Overcooked Free-Trade Dogmas in the Debate on TTIP

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1. Projecting the Effects of TTIP: What to Expect from Different Economic Models

In recent months the debate over mega-regional trade and investment agreements has echoed concerns that the type of liberalization these agreements entail, far-reaching and replete with constraints for national policies, might have perverse effects.[2] From an economic perspective a critical question is whether a large-scale attempt to expand trade and investment will actually lead to higher economic activity or will it be counterproductive due to negative effects on income distribution, employment and other important variables. The answer largely depends on how we see economic adjustments operating or, put differently, on the economic model we choose.

"Full-employment" models, such as commonly used Computable General Equilibrium models, assume that prices and wages are flexible enough to ensure that all resources are fully utilized, including labor.[3] If business activity were to contract, wages would immediately fall enough to keep everyone employed. And because everyone is always employed there is no risk to liberalizing trade and investment. In contrast, "demand-driven" models recognize that the level of economic activity is primarily – although not only – constrained by people's disposable incomes. When business activity contracts, employment shrinks and any fall in wages makes the situation worse unless a large increase in investment or exports turns it around. Thus, seen through the lens of these models, large-scale liberalization entails a serious risk: while higher international competition might force labor incomes downward harming domestic demand exports might not increase as hoped.

In the case of the Trans-Atlantic Trade and Investment Partnership (or TTIP), projections with full-employment models suggest net economic benefits while a demand-driven model projects net losses (Capaldo, 2014). It is up to policymakers to take one view or the other based on how sensible the respective underlying assumptions appear.

In this context, a *fresh* paper (ECIPE, 2015) provides an opportunity to emphasize some important points about economic projections of mega-regional trade liberalizations and underlying models. Indeed, the wittily titled paper is a useful example of dogmas and omissions that have beset the trade policy debate on TTIP and other agreements. The authors advance two types of critiques of the demand-driven approach taken in Capaldo (2014) – firstly on the appropriateness of using the United Nations model in general and secondly on specific choices made in assessing TTIP – and express confidence in the official assessments based on (full-employment) Computable General Equilibrium models. In all these critiques the authors seem to miss the most important aspects that modeling TTIP requires to consider. But the most striking feature of the paper is the conspicuous absence of any mention of unemployment or inequality.

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[2] See Baker (2014), Krugman (2014, 2015, 2015a) Lamy (2014), European Parliament (2015) or the recent resolution on Investor-State Dispute Settlement adopted by the Dutch Parliament (2015).

[3] CGE models do not necessarily assume full employment but nowadays they typically do (Taylor, 2011).

2. The UN Model: More Appropriate than Other Models to Project the effects of TTIP

ECIPE (2015) claims that using the United Nations model to analyze TTIP is inappropriate for several reasons. However, the authors seem to be missing the most critical points about the model and the challenge of projecting the effects of TTIP. Their main critiques are the following:

a) The UN Model Over-Simplifies Reality.

While this may be true of the UN model it is also true for all economic models. As explained in the model's documentation[4], the UN model contemplates four broad economic sectors (energy, primary commodities, manufacturing goods and services) but it does not offer industry-level insights (on, for example, the chicken market). However, the model does *not* simplify away critical aspects of reality such as persistent unemployment and increasing inequality.

In contrast, the CGE models advocated in ECIPE (2015) offer a lot of industry-level detail on economic sectors ranging from food to cosmetics. But they simplify reality in other ways. Most importantly, they typically assume that individuals are perfectly rational, that the economy is constantly in a state of full employment and that income distribution follows a simple rule, namely that wages increase at the same rate as productivity. Obviously unreasonable yet too rarely questioned, these assumptions feel more like dogmas than instruments of research.

In light of these differences, the question becomes: what good is all the detail we can extract from full-employment CGE models if they ignore some of the most problematic economic realities such as unemployment and inequality?[5]

b) The UN Model Does Not Consider Supply-Side Factors.

This is incorrect. In fact, the model contemplates both demand and supply factors[6]. In particular it captures the possibility that capacity constraints – when they are actually binding[7] – give way to inflationary dynamics or specific policy responses. But the model also recognizes that the economy often operates below full capacity (i.e. below full employment)[8]. This makes a great deal of difference. For example, if the EU and the US were operating at full capacity, a decrease in production costs (due for example to a reduction of labor shares) might lead to higher economic activity – producing more would reasonably lead to selling more. But with insufficient aggregate demand, signaled by high unemployment and under-utilized capital, a decrease in labor incomes would lead to even lower demand. In this case one might hope that lower costs will trigger a large increase in exports or investment but a long history of failed austerity measures in the EU seems to indicate that this is unlikely.[9]

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[4] See Cripps and Izurieta (2014).

[5] This issue has been taken up in numerous academic papers. See Akerman and Gallagher (2005) and Taylor and Arnim (2006) for the most insightful analyses.

[6] See again Cripps and Izurieta (2014).

[7] Storm and Naastepad (2012) analyze the differences between macroeconomic processes that operate in the presence of supply vs demand constraints.

[8] According to Krugman (2015a) "the immediate problem facing much of the world is inadequate demand […]. Would trade liberalization help on that front? No, not at all."

[9] Again see Krugman (2015a): "trade liberalization would change the composition of world expenditure, with each country spending more on foreign goods and less on its own, but there's no reason to think it would raise total spending".

c) *The UN Model Cannot Estimate the Impact of Trade Reforms.*
This criticism refers to the absence in the UN model of indicators that measure tariffs and non-tariff measures. This seems to miss a central point about mega-regional trade agreements. While it is true that tariffs and non-tariff measures are not explicitly measured in the UN model, it is not clear why they should be. The starting point in Capaldo (2014) is that these agreements are about much more than international trade since they entail significant effects on income distribution, unemployment and economic stability. This view is supported by recent authoritative pronouncements. In a debate at the EU Parliament (2015) the lead author of CEPR (2013), the main study endorsed by the European Commission, acknowledged that TTIP is about much more than tariffs. Krugman (2015), who was awarded the Nobel Prize for his contribution to trade theory, goes further stating that the Trans-Pacific Partnership is "not a trade agreement" but will only serve special interests. Therefore, models that focus on trade dynamics while overlooking important realities such as income distribution are likely to give biased projections.

d) *The UN Model Emerged in the 1970s and It Has Not Been Applied to Trade Policy Since.*
This is puzzling. The UN model was indeed first developed in the 1970s at the University of Cambridge and its intellectual roots hark back to ideas emerged in the 1930s. In contrast, the full employment assumption central to many CGE models appeared in the late 1700s[10]. It made sense at a time when agriculture absorbed virtually the entire workforce but its appropriateness today is dubious.
Today, with the emergence of mega-regional trade agreements, it makes more sense than ever to analyze trade liberalization with a macroeconomic model that can explain unemployment, stagnation and inequality.

e) *The UN Model Is Hidden from Other Scholars*
This is incorrect. The model is described in detail in a publicly available paper, duly referenced in Capaldo (2014). The paper describes underlying concepts, assumptions, mathematical rules, and data and it contains a full list of the variables. What is not available is the computer code through which the calculations are carried out. It is a bit like a restaurant menu – it describes the ingredients and, sometimes, the cooking "philosophy" but not the recipe.
This critique would sound quite different had the authors pointed out that not disclosing the computer code seems to be the prevailing practice among international organizations, such as the World Bank, the IMF or OECD, that operate a macroeconomic model.

A final point that deserves attention is the claim, in ECIPE (2015), that the features of the UN model make it the "go-to" for the sworn enemies of trade liberalization. This seems a reversal of the burden of proof. The models that project positive effects from TTIP typically do so by assuming full employment. It is rather those advocating the use of those models who should show that the full-employment assumption is not essential to rosy projections. Without such explanation it is hard to justify the use of CGE models on rational grounds.

On the positive side, the criticism advanced in ECIPE (2015) seems to confirm one of the most important points made in Capaldo (2014) – economic models are not neutral in policy debates. A model can be nonetheless useful in clarifying economic processes if one finds its central assumptions sensible.

[10] See Say (1803).

3. On the Use of the United Nations Model in Capaldo (2014)

The authors of ECIPE (2015) claim that the assessment of TTIP carried out in Capaldo (2014) makes up for the supposed shortfalls of the UN model (analyzed in the previous section) with a series of contradictory and unjustifiable assumptions. Their main reasons seem to be the following:

f) The Reference Scenario Is Not Based on All Factors of Trade.

This suggests little understanding of model projections. In every projection exercise, the first scenario to be constructed is a "baseline", a scenario that will be used as the reference to which alternative scenarios are compared. By definition, the baseline assumes no policy changes (a "no-TTIP future") while alternative scenarios reflect one or more such changes. However, the authors of ECIPE (2015) seem to suggest that the baseline should have more detail about trade liberalization and its dynamics. But it's not from the baseline scenario that one should expect a complete accounting of the various factors of trade – rather from the alternative scenario. This brings up again the point that TTIP is unlikely to be correctly captured by typical trade models (see point *c* above).

The baseline scenario is also criticized for the embedded assumption of continued austerity. Apart from denying the persistence of austerity policies in the EU, this is perplexing for another reason. Removing the austerity hypothesis would set the baseline scenario on a higher growth path making the comparative losses from TTIP even larger. Given their optimistic views on TTIP, it is unclear why the authors find this approach, which leads to smaller projected losses, disreputable.

g) Results Are Obtained Assuming Dynamics That Are Not Verified Empirically

This critique refers to the idea, central in Capaldo (2014), that TTIP would induce European policymakers to facilitate cuts in labor costs in order to increase competitiveness. The authors of ECIPE (2015) disagree that this effect has occurred after other experiences of liberalization. Their opinion is of course legitimate but it enjoys no more empirical verification than the opinion they criticize.

While it's possible to observe trends in the data, empirical analysis cannot identify causal relationships between different indicators. Modelers should base their assumptions on available empirical evidence but they can't count on the type of empirical verification available to experimental sciences.

Surprisingly, in a different section of ECIPE (2015) the authors seem aware of this problem. Discussing the allegedly "proven" benefits of free-trade agreements they claim that "while it is difficult to disentangle the precise numerical impact of FTA's, it is much easier *ex post* to identify common economic trends after an FTA has been enforced". In other words, the authors acknowledge the difficulty of quantifying the impacts of liberalization and find it admissible to arbitrarily choose *ex post* a few variables interpreting their changes as proof of positive impacts. For example, they point to the increase in trade volumes and nominal wages as proof that liberalization has benefited labor. However, they find it inadmissible or ideological to focus on the wage share (a more meaningful indicator than the nominal wage) or components of GDP and specific policies that might affect them, as done in Capaldo (2014).

h) Results Conflict with the UN's Assessment of Global Rebalancing Based on the Same Model

This critique seems based on a misreading of United Nations publications (United Nations, 2012; UNCTAD, 2014).

Global imbalances consist of two inseparable facts: an enduring trade surplus in some countries and an enduring deficit in others. The persistence of such imbalances is problematic because the inevitable accumulation of liabilities in deficit countries may lead to crises of various types. However, not all ways to a global rebalancing are desirable. A rebalancing driven by increasing labor incomes and domestic spending in surplus economies is likely to have positive effects on inequality, growth and employment.

On the other hand, a rebalancing achieved by reducing incomes in deficit countries is likely to have grave social consequences. The recent experience of Greece is a case in point – widespread wage and spending cuts have reduced its trade deficit but also aggravated the recession and triggered a social crisis. Therefore there is no contradiction between the results obtained in Capaldo (2014) and the UN's analysis of rebalancing based on the same model.

i) Capaldo's Thesis Does Not Fit with History and a "Reality Check" Is Needed (Dulcis in Fundo)

On a personal note, this is my favorite critique. Firstly, it is based on hasty reading. The claim that TTIP would lead to a reduction of intra-European trade is made in several CGE-based assessments (see Raza *et al.*, 2014), not in Capaldo (2014) – an unfortunate case of friendly fire!

Secondly, ECIPE (2015) compares TTIP with the North-American Free Trade Agreement, perhaps not inappropriately given the structure of the two agreements. But the comparison doesn't offer any indication that TTIP will be beneficial to the EU unless one is very selective in the choice of data (see point *g* above). Indeed the empirical "evidence" on the effects of NAFTA is at best inconclusive.[11]

Thirdly, the suggestion of a reality check is perplexing in a paper advocating for the use of economic models that ignore unemployment and inequality. The case of inequality seems especially telling. In full-employment CGE models income distribution is generally assumed to follow the productivity rule – real wages increase at the same rate as labor productivity. If this were the case, the labor share (defined as the ratio of real wages to productivity) would remain constant over time.[12] But labor shares in the EU and the US have been on a decreasing trend for at least two decades.[13] Since the modeling approach advocated in ECIPE (2015) cannot explain this critical fact, the authors' call for a reality check appears ironic.

4. Conclusions

A recent paper (ECIPE, 2015) offers a useful example of dogmas and omissions that beset the trade policy debate on TTIP and other agreements. The main arguments, reviewed in this note, are based on the misperception of TTIP's most important impacts and on selective choice of evidence. Most strikingly the authors criticize the use of the UN model in Capaldo (2014) on the grounds of realism while advocating for a modeling approach that excludes by assumption the possibility of unemployment and increasing inequality.

On the positive side, ECIPE (2015) confirms an important fact: economic models are not neutral in the policy debate. They can be useful to understanding economic processes only if their basic assumptions are reasonable.

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[11] For a review of this evidence see Raza et al. (2014) and references therein.
[12] If two numbers increase at the same rate, their ratio doesn't change. See, for example, Patnaik (2006)
[13] See Taylor (2010) and Lavoie and Stockhammer (2012).

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