

Future Social Market Economy



Policy Brief # 2013/04

Who Benefits from a Transatlantic Free Trade Agreement?

From a purely economic standpoint, the US and the entire EU will profit from a dismantling of tariffs and non-tariff trade barriers between both regions. The real gross domestic product per capita would increase in the US and in all 27 EU member countries. Also when one looks at labor markets, the positive effects on employment predominate: Two million additional jobs could be created in the Organization for Economic Co-operation and Development (OECD) zone over the long run. The public welfare gains of these economies admittedly do stand in contrast with real losses in income and employment in the rest of the world. On balance, however, the beneficial effects on economic welfare prevail.

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Focus

Country	Long-term percentage change in real GDP per capita
United States	+ 13.4 %
United Kingdom	+ 9.7 %
Sweden	+ 7.3 %
Spain	+ 6.6 %
EU (27 countries)	+ 5.0 %
All 126 countries	+ 3.3 %
Algeria	- 3.5 %
Niger	- 4.0 %
Japan	- 5.9 %
Mexico	- 7.2 %
Australia	- 7.4 %
Canada	- 9.5 %

Source: ifo Institute.

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Along with the US and the UK, crisis-ridden Spain would also be a big winner from a comprehensive free trade agreement. On the other hand, the countries that are not part of this free trade agreement would have to expect losses in real earnings, which could be substantial in some cases.

Since the 1990s, a free trade agreement between the US and European Union (EU) has been discussed time and again. At least since the beginning of 2013, negotiations regarding a transatlantic free trade agreement seem to be within reach. The goal for this type of free trade agreement is to remove barriers to trade between allied partners, thereby intensifying the exchange of goods and services between participating economies. Deepening of trade is linked with the expectation that production, employment and income will increase in the countries that are party to a free trade agreement, thereby raising the citizens' material standard of living. However, would this also be the case in the event of a yet-to-be-negotiated "Transatlantic Trade and Investment Partnership" (TTIP)? Which economies would actually profit from an agreement, which would not?

1. Regarding the method of calculation

The goal of the simulations presented here is to assess the economic effects of a free trade agreement between the 27 EU member countries and the US. The investigation seeks to determine what the effects will be on international trade flows, quantities of goods and services produced (in other words, the real gross domestic product), and labor markets. It not only considers the countries that would be signing the agreement, but 126 countries in all. This comprehensive approach takes into account the fact that

a bilateral free trade agreement between the EU and the US will also affect the rest of the world (called third-country effects). The study here is limited and only considers economic issues. More far-reaching aspects such as questions of data protection, consumer protection and protection of intellectual property are expressly not addressed here.

This study considers two scenarios. In the first - the tariff scenario - we calculate what the economic consequences would be if all tariff-type trade barriers between the EU and the US were dismantled. In the second scenario - the liberalization scenario - not only tariffs, but also all non-tariff trade barriers are abolished between the parties to the agreement. Both scenarios are compared with a situation in which there is no transatlantic free trade agreement. The effects that result exclusively from removing the tariff and non-tariff trade barriers are calculated with the help of a model developed by the ifo Institute for analyzing free trade agreements (for a detailed description, see Felbermayr et al. 2013).

Experiences with existing free trade agreements are taken into consideration in the estimation of trade effects that can be expected. Examples of such agreements include the North American Free Trade Agreement (NAFTA, which involves the US, Canada and Mexico) and the EU as

Tariff and Non-tariff Trade Barriers: Trade barriers are measures that limit the exchange of goods and services between countries. Tariff barriers primarily consist of tariffs on importing products from abroad. Non-tariff trade barriers restrict the importation of goods and services from abroad by means other than tariffs. Examples include quality standards, shipping and labeling requirements, technical or legal requirements for imported products, and import restrictions ranging from import quotas to bans on imports. Non-tariff trade barriers also include subsidies of a country's own exports through tax advantages or financial assistance.

well as numerous bilateral agreements that the US and EU have with other countries that have a common market with free traffic of goods and services without trade barriers. With the help of econometric estimates, we can make statements about the effects that the removal of trade barriers will have on international trade—not only between the parties to the agreement, but also for the rest of the world. The figures we determine for the effects of free trade agreements on trade are then integrated into a simulation model that includes 126 countries, in order to simulate the trade-creating and trade-diverting effects that a transatlantic free trade agreement might have on the economies under consideration. The related exports and imports, in turn, have an impact on the real gross domestic product numbers and the level of employment in the individual economies.

The following section briefly summarizes the economic effects that would result in the event of a free trade agreement between the EU and US. For this purpose, the actual economic reality of the year 2010 is compared with a hypothetical reality in which we assume that the two scenarios regarding a transatlantic free trade agreement (tariff scenario and liberalization scenario) were already in full effect in 2010. Thus, any adjustment processes, which would realistically occur after the signing of a free trade agreement, are explicitly omitted. The following briefly summarized consequences are therefore long-term effects. In addition, it should be noted that all results presented in the following section exclusively describe the isolated effect of a free trade agreement. In other words, in economists' jargon, these are "ceteris paribus" calculations (Latin for "all other things being held constant").

2. Consequences for Foreign Trade

Removal of trade barriers between the EU and US makes imports less expensive on both sides. Declining trade costs lead to an increase in trade activities between the two regions. At the same time, pre-existing trade agreements—in other words, the North American Free Trade Agreement, for example, and/or the trade between member states of the EU—lose value because the preferred status of the respective trading partner is less relevant. Thus, the price for intensifying trade relationships between the US and EU is a reduction of trade activities within the EU and a decrease in foreign trade relationships with most third countries. These effects are illustrated by the example of Germany and a few selected trading partners (see Fig. 1). Since the tariffs in transatlantic foreign trade are already very low, dismantling the tariff barriers to trade (tariff scenario) has only a very minor effect on trade flows. By contrast, a comprehensive free trade agreement that also removes the non-tariff trade barriers (liberalization scenario) would have considerably stronger impacts.

3. Effects on Economic Welfare Worldwide

In regard to people's material living conditions, trade flows are less relevant than the trend in the real gross domestic product per capita. This figure - hereafter referred to as "real per capita income" - is an indicator of the gains or losses in economic welfare, which are related to a transatlantic free trade agreement. Because a tariff scenario alone has only minor effects

on trade, the following section will only deal with the comprehensive free trade agreement. Figure 2 shows how the long-term per capita income would change for all 126 countries as the result of a transatlantic free trade agreement. The following main developments can be observed in this regard: The US shows the greatest growth in real per capita income. There, the long-term gross domestic product per capita grows by 13.4 percent. The EU as a whole also shows gains in economic welfare. In the case of a comprehensive transatlantic free trade agreement, the real per capita income in all 27 member countries is on average almost five percent higher than without this agreement. Great Britain shows the largest growth in income. There, the real per capita income grows by almost ten percent over the long term. The main reason for this growth: Great Britain already has a high trade volume with the US and therefore profits particularly well from a dismantling of trade barriers with the US.

Other EU countries that profit from this treaty well above average are small economies such as the Baltic States. Small countries tend to export and import a larger proportion of their gross domestic product than large economies, because the latter have a large domestic market and are therefore less strongly tied to the international division of labor. Since they are more strongly integrated in foreign trade, small economies also profit to a greater degree from declining trade costs. Most of the southern European countries in crisis derive a greater-than-average benefit from the free trade agreement. In that regard, Spain shows the greatest gain in income because it can replace the relatively expensive imports from European countries with cheaper imports from the US. The related surge in purchasing power increases the real gross domestic product per capita. Thus, a transatlantic free trade agreement would not widen the gap between the crisis-ridden southern European countries and the other EU member states.

Figure 1: Change in German foreign trade with selected partner countries

Exporter	Importer	Trade Volume in 2010 (in millions of US dollars)	Liberalization Scenario (change in trade flows as a %)	Tariff Scenario (change in trade flows as a %)
Germany	United States	83,553	93.54	1.13
United States	Germany	51,645	93.56	1.65
Germany	United Kingdom	72,052	- 40.91	- 0.70
United Kingdom	Germany	43,583	- 40.93	- 0.57
Germany	France	109,223	- 23.34	- 0.38
France	Germany	76,518	- 23.34	- 0.24
Germany	Italy	74,245	- 29.45	- 0.37
Italy	Germany	52,687	- 29.45	- 0.55
Germany	Japan	17,487	4.81	2.40
Japan	Germany	24,891	4.76	- 1.68
Germany	China	67,728	- 12.68	2.19
China	Germany	92,536	- 12.71	- 2.94
Germany	Brazil	12,951	- 7.58	2.41
Brazil	Germany	8,844	- 7.92	- 3.67

In general, we determined that this agreement does not increase income differences within the EU.

The EU countries that benefit less than average from a free trade agreement between the EU and US include the large economies of Germany and France. In fact, of all the 27 EU countries, after the Czech Republic, France is the country that shows the smallest increase in real income per capita due to its relatively small trade in goods with the US.

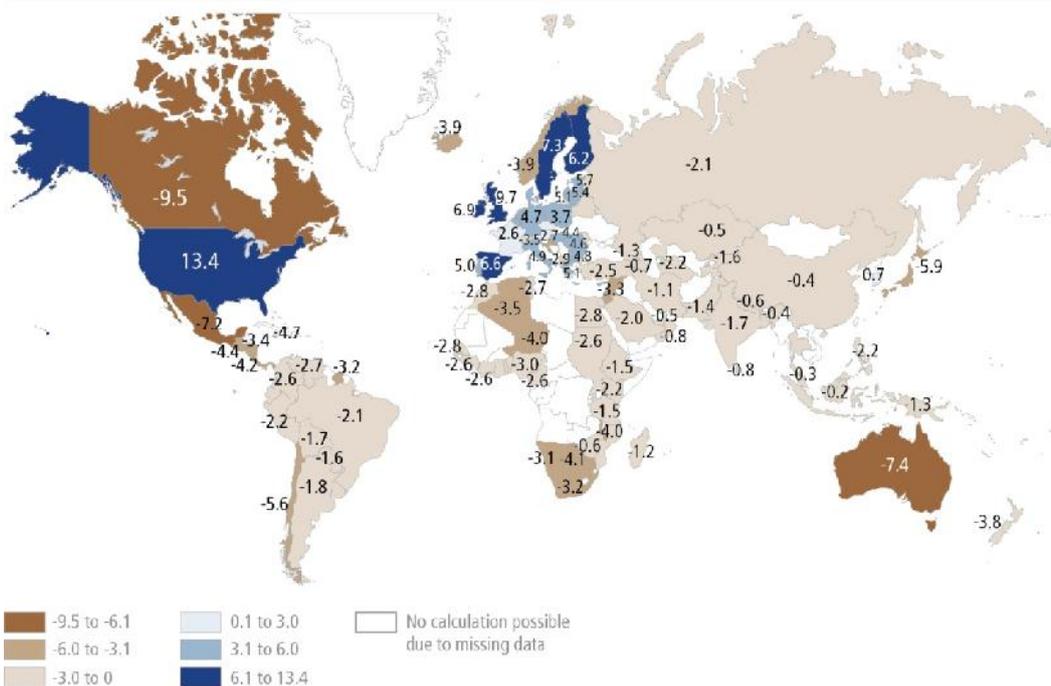
While the US and EU member countries benefit from a transatlantic free trade agreement, most other countries suffer from trade redirection effects. The intensification of trade relationships between the EU and US results in these economies importing fewer goods and services from the rest of the world. This affects Canada and Mexico to a particularly large degree because these two countries currently have a

free trade agreement with the US that will lose value as the result of a transatlantic free trade agreement. Shrinking exports would cause long-term real per capita income declines by 7.2 percent in Mexico and by as much as 9.5 percent in Canada. In Japan long-term real per capita income would decline by almost six percent. Losses in real income also occur in European countries that do not belong to the EU.

Other big losers include developing nations. The intensification of trade relations between the EU and US reduces developing countries' exports to these regions. In particular, because of their geographical location, countries in North and West Africa that previously had strong trade relations with the EU would have a hard time finding alternative markets for their export products. In this regard, however, it should also be taken into account that economic growth in the countries that are

Figure 2: Change in real income per capita under a liberalization scenario

Figures in %



party to the transatlantic free trade agreement might result in an increased demand for products from the rest of the world, which would then also increase exports from developing countries. These effects on growth - in other words, the dynamic effects of a free trade agreement - are not considered in the above calculations. Therefore, the negative impacts on real per capita income could in fact be lower. Regardless of that, however, we determined that the world as a whole profits from the free trade agreement at issue here: The average real per capita income rises by almost 3.3 percent. In view of this global growth in income, there is a possibility—at least, theoretically—that the winners of the transatlantic free trade agreement will compensate the losers.

4. Labor Market Effects

Economic growth stimulated by intensifying foreign trade also affects labor markets. Because of the relatively small effect on trade from just abolishing tariffs, there are no labor market effects worth mentioning in the tariff scenario. On the other hand, a comprehensive trade agreement between the US and EU would result in a considerably greater increase in employment in the economies that are party to the agreement (see Fig. 3). The US and the UK benefit to a particular degree, with almost 1.1 million and 400,000 additional jobs created, respectively. For the crisis-ridden southern European countries as well, there is an above-average positive effect on employment,

which is then reflected in a corresponding reduction in the unemployment rate. While the unemployment rate in the OECD declines by an average of 0.45 percentage points, in the four countries in crisis, the decline ranges from 0.57 percentage points in Italy to 0.76 percentage points in Portugal. In general, we observed that countries currently affected by above-average unemployment would see an above-average decline in unemployment in the wake of a transatlantic free trade agreement. This agreement would therefore have a converging effect on the labor markets as well. Like the effects on social welfare, there are also losers when we look at the labor markets. In the OECD countries that are not included in the transatlantic free trade agreement, jobs are lost. On balance, however, the job-creating effects predominate, resulting in about two million more jobs over the long term.

Figure 3: Number of jobs in selected OECD countries likely to be created by a transatlantic free trade agreement (rounded to thousands)

Country	Liberalization Scenario	Tariff Scenario
Australia	-52,000	-14,000
Germany	181,000	45,000
France	122,000	30,000
Greece	34,000	9,000
Italy	141,000	36,000
Japan	-72,000	-19,000
Canada	-102,000	-26,000
Poland	93,000	23,000
Portugal	43,000	11,000
Spain	143,000	36,000
South Korea	-30,000	-8,000
Czech Republic	22,000	6,000
Turkey	-95,000	-25,000
United States	1,086,000	277,000
United Kingdom	400,000	106,000
Jobs created in the OECD	2,043,000	519,000

5. Conclusion and Economic Policy Consequences

Intensifying trade between the US and EU would have positive effects on income and employment in the participating economies, especially with a comprehensive agreement that eliminates non-tariff barriers as well as tariffs. A transatlantic trade and investment partnership (TTIP) would therefore be an important tool and vehicle for increased growth and competitiveness in the European Union, which is still burdened by the financial and debt crisis in many places - and therefore by economic recession. Meanwhile, a trade agreement of this sort does not increase the economic disparities among EU member countries. Southern Europeans, who are particularly affected by the financial crisis, would benefit more than average according to the scenarios that are used as a basis here. Since a precise scope of an agreement is hard to assess, however, the economic convergence idea for Europe should be checked repeatedly during the negotiations, and should not be lost from sight.

Improvements in social welfare in the US and EU do indeed stand in contrast with identifiable real income losses in third countries, including a number of developing countries. These negative effects need to be avoided or reduced. Traditional trading partners of the two large economies, in particular, should be included in negotiations or get an early opportunity to conclude similar, compatible agreements with these economies, if this has not already happened. At the same time, the real gains in social welfare for the western industrial countries should be an incentive for adequately compensating losers of the

agreement, and for demonstrating readiness to compromise in multilateral negotiations. Transatlantic trade and investment partnerships could and should serve as an impetus, and not as a hindrance, on the multilateral negotiations that have stalled in the Doha Round.

Further Reading

- Felbermayr, Gabriel et al., Dimensionen und Auswirkungen eines Freihandelsabkommens zwischen der EU und den USA, Studie im Auftrag des Bundesministeriums für Wirtschaft und Technologie, Endbericht, Munich 2013.

Policy Brief 2013/02: Green and fair economy – a holistic concept for a sustainable economy

Solution approaches based purely on economics do not lead to optimal success—at least, not in the medium to long term. Rather, a sustainable economy requires an equal consideration of the ecological and social dimensions. The green economy concept, or, better said, the *green and fair economy* concept, is in principle suitable for, if not avoiding an economic and financial crisis as experienced in the last five years, at least moderating its negative effects. The important thing here is to integrate the design of the concept as much as possible at the political, economic and individual level.

Policy Brief 2013/03: A European Social Market Economy? - Index Results

The 'highly competitive social market economy' represents the targeted common economic order of the European Union as it is stated as a goal in the Lisbon Treaty. Yet, this endeavor requires a mutual understanding of which institutions constitute a modern social market economy. The results of the Index of Modern Social Market Economies (IMSME) show congruence around a liberal market economy, but great diversity in principles indispensable for a social market economy.

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