Estimating the Potential Benefits of an EU-US Free Trade Agreement

BY STEPHEN EZELL | March 14, 2013

"An EU-US FTA would signal to the world the seriousness with which both parties take true free trade, and that more than anything else would animate the global dialogue in favor or more serious multilateral trade liberalization."

On March 13, 2013, ITIF moderated an event at the Swedish Embassy that focused on estimating the potential economic benefits of an EU-US free trade agreement—what's now being called the "TTIP," or Transatlantic Trade and Investment Partnership Agreement. This relationship is important because the United States and European Union (EU) together account for one-half of the world's GDP and one-third of world trade. The event featured the presentation of a new paper prepared by Sweden's National Board of Trade, Potential Effects from an EU–US Free Trade Agreement—Sweden in Focus.

The paper models the economic benefits of a trade pact in which tariffs are completely eliminated (currently, average tariff rates between the EU and US are less than 4 percent) and non-tariff barriers (NTBs) are reduced by 25 percent (the limited scenario) or by 50 percent (the more comprehensive scenario). Their more comprehensive scenario finds that U.S. national income would increase by 0.5 percent, or $76.5 billion, per year, and by $36 billion in the more limited scenario. EU national income rises by that same amount, $36 billion, in the more comprehensive scenario. Though the United States runs an approximately €72 billion ($94 billion) trade deficit with the EU in goods annually, the primary reason the United States benefits more (in this model) is that 20 percent of U.S. trade flows toward the EU, while only 8 percent of EU trade flows toward the United States.

The authors of the Swedish paper seem to have a slightly more conservative estimate than some other organization's estimates of the benefits from an EU-US trade agreement. (Though the authors do note that their estimates are likely to be more conservative because their economic model does not include foreign direct investments or consider dynamic effects.)

Perhaps the most aggressive estimate of economic benefits from an EU-US free trade agreement (FTA) has come from the U.S. Chamber of Commerce, which estimates that a 50 percent NTB reduction scenario would increase both EU and US GDP by 3 percent, generating annual gains of $450 billion for the United States and $495 billion for Europe. The Chamber also estimates that full tariff elimination alone would boost combined EU-US GDP by $180 billion within five years. A more middle-ground estimate comes from the German Marshall Fund, which predicts that a trade pact would boost EU GDP by €190 billion ($250 billion) and U.S. GDP by €100 billion ($130 billion) annually. Likewise, new research released on March 12 by the European Commission and performed by the Center for Economic Policy Research in London estimates that a transatlantic trade and investment pact would generate economic gains for the EU of €119 billion (or $155 billion) per year and for the United States of €95 billion (or $124 billion) per year, while increasing GDP across the rest of the world by €100 billion ($130 billion) annually. Regardless of which estimate proves closest to correct, they all make the central point that the gains from an EU-US trade pact are real and significant. Moreover, it's important to remember that the benefits of a free trade agreement are much less about static equilibrium gains than they are about innovation gains. For example, car manufacturers being freed from having to obtain multiple certifications every time they put a new vehicle on the market or the pharmaceutical industry being freed from having to separately test new treatments on both sides of the Atlantic.

Sweden's National Board of Trade report makes several fabulous points in this regard. Perhaps the report's most important finding is that, "The positive impacts on national income stem primarily from a nation's liberalization of its own barriers. [This is]

because they result in lower costs for imports and lead to a better use of domestic and imported resources." This is a critical message to get across to countries that are now not only wary of entering into new trade agreements but are also actively imposing a wide range of forced localization trade barriers. These represent modern import substitution industrialization policies that seek to restrict imports with the goal of seeding the development of indigenous manufacturing industries (such as computer and electronics manufacturing) and then turning those industries into export powerhouses. But when nations impose tariff and other trade barriers, especially on general purpose technologies like information and communications technologies (ICTs), they only end up damaging their own economies. That's why economists have found that India suffers $1.30 in economic losses for every $1 of tariffs it imposes on ICT products. The message is that even unilateral trade liberalization can be beneficial to countries.

Another interesting finding from the Swedish report is that the liberalization of the business services sector would generate the greatest welfare gains to Sweden. The paper notes, "the reduced costs of business services sector imports could have a very positive impact on overall Swedish production and income because the business services sector is used to a large extent as inputs to other sectors of the economy, and represents a third of all inputs used in total production." While the paper notes that this will be particularly important for Sweden's financial services and insurance industries, it's also vital to ensure a competitive manufacturing sector. And that's another lesson developing countries can take: since services account for at least 30 percent of the inputs used by manufacturing industries, lowering barriers to trade in services decreases their import costs and thus raises the competitiveness of domestic manufacturing industries in developed and developing countries alike.

The Swedish report also makes important contributions to understanding the nature and extent of the non-tariff barriers that exist between the United States and in Europe. It's exactly right that it will be through harmonization, simplification, and mutual recognition—and probably in some cases "regulatory approximation"—that the United States and Europe can address NTB hurdles. The authors distinguish between "cost-creating" NTBs that are not in themselves discriminatory but that produce efficiency losses for both foreign and domestic firms and "rent-creating" NTBs that explicitly discriminate against foreign firms and generate "rents" for domestic firms or state regulators. They note that 40-45 percent of the NTBs afflicting EU-US trade are rent-creating, with the remainder cost-creating. Also useful was the authors' inclusion of data providing trade cost estimates for NTBs as a percentage of import value by sector. Particularly surprising (and perhaps controversial) was the authors' finding that the cost of NTBs as a percentage of import value are 17 percent higher in the United States than in the European Union.

Another striking data point from their report is that—though services account for 75 percent and 82 percent of EU and US total production, respectively—approximately 70 to 80 percent of EU-US trade takes place in the industrial sector, which very much highlights the need to bolster trade in services. While the paper posits several explanations for this—including that a substantial share of the services sector consists of less tradable services (like defense or health care) and challenges regarding data on trade in services—the reality is that EU-US trade in services is so low because of a wide range of trade barriers. These include: the lack of recognition of professional qualifications (e.g., lawyers, architects, engineers, etc.); localization requirements such as having to store data on local servers to provide financial services (for instance, both the Norwegian and Danish Data Protection Authorities have issued rulings to prevent the use of cloud computing services when servers are not located domestically); limits on American or European firms participating in each other's public procurement; EU Member State content quotas for broadcasting; and many others. It will be through eliminating barriers to trade in services that an EU-US FTA generates some of its most significant economic gains.

However, as important as the economic gains from an EU-US FTA will be, ITIF sees the biggest benefits of an agreement in establishing a political alliance against would-be innovation mercantilist countries. Indeed, there's a battle being fought now for the soul of the global trading system. Developing countries like Brazil, India, and Russia are looking to the West and seeing stagnating economies with high unemployment rates and comparing them to the more rapid (albeit somewhat slowing) growth in China and wondering if the adoption

of innovation mercantilist policies, as China has done in many cases, is the better way to go. But as the countries that believe more than any other in the benefits of free trade and globalization, it's incumbent on the European Union and United States to chart a path forward for deeper trade liberalization, and to make the case that a firm rejection of mercantilism and embrace of economic and trade liberalization is the pristine path for countries to take toward accelerated economic growth.

While some like Marcel Fratzscher (President of the German Institute for Economic Research), writing in the *Financial Times* last month, see an EU-US FTA as distracting from the multilateral Doha approach, rather the reality is that the United States and Europe have to take a leadership approach that establishes a high-standard FTA which becomes the benchmark by which future free trade deals are measured. The agreement will need to impose strong disciplines on state owned enterprises, significantly reduce if not completely eliminate localization barriers to trade, and maintain the highest intellectual property protections. If the United States and Europe can achieve such a gold-standard agreement, it will signal to the world the seriousness with which both parties take true free trade, and that more than anything else can animate the global dialogue in favor or more serious global multilateral trade liberalization.

ABOUT ITIF

The Information Technology and Innovation Foundation (ITIF) is a Washington, D.C.-based think tank at the cutting edge of designing innovation strategies and technology policies to create economic opportunities and improve quality of life in the United States and around the world. Founded in 2006, ITIF is a 501(c)(3) nonprofit, non-partisan organization that documents the beneficial role technology plays in our lives and provides pragmatic ideas for improving technology-driven productivity, boosting competitiveness, and meeting today's global challenges through innovation. Email us at mail@itif.org.

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