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How Not to Use the International Trade Commission's Economic Analysis of Trade Agreements

by Daniel Pearson

Introduction

The Trans-Pacific Partnership (TPP) has been concluded and is pending approval by the 12 member nations. Negotiations on the Transatlantic Trade and Investment Partnership (TTIP) between the European Union and the United States are continuing. Whether the public and policymakers are supportive of these agreements will depend in part on the economic results they are expected to deliver. Estimated economic effects depend heavily on the type of model used and the assumptions that constrain it. Interested parties often tend to cherry-pick the study results that best support their own policy positions, which leads to conflicting claims and a great deal of public confusion and doubt about trade agreements.

Sound economic analysis of trade agreements is important. Policymakers need to understand the likely costs and benefits of trade liberalization in order to focus on sectors that would be most affected by reform. Public support for trade agreements depends at least in part on the expectation that the U.S. and global economies will tend to grow when trade restrictions are reduced. Credible assessments of the likely economic effects of recent trade agreements have shown results consistent with economic theory—policy liberalization leads to increased economic activity and expanded trade.

Nonetheless, critics opposed to further reductions in U.S. trade barriers often claim that past trade agreements haven't delivered the results that were expected. They point to numbers reflecting imports, exports, or the trade balance to illustrate their view that earlier economic analysis was flawed. "Since past agreements haven't worked out as promised," they say, "why should we support any future trade deals?"

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This trade-skeptical attitude reflects several realities. One is that some people opposed to trade liberalization seem willing to offer any argument that might derail steps toward enhanced global economic integration. Another is that quantitative analysis of the effects of trade agreements has become more difficult as the pacts have expanded beyond tariff reductions and into reforms of domestic policies relating to investments and services. One more reality (and the topic of this paper) is that some people misunderstand—whether intentionally or not—the methodology used by the U.S. International Trade Commission (ITC) to prepare official estimates of U.S. trade agreements, which leads them to misinterpret what the numbers actually mean.

The U.S. International Trade Commission's Economic Analysis

The ITC is an independent federal agency that is directed by statute to prepare estimates of the economic effects of trade agreements.[1] The Bipartisan Congressional Trade Priorities and Accountability Act of 2015 states that:

> Not later than 105 calendar days after the President enters into a trade agreement under section 103(B), the Commission shall submit to the President and Congress a report assessing the likely impact of the agreement on the United States economy as a whole and on specific industry sectors, including the impact the agreement will have on the gross domestic product, exports and imports, aggregate employment and employment opportunities, the production, employment, and competitive position of industries likely to be significantly affected by the agreement, and the interests of United States consumers.[2]

To prepare such a wide-ranging study requires input from a diverse group of specialists. The ITC's Office of Economics and Office of Industries together employ more

than 80 economists and international trade analysts with expertise in a wide variety of trade issues. Their analysis generally begins prior to the formal signing of an agreement, then is adjusted and finalized within 105 days of when the definitive text becomes available. The ITC's report does not make policy recommendations. Rather, it attempts to present an objective view of potential effects—both positive and negative—of implementing a trade agreement. Thus, it's not unusual to find opponents and supporters of an agreement both quoting the ITC's analysis, but only those parts that coincide with their views.

A useful perspective on the analysis the ITC will prepare for TPP and TTIP can be gained from reviewing the Commission's comprehensive 2007 report on the Korea–U.S. Free Trade Agreement, commonly known as KORUS.[3] The 390-page KORUS study contains detailed econometric analysis of the effects of changes to tariffs and quantitative restrictions. This includes quantitative assessments of likely shifts in imports and exports for 20 widely traded goods sectors, ranging from grains and livestock products to textiles, pharmaceuticals, and automobiles. Some provisions of the report cover policy changes that are difficult or impossible to quantify, such as market access in services, trade facilitation improvements, and regulatory measures. The study provides qualitative assessments detailing how those issues have been addressed in the agreement. The report also incorporates comments submitted by interested parties, as well as information gleaned at a public hearing convened by the six-member Commission. The final report provides policymakers and interested parties with information regarding the likely influence of the agreement on the economy overall, as well as some of its key sectors.

For its econometric analysis, the ITC uses a well-regarded computable general equilibrium (CGE) model, known as the Global Trade Analysis Project (GTAP).[4] This is a multi-country model with economy-wide coverage of merchandise and service sectors. The model provides economic parameters for many nations. Those parameters include GDP, exports to all countries, imports from all countries, and bilateral trade balances.

The GTAP model is well suited to what's known as "comparative static" analysis. A comparative static approach can be likened to taking two snapshots of the economy. Using the ITC's analysis of KORUS as an example, the first snapshot was of the baseline economy as it existed in 2007—without the policy reforms agreed to in KORUS. The second snapshot also was of the 2007 baseline economy, but this time all provisions of KORUS were incorporated as though they had been fully implemented. (In actuality, some policy changes have phase-in periods of up to 20 years.) Note that there was no attempt to estimate how the U.S. and global economies would evolve over time. Rather, the analysis looked at the most-current version of the economy available in 2007, then assessed how that baseline economy would have been different, assuming all of the KORUS changes already had been implemented.

This counterfactual approach is quite well suited to assessing how immediate implementation of the readily quantifiable provisions of a trade agreement would have led to changes in the baseline economy. It takes the existing global economy and modifies it by making the changes in tariffs and quantitative restrictions that are included in the new trade agreement. Would the United States have produced more or less of an item? Would exports have been larger or smaller? How about imports? A comparative static analysis provides a great deal of useful information about this "What if?" world. However, it tends to look backward as it assesses how the baseline economy would have responded to shocks induced by trade liberalization.

Frankly, some people find the comparative static approach to be counterintuitive. They often do not care much about hypothetical changes in the baseline economy. Instead, they want to know what's likely to happen in the future. Is it certain that implementing a free-trade agreement (FTA) will lead to economic growth over the next five years? Will new overseas marketing opportunities be created for efficient U.S. firms, thus leading to an increase in exports over time? Will a wider variety of imported products be available in the U.S. marketplace, which would provide greater choice and value to consumers? Will there be attractive career opportunities for people with my skills? Economic modeling cannot provide definite and detailed answers to these questions.

Making accurate economic projections several years into the future is pretty much impossible. Will there be a serious recession? How might the comparative advantages of various sectors in different countries evolve over time? Will consumer tastes and preferences remain frozen in place, or will they continue to change as they have for thousands of years? International trade economists may be good at their work, but none of them are clairvoyant.

Misinterpreting the Analysis of KORUS

Given the reality that the ITC's analysis doesn't directly answer the questions that many people have in mind, perhaps it's not surprising that the results often are misinterpreted. These misunderstandings are exemplified by the Coalition for a Prosperous America (CPA), an organization that is somewhat reluctant to embrace imports that compete with U.S. products. The Coalition sent a letter to ITC Chairman Meredith Broadbent dated February 26, 2015, requesting that the ITC upgrade its methods for evaluating trade agreements.[5] Anticipating the successful conclusion of negotiations for the Trans-Pacific Partnership (TPP), the letter states:

> There has been a persistent pattern of large gaps between estimated and actual outcomes in similar past USITC reports. For example, the USITC report on the probable impact of the Korea–US free trade [agreement] estimated that imports from Korea would increase by $6–7 billion and that the annual U.S. trade balance would improve by about $4–5 billion. Neither of these projections have proved to be remotely accurate, suggesting that the guidance provided to policy makers and the public may have been inaccurate in important ways.[6]

Table 1
United States Trade in Goods with South Korea (2005–2014)

	U.S. Exports	U.S. Imports	Balance
2005	27,571.60	43,781.40	-16,209.80
2006	32,219.10	45,803.60	-13,584.50
2007	34,401.70	47,562.30	-13,160.60
2008	34,668.70	48,069.10	-13,400.40
2009	28,611.90	39,215.60	-10,603.70
2010	38,820.60	48,875.20	-10,054.50
2011	43,461.60	56,661.40	-13,199.70
2012	42,282.60	58,898.90	-16,616.40
2013	41,686.60	62,433.20	-20,746.60
2014	44,471.30	69,518.40	-25,047.10

Source: United States Census Bureau, Foreign Trade, "Trade in Goods with Korea, South," https://www.census.gov/foreign-trade/balance/c5800.html.
Note: All figures are in millions of U.S. dollars and not seasonally adjusted.

The Coalition for a Prosperous America makes the common mistake of taking the ITC's estimates of U.S.–Korea trade relative to the 2007 baseline and comparing them with actual trade flows from several years later. The global economy—and bilateral trade between the United States and South Korea—has changed substantially since then.

A correct understanding of the ITC's analysis can be illustrated with a few numbers. In response to the agreed tariff and tariff-rate quota (TRQ) changes in the KORUS FTA, the ITC reported that U.S. exports to Korea were estimated to be $9.7 to $10.9 billion higher once the agreement was fully implemented.[7] (This, of course, was measured against the baseline economy that existed in 2007.) United States imports from Korea were estimated to be $6.4 to $6.9 billion higher.

Because U.S. exports to Korea in 2007 amounted to $34.4 billion,[8] the roughly $10 billion rise estimated by the ITC would amount to about a 30 percent increase. The 2007 number for U.S. imports from Korea was $47.6 billion, so the ITC estimate of approximately a $6.6 billion change would mean increasing imports by about 14 percent. If the global economy otherwise had remained frozen in 2007, KORUS likely would have reduced the U.S. bilateral trade deficit with Korea from about $13 billion to about $10 billion.

Those numbers seem intuitively reasonable. Korea was recognized as having a higher degree of protection against imports than the United States, so the market-opening provisions of KORUS would be expected to lead to a relatively larger increase in imports to Korea than to the United States.

Now, let's shift away from a comparative static approach and flip the calendar ahead a few years. By 2014, actual U.S. exports had grown 29 percent to $44.5 billion, and U.S. imports had risen by 46 percent to $69.5 billion, so over seven years the trade deficit actually widened from $13.2 billion to $25.0 billion.[9] This result is opposite to what some people expected based on their misunderstanding of the ITC study.

In this situation it isn't entirely surprising that someone who is unfamiliar with the strengths and limitations of the ITC's analysis might be tempted to say, "Wow, the ITC certainly doesn't know what it is doing. They said KORUS would reduce the trade deficit, but it went up." Or, taking the next step, someone might assert, "KORUS caused the deficit to increase!" This would be a particularly bold conclusion since KORUS did not start to be implemented until 2012 and won't be fully phased in until 2032.

It is difficult to be much impressed by poorly informed (or poorly motivated) arguments from critics of trade liberalization who ignore the actual nature of the economic analysis. They also ignore many other things that are happening in the dynamic global economy. With respect to developments since 2007, the world experienced a particularly deep recession in 2008–2009 that has had a pronounced effect on production, consumption, and trade flows among many countries. (Bilateral trade between

the United States and Korea fell 17 percent ($14 billion) between 2007 and 2009.) Substantial investments by Korean firms in the manufacturing sector may have shifted the comparative advantage of some industries in favor of Korea. Consumer tastes and preferences have continued to evolve. Americans appear to like telephones manufactured in Korea, not to mention automobiles. (From 2007 to 2014, U.S. imports of telephones from Korea rose 167 percent; automobile imports rose 66 percent.) There seems little doubt that those fundamental changes in the U.S. and Korean economies have had far greater effects on bilateral trade flows than KORUS. And it is ludicrous to think that those changes could have or should have been projected by economists focused on the effects of tariff reductions.

Conclusion

Looking ahead to the possible conclusion of TPP and TTIP, economic analysis no doubt will play an important role in the debate over those agreements. During consideration of previous FTAs, pro-trade and anti-trade members of Congress cited portions of the ITC's findings that supported their views. Debates over the upcoming agreements certainly will provide similar opportunities.

Opponents of trade liberalization at times have sought to undermine the credibility of the ITC's studies by claiming that economic analysis of past trade agreements has been incorrect. Simply enough, people always will be able to misconstrue the results of any modeling for any trade agreement. This will be an issue again for the TPP and for TTIP. Note that it's still an issue for the North American Free Trade Agreement (NAFTA), which some commentators seem to believe has caused most U.S. economic problems for the past 20 years.[10]

Supporters of trade liberalization should be prepared to counter those who would misinterpret the economic analysis of trade agreements in order to advance anti-trade arguments. Yes, trade liberalization will produce both winners and losers. But credible analysis clearly indicates that making markets more open and competitive will lead to improved resource allocation, expanded international trade, greater economic growth, and higher consumer welfare. Those objectives are genuinely worth pursuing.

Notes

1. United States International Trade Commission, "About the USITC," http://www.usitc.gov/press_room/about_usitc.htm.
2. Bipartisan Congressional Trade Priorities and Accountability Act of 2015, PL 114-26, Sec. 105(c)(2), http://www.finance.senate.gov/legislation/details/?id=09a8e24a-5056-a032-52c2-e543475d6f92.
3. United States International Trade Commission, "U.S.-Korea Free Trade Agreement: Potential Economy-wide and Selected Sectoral Effects," September 2007, http://www.usitc.gov/publications/332/pub3949.pdf.
4. Ibid., ch. 2 and Appendix F.
5. Coalition for a Prosperous America, "Request for Delay of Economic Analysis of TPP and Upgrading of Methods," letter to Meredith M. Broadbent, chairman, U.S. International Trade Commission, February 26, 2015, http://www.prosperousamerica.org/news_release_international_trade_commission_refuses_to_respond_to_cpa_letter.
6. Ibid.
7. United States International Trade Commission, "U.S.-Korea Free Trade Agreement," p. xvii.
8. Ibid.
9. American Federation of Labor – Congress of Industrial Organizations (AFL-CIO), "Issues, Trade, NAFTA," 2015, http://www.aflcio.org/Issues/Trade/NAFTA.