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Economists Duke It Out Over TTIP And How To Measure Impacts Of Trade

Behind the scenes of the broader public debate about the potential benefits and dangers of the Transatlantic Trade and Investment Partnership (TTIP), a fight has broken out among economists and academics over what is the most accurate way to predict the effects that the agreement — or any similar deal — will have on the economies involved.

The sparring over this issue has played out in a series of different academic papers, issued over the span of the last couple years, that all paint vastly different pictures of what TTIP could mean for economic growth and jobs. Their conclusions have therefore cast controversy on the basic underlying rationale for the free trade initiative, which is that TTIP will help the United States and the European Union emerge more firmly from the clutches of the recession.

At the heart of this fight is a nuanced debate over how to structure the economic model that most of these studies use to generate their predictions. This model, called a “computable general equilibrium” (CGE), attempts to replicate an economy through a series of complex formulas that predict the trade flows between consumers and firms.

The chief criticism of studies like the one most often cited by the European Commission — which was authored by the London-based Centre for Economic Policy Research (CEPR) and finalized in March 2013 — is that they start with the assumption of fixed full employment in their CGE model. In other words, jobs are never created or lost, but simply move from sectors that become less competitive under the trade deal to more competitive ones.

Critics argue this approach is not only unrealistic, but fails to account for the costs to an economy that are incurred when workers lose their jobs. This risks overstating the gains of the trade deal and perhaps mischaracterizing entirely whether it will carry a net benefit or have an overall negative impact, critics say.

But advocates of using the fixed-employment approach with the CGE model say there are no good alternatives. Another option is to assume that lost jobs are not reabsorbed into the economy, which economists on this side of the debate argue would severely distort the model’s findings and tilt them toward the negative.

There is a third, little-used option that attempts to factor in employment fluctuations into the economy, one economist pointed out, but there are several reasons it is not regularly used. One of those reasons is that economies such as the U.S. and EU typically have steady unemployment rates that hover around the “natural unemployment rate,” said one economist who does government contract work and asked not to be named.

CGE models are also designed to show the long-term impacts of trade reforms, and over that span employment levels will even off due to new entries into the workforce and the retirement of displaced workers. Finally, studies using the CGE model are inherently not focused on the labor market, and adding more labor calculations could have unintended affects on the ability of the model to accurately show production growth, this economist argued.

Another element of this fight is a disagreement over how to measure the impact of non-tariff barriers (NTBs), and thus the possible positive gains achieved by eliminating them. Depending on the assumptions around these variables, the results of the analysis can vary widely, experts note.

The CEPR study estimated gains for the U.S. and EU of 0.5 and 0.4 percent in GDP growth over 10 years, or \$199 billion and nearly 95 billion euros, respectively. It said this translated into an extra 545 euros in disposable income each year for a family of four in the EU, on average, and 655 euros per family in the U.S. — a set of figures that has been lampooned by critics as overstated and misleading.

Jeronim Capaldo, a research fellow at Tufts University’s Global Development Environment Institute, argued in his own analysis that TTIP would result in a loss of GDP for all EU countries and a loss of about 600,000 jobs in the EU.

His model, in contrast to CEPR, did not assume fixed employment and instead included an employment estimation based on the relationship between productivity growth and employment numbers, using data from the International Labor Organization.

“[E]xisting assessments of TTIP do not offer a suitable basis for important trade reforms,” Capaldo’s paper says. “Indeed, when a more realistic model is used, results change dramatically.”

Rudi von Arnim, an assistant professor of economics at the University of Utah and co-author of a separate study that also took a critical view of the CEPR findings said in an interview that the gains are small enough to be in the rounding margin of error, and could easily be offset by the adjustment costs associated with implementing TTIP.

Von Arnim argued that increased social costs to the government such as paid out unemployment benefits and trade adjustment assistance could eat away as much as one-third of the claimed GDP benefits.

Another paper by Rashmi Banga, a senior economist at the Geneva-based United Nations Conference on Trade and

Development (UNCTAD), also criticized the CGE model employed by various studies, that found trade benefits for parties currently negotiating the Trans-Pacific Partnership (TPP). Banga, whose paper does not represent the views of UNCTAD, also argued the assumption of full employment in a CGE model always yields projections of net gains.

Banga took issue with the full employment assumption and the failure of recent models to ignore the adjustment costs of cutting NTBs. The paper explains that the assumption that expanding sectors can absorb the workers displaced by contracting sectors is unrealistic because the rate of expansion does not match the rate of jobs being lost. Additionally, laborers are not necessarily transferable between sectors because of sector-specific skill requirements. The full employment assumption assumes away these issues.

In terms of cutting NTBs, the paper says that because the cost of adjustment to remove NTBs — including higher levels of unemployment and lost tariff revenue — is neglected in recent CGE models, the gains of cutting NTBs is overstated.

These adjustment costs could theoretically not be offset by GDP gains as a recent study released by the U.S. Department of Agriculture found that TPP would have zero impact of U.S. GDP. The model envisioned the elimination of all tariffs and tariff-rate quotas in the region, but did not take into account the impact of other TPP chapters, such as services, investment, sanitary and phytosanitary rules, or rules of origin.

Similarly, other CGE models do not capture these other economic elements, leading to the potential gains of a trade agreement being understated. Federica Mustilli, a researcher at the Centre for European Policy Studies and coauthor of the European Parliament's April 2014 appraisal of the commission's impact assessment on TTIP, noted the commission study also did not factor in potential gains the U.S. and EU stand to make in the investment and financial sectors. Those factors, she argued, could outweigh the negative impacts the study also omitted.

The CEPR study found that, given that tariff rates between the U.S. and EU are already relatively low, the most important benefits of TTIP will be found in the reduction of NTBs — with up to 80 percent of the economic gains stemming from those reductions.

But NTBs are difficult to measure because of the wide array of different factors that could make up an NTB, according to Mustilli. Another economist familiar with different trade models explained that to identify NTBs, the commission study employed what is known as a “dynamic gravity model,” which predicts the ideal amount of trade between two partners. The ideal amount of trade and the actual amount of trade are then compared, with the remaining difference being attributed to the impact of NTBs.

However, this could lead to an overestimation because that difference is not necessarily entirely attributable to NTBs, one economist said. Other factors such as weather could cause trade flows to slow from year to year. Those uncontrollable factors cannot be extricated from the calculation, the source said.

A 2009 commission study conducted by Ecorys, found that up to 50 percent of NTBs were “actionable” and could be removed. One economist argued the finding that only 50 percent of NTBs could be removed was a way that the authors of the study sought to reduce the overestimation of NTBs.

Additionally, the Ecorys study also interviewed European importers and exporters and used the results of that survey to determine the appropriate value of a given NTB. In order to estimate the impact of reducing an NTB in a CGE model, each sector is assigned an “ad valorem” number, which is the approximate tariff equivalent of a NTB. An “ambitious agreement” would then cut the ad valorem in half to measure the impact of an FTA, the Ecorys study said.

Capaldo said that estimating the impact of reducing NTBs in TTIP is particularly difficult because negotiations are still ongoing and it is uncertain which NTBs will be addressed in a final agreement.