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Journal of International Economics 59 (2003) 367–397

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**Journal of  
INTERNATIONAL  
ECONOMICS**

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## Gradualism in free trade agreements: a theoretical justification

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Received 29 September 1999; received in revised form 22 February 2001; accepted 26 September 2001

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### Abstract

A notable feature of many recent trade agreements is the gradual, rather than immediate, reduction of trade barriers. In this paper we model trade liberalization as a cooperative relationship that evolves gradually in a non-cooperative environment. We show that specialization, capacity irreversibility and the development of trade-partner specific capital increase the benefit of continuing the liberalizing relationship and decrease, over time, the lowest obtainable self-enforcing tariff. By increasing the penalty of future defection, sunk costs ensure that the self-enforcing trading relationship starts slowly, but once in progress the level of cooperation continues to improve.

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*Keywords:* Trade negotiations; Gradualism; Irreversibilities; Economic integration; Dynamic games

*JEL classification:* F13; F15; C73

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### 1. Introduction

A notable feature of many trade agreements in the post World War II era is the gradual, rather than immediate, reduction of trade barriers. For example, European, Japanese and U.S. average tariffs have declined by over 90 percent since the first GATT round. These gradual reductions are partly attributable to deeper tariff cuts in successive GATT rounds, partly attributable to an increase in the types of trade

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barriers addressed by the GATT and partly attributable to an expansion in the number of sectors covered by the GATT. Furthermore, starting with the Kennedy round negotiations, new tariff reductions were given an explicit phase-in period. Many regional and bilateral agreements exhibit these same incremental reductions and well-detailed phase-in periods.<sup>1</sup>

Because of their smaller scale, bilateral trade agreements allow us to more clearly see the gradual increase in economic integration that may be generating these incremental reductions. For example, recent trade agreements with Canada, Israel and Mexico were preceded, if not initiated, by a unilateral reduction in U.S. tariffs levied against the prospective partner. As a result of this conventional unilateralism these countries increasingly oriented their exports toward the U.S. and were, therefore, more susceptible to a subsequent increase in aggressive unilateralism (increased use of anti-dumping duties, countervailing measures and safeguard actions) by the U.S. The free trade agreement essentially constituted a reciprocation of the U.S. tariff reductions along with a promise of further concessions by both parties. The U.S.–Israel free trade agreement provides a straightforward example. The agreement called for the removal of all tariffs and many other forms of protection over the course of a ten-year period beginning with implementation on September 1, 1985. The U.S. tariff reductions were quick, and relatively easy, with many Israeli goods already entering the U.S. duty free under the U.S. Generalized System of Preferences.<sup>2</sup> The first order of the agreement was, therefore, essentially a reciprocating reduction in Israel's tariffs against U.S. imports. In response, the U.S. was to curb its use of aggressive unilateralism. Israel would then liberalize some of its licensing procedures. Furthermore, a nonbinding commitment to liberalize trade in services between the partners was part of the U.S.–Israel agreement.

As illustrated above, there is a similarity in the gradual steps that were taken in large multilateral agreements, such as the GATT, and in many regional and bilateral agreements. In the bilateral agreements, we also see an example of the mechanism that could lead to this gradualism process: Initial tariff reductions may lead to a growing interdependence between the trading partners.

In this paper, we develop a simple model that addresses these stylized facts.

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<sup>1</sup>In Mercosur, for example, which was formed on March 26, 1991, tariffs levied by Argentina and Brazil were to decline by sixty-one percent by June 30, 1992 and by one hundred percent by December 31, 1994. Paraguay and Uruguay were given an additional phase in year. In addition to the covered sectors, the treaty outlined plans for harmonization on intellectual property protection and foreign direct investment and found the possibility of future harmonization on anti-dumping duties and countervailing measures to be desirable. For more on Mercosur, see Rowat et al. (1997).

<sup>2</sup>Israel's accession to the GATT, as part of the agreement, and its subsequent receipt of MFN status further reduced the number of Israeli exports subject to U.S. tariffs. Approximately eighty percent of Israeli exports to the U.S. and fifty percent of U.S. exports to Israel entered duty free on the agreement's inception. Naturally, the most sensitive sectors had the longest phase-in periods. For more on the U.S.–Israel free trade agreement, see Rosen (1989).

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