public policy goals (e.g. consumer safety, public health, environmental safety), which are not taken care of by some other measure or policy. The analysis of NTMs in the Ecorys study completely ignores these problems. Instead, it is assumed that 25% - 50% of all existing NTMs between the EU and the US are actionable, i.e. can be eliminated or aligned to some international standard, while CEPR assumes a 25% actionability level. This includes sensitive sectors such as foods & beverages, chemicals, pharmaceuticals and cosmetics or automotives. In order to arrive at its optimistic welfare estimations, strong reductions/alignments of NTMs in precisely those sectors are necessary, where the safeguarding of public policy goals is perhaps most crucial. It is highly doubtful that such high levels of actionability could be implemented without any losses to the quality of regulation in the public interest. Though subject to considerable uncertainty, the incurred social costs of TTIP regulatory change might be substantial, and require careful case-by-case analysis.

In connection to this, any future regulatory act would be under the threat of being challenged under investor-to-state dispute settlement (ISDS), if the negotiating partners stick to their intention to include such a mechanism in TTIP. Thus, a social cost might be implied for society in two distinct forms: firstly, governments might abstain from enacting regulation or change it according to investor interests, for fear of being challenged under ISDS; and secondly, in case of litigation, compensation payments issued against governments would have to be financed out of public budgets, aka from taxpayers' money.

4. Ex-ante & ex-post assessments of similar trade liberalization ventures strongly differ:

The NAFTA agreement between the US, Canada and Mexico is often cited as a role-model for the kind of agreement that is negotiated between the EU and the US. Its conclusion was justified on the grounds of ex-ante assessments that claimed considerable economic benefits for the participating countries. Ex-post analysis of the impacts of NAFTA however suggests that ex-ante impact projections substantially overestimated the economic effects. Most of these ex-ante assessments were based on the kind of CGE-modeling, which is also used for TTIP. While ex-ante studies projected net gains for all NAFTA parties, but particularly for Mexico and Canada, with real GDP increases up to 11 %, employment gains of up to 11 %, and real wages increases of up to

16 %, ex-post assessments conclude that for the US NAFTA impact on welfare and GDP were negligible. For Mexico, a number of studies suggest that NAFTA had negative effects on GDP, real wages and the distribution of income. Those few studies that do find positive effects of NAFTA are well below the estimations of ex-ante studies. On jobs, ex-post studies found US labor displacement in the range of 600.000 – 1.2 million jobs because of NAFTA, i.e. up to 10 % of total job losses in the US between 1993 and 1999. For Mexico, net job gains in manufacturing appear to be small, mainly because of increasing productivity, while job losses in agriculture amount to up to one sixth of the total workforce, with roughly 1 million jobs lost in corn production in the first ten years after NAFTA's entry into force. Though, of course, ex-ante studies were performed on the basis of assumptions about the results of negotiations, their bias to overestimate positive impacts remains, even if one controls for the difference between scenario assumptions and actual negotiation results.

5. Methodology is based on unrealistic and flawed assumptions:

a. Methodological critique of Ecorys, CEPR and CEPII in a nutshell:

- Even 25 – 50 % “actionable”, i.e. reducible NTMs of Ecorys's estimates (as assumed by Ecorys and CEPR) are likely too high to be realistically achievable.
- The CGE models assume full employment and balanced budgets, and thus cannot speak to key macroeconomic variables of interest.
- All models concern the long run. Possible adverse effects in the short and medium run are neglected.
- Price elasticities, which determine the quantitative reaction of demand and supply in the models used are high, typically double the size compared to the macroeconomic literature. High elasticities, however, drive the gains from trade, i.e. the higher the assumed values for the elasticities, the higher the estimated gains in exports, output and income.
- All put together, the assumptions underpinning NTM estimation and modeling likely bias the projected gains from TTIP upwards.

b. Quantification of Non-Tariff Measures:

How NTMs are defined and estimated matters greatly. Simply put: The higher the NTM to be removed, the higher the potential gain from ‘free trade.’ Broadly conceived, NTMs are trade policy instruments other than tariffs. NTMs can be decomposed into policy barriers, meaning those related to regulations and procedures pertaining to the sale of a product across borders, and inferred barriers, meaning those related to different languages, cultures, currencies, etc. In TTIP only the former are potentially subject to removal. An authoritative study of trade costs by Anderson and van Wincoop

(2004) suggests that NTMs related to border policy barriers between industrialized countries add on the order of about 3 % (or so) to cost of production, whereas inferred barriers average – roughly – 30 %. In the study by Ecorys, in contrast, NTMs are defined to include any regulatory divergence, and indices are built on firms' perceptions about the restrictiveness of these. Ecorys's estimates show an unweighted average of 17 % tariff cost equivalent, and thus are a multiple of the 3 % (or so) of Anderson and van Wincoop. Ecorys, CEPR and CEPII assume removal of 25 - 50 % of Ecorys's NTMs in their CGE scenarios, which has to be considered very optimistic. Hence, a vast overestimate of removable NTMs has very likely been fed into the models.

c. CGE models and closure assumptions used in the studies:

The CGE models used are GTAP (Ecorys, CEPR) and MIRAGE (CEPII, as well as a chapter by IFO). Both models are standard neoclassical models of production and trade. The key assumptions of the models include (i) full employment of factors, including labor, (ii) price clearing markets and (iii) a constant government deficit. These assumptions are unrealistic. As such, these models cannot speak to aggregate employment, aggregate demand or fiscal effects of trade policy changes. Rather, the respective reports highlight microeconomic modeling detail. These concerns do not, however, matter for results nearly as much as the implicit macroeconomic structures: With models that feature full employment, trade liberalization tends to produce positive – though small – gains in GDP. None of the studies considers alternative modeling approaches that could provide a robustness check on these results and inform on key macroeconomic issues.

d. Bertelsmann/ifo study:

The Bertelsmann/ifo study takes a very different approach than all other studies. The model applied is not a CGE model of the GTAP/MIRAGE type, but rather is a gravity model augmented with a New Keynesian search unemployment labor market. Bertelsmann/ifo first estimates that a free trade agreement between EU and US would create roughly 80 % growth in bilateral trade. In the calibrated gravity-cum-unemployment model trade costs are then reduced so as to produce this trade creation effect. Despite the unusually large trade creation effect, the long run gains in GDP (1.35 %) from TTIP remain small. The expected gains in employment for TTIP countries which amount to 2.4 million jobs, of which roughly 1.3 million accrue to the EU, however are very large. In our view, the latter depend on the properties of the utilized labor market model, which assumes large employment gains in EU countries with pronounced labor market frictions and high unemployment rates. In addition, job reallocations within sectors due to trade liberalization have apparently not been accounted for. Thus, employment gains from TTIP do not seem plausible to us.

III. Conclusion

The five main conclusions of our assessment are

1. The estimated economic gains of TTIP-studies on income and growth are small – in general less than 1%, and accrue only over a transition period of 10 – 20 years.
2. With transatlantic trade and investment already largely liberalized, the economic gains critically depend on the reduction and/or alignment of Non-Tariff Measures (NTM). The latter include a wide range of standards, regulations and laws, and include sensitive public policy issues, e.g. public health & security, consumer protection, social and environmental regulations.
3. The social costs of NTM reductions/alignments might be substantial, and have been completely neglected in the economic impact assessments so far.
4. Macroeconomic adjustment costs are not negligible and are particularly relevant with regard to unemployment costs and losses of public revenue.
5. Other potential adverse effects include (i) trade & income reductions for LDCs because of trade diversion in favor of the US and EU, and (ii) a reduction of intra-EU trade with detrimental effects upon EU integration.

As a consequence of these results, we consider it timely that the European Commission has initialized a three month public consultation on a particularly sensitive component of TTIP, namely the investor-to-state-dispute settlement mechanism (ISDS), and has thus opened a space for a broad public debate on TTIP. Policy-makers in the EU should take up this opportunity and scrutinize the problematic aspects of the TTIP negotiations in order to arrive at a more balanced outcome, an outcome that safeguards in particular legitimate public policy goals and social and environmental interests.

i See <http://ec.europa.eu/trade/policy/in-focus/ttip/about-ttip/> (last accessed 03/24/2014).

ii The CEPR (2013) report is listed in the references as Francois et al. (2013), the CEPII (2013) policy brief as Fontagné/Gourdon/Jean (2013) and Ecorys (2009) as Berden et al. (2009). Throughout the main text, we will refer to these simply as the Ecorys, CEPR and CEPII study, respectively.

iii The Bertelsmann Foundation has published a study on TTIP with two parts. Our analysis is based in particular on part 1: macroeconomic effects. This report is listed in the references as Felbermayr/Heid/Lehwald (2013) and referred to as Bertelsmann/ifo throughout the main text.

iv The report was commissioned by the GUE/NGL political group in the European Parliament. The full report can be downloaded at: http://guengl.eu/uploads/plenary-focus-pdf/ASSESS_TTIP.pdf

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