

Preference Erosion and the Doha Development Agenda*

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Introduction

Non-reciprocal trade preferences have long been granted by industrialized countries to various developing countries. In 1968, the UN Conference on Trade and Development (UNCTAD) recommended the creation of a ‘Generalized System of Preferences’ (GSP) under which industrialized countries would grant trade preferences to all developing countries on a non-reciprocal basis, not just to former colonies. Since then a plethora of non-reciprocal preferential access schemes have been put in place by OECD countries, including national GSP programs, GSP+ programs for the Least Developed Countries (LDCs) such as the EU Everything but Arms (EBA) initiative, and special arrangements for subsets of developing countries such as the African, Caribbean and Pacific (ACP) countries (under various conventions with the EU), Africa (the US African Growth and Opportunity Act – AGOA), the Caribbean (the US Caribbean Basin Initiative), etc.¹

Trade preferences are a central issue in ongoing efforts to negotiate further multilateral trade liberalization in the Doha round. Middle-income countries are increasingly concerned about the discrimination they confront in OECD markets as a result of the better access granted to “more preferred” countries, not just developing but also other industrialized countries because of free trade agreements. Conversely, LDCs and non-LDC ACP countries worry that general, most-favored-nation (MFN)-based liberalization of trade will erode the value of current preferential access regimes. Preference receiving countries are also concerned about the potential negative terms of trade effects of multilateral liberalization insofar as this raises the price of their imports, especially of goods that currently benefit from subsidies and protection in OECD markets, by more than the price/quantity of their exports.

Preference erosion has been ongoing for years as a result of trade liberalization in preference-granting countries and the pursuit of regional trade agreements. The most recent example of a significant preference erosion shock was the implementation of the Agreement on Textiles and Clothing (ATC) on January 1, 2005, which confronted all countries with the prospect of much greater competition from the lowest-cost suppliers of textiles and apparel—especially China—as quantitative restrictions on exports were removed. While this was not due to the removal of a program that was explicitly aimed at granting preferential access, the effect of the quotas was to give less competitive producers an advantage in contesting a highly restricted market.

¹ In practice, non-reciprocity is a bit of a misnomer as the preferential access is often conditional on non-trade-related actions or behaviour by the recipient countries.

Preferences were designed to be an instrument to promote trade. Insofar as they generate rents for exporters they act as a mechanism to transfer resources from OECD consumers. By raising returns, they imply a financial transfer—an improvement in the beneficiary countries' terms of trade. Insofar as they encourage investment in 'nontraditional' activities – a major rationale for these programs when they were designed in the 1960s – they may also stimulate export diversification. The extent to which they achieve the latter objective may be affected by the magnitude of rents available in traditional products: by encouraging trade in sectors where there are rents, preferences induce specialization in those sectors, which may work against export diversification objectives. In assessing the magnitude of the effects of erosion much will depend not only on the depth of liberalization by preference-granting countries—e.g., the extent to which sectors such as sugar, beef, rice and apparel are opened up—but also on what other countries do and the actions of the preference-receiving country itself to improve the productivity of national firms and farmers.

A premise of this paper is that non-discriminatory liberalization by WTO members has the characteristics of a global public good. Preferences are distortionary and help generate increasing preferential trade in the world trading system as excluded (less-preferred) countries confront incentives to negotiate reciprocal free trade agreements (FTAs) with major donor countries. This is not to deny preferences are legitimate or to say that they do not benefit recipients. What is needed is an explicit transition strategy that moves the trading system back towards nondiscrimination. This strategy must recognize the adjustment costs this shift will impose on the beneficiaries of preferences and include a credible commitment that alternative instruments will be used to by rich countries to offset the losses associated with a move towards nondiscriminatory trade policies.

The plan of the paper is as follows. Section 1 briefly reviews some of the literature assessing the value of preference programs and potential losses from erosion. Section 2 turns to potential policy responses. It argues that from a "mercantilist" perspective what matters is that the loss of benefits stems from the removal of a specific policy that has been put in place by OECD countries, and that these countries therefore should offer compensation for these losses. Moreover, such compensation should occur outside the WTO system, i.e., not involve new forms of discrimination in trade. Section 3 argues that assistance for preference erosion should be considered as part of a broader response by OECD countries to calls to make the trading system more supportive of economic development. One reason for this is that erosion has been and will continue to be an ongoing process, with or without a Doha Round. More important is that many developing countries have not been able to benefit much from

preferences. This suggests the focus should be on identifying actions and policy measures that will improve the ability of developing countries to use trade for development. This spans not just an expansion of “aid for trade” but also different approaches to special and differential treatment of developing countries in trade agreements, which is briefly discussed in Section 4. Section 5 concludes.

1. Preferences: Stylized Facts and Recent Research

The rationale for nonreciprocal preference programs was elaborated by Raúl Prebisch and Hans Singer in the late 1950s and early 1960s (see UNCTAD 1964).² Their main argument was that developing countries needed to foster industrial capacity both to reduce import dependence and to diversify away from traditional commodities that were subject to declining long run terms of trade and adverse price volatility in the short-term. Part of the recommended policy prescription was trade barriers to protect infant industries—i.e., import-substitution industrialization. At the same time, it was recognized that exports were needed to generate foreign exchange and that the local market is generally too small for domestic industry to capture the economies of scale that accompanies industrial expansion. Preferential market access would help bolster the needed exports.

Most of the problems associated with the implementation of preference programs were already identified in the 1960s, including by proponents. Thus, UNCTAD (1964) recognized that preferences could have negative impacts on the process of multilateral MFN-based trade liberalization. It also foresaw one of the problems that has plagued the implementation of preference programs, namely, which countries should be eligible and for how long? The report argued that preference margins should decrease as the income levels of beneficiaries increased, and recognized that administrative issues such as documentary requirements could reduce the benefits of preference programs.

Gardner Patterson (1965) elaborates in detail many of the criticisms that have been raised repeatedly against preferences since the mid 1960s. He questions whether preferences are the most efficient way to help developing countries, noting that preferences could lead to specialization in products where the beneficiary country did not have inherent comparative advantage, resulting in socially wasteful investment; that they might generate political frictions among beneficiary and excluded countries, as well as among developing countries that are at different stages of development. He also noted that OECD parliaments would have

² UNCTAD was founded in 1964, with Raúl Prebisch as the first Secretary-General.

to get involved in the process of granting preferences, opening the gates to excessive conditionality and tailoring of the product coverage of programs to assuage protectionist pressures. In this connection, Johnson (1967) noted that preferences will yield the highest benefits to developing countries in sectors that are the most protected in high-income countries—making it difficult to implement meaningful preference schemes. In practice agricultural products, textiles and apparel frequently have been excluded from preference programs. Johnson was also concerned that donor countries would use preferences for political purposes “to reward and punish the recipients for their behavior and performance” in non-economic areas (p.199). Hudec (1987) argued that because under GATT preferences were not contractual obligations, their value was limited in that the moment beneficiary countries increased their exports considerably they were likely to lose eligibility (be “graduated” out of the program).

Researchers have returned again and again to these issues. They note that exclusions reduced the value of preferences and that preferential access can only have an impact if there is a non-zero tariff in the importing market. Two-thirds of the major items Africa exports to Canada, for example, already faced zero MFN tariffs before the 2003 initiative in favor of LDCs. Similarly, before EBA was introduced in 2001, some 69 percent of EU imports from Africa (by value) were in items facing zero MFN duties (Stevens and Kennan, 2004).

Research has also documented that compliance costs (paperwork, red tape, documenting origin, etc.) are significant. The average estimate in the recent empirical literature is that documentary requirements imply costs of some 3-5 percent of the value of processed goods (Brenton and Manchin, 2003; Brenton and Ikezuki, 2004; Anson et al. 2003; Candau et al. 2004; Carrère and de Melo, 2004). This requires MFN tariffs to exceed 4 percent on average for preferential access to be meaningful. Given that the average MFN tariff in OECD countries is only 4 percent or so, preferences can only matter where there are tariff peaks or quotas (Hoekman, Ng and Olarreaga, 2002).

Moreover, to the extent there is market power on the part of either importers (distributors) (Francois and Wooton, 2005) or the transport and logistics sector (Francois and Wooton, 2001), the terms of trade benefits of preferential tariff reductions may be captured in part by these intermediaries rather than the exporters (although any diversification benefits will remain). If preferences apply to highly protected sectors in donor countries, they will result in high rents for those able to export free of trade barriers. However, buyers will know the existence of these rents, and if they have the ability to set prices (have market power), the rents may predominantly be captured by distributors or other intermediaries (Tangermann,

2002). There is evidence, based on the AGOA preference scheme, that the pass through of preference margins is indeed partial at best. Olarreaga and Özden (2005) find that the average export price increase for products benefiting from preferences under AGOA was about 6 percent, whereas the average MFN tariff for these products was some 20 percent. Thus, on average exporters received around one-third of the tariff rent. Moreover, poorer and smaller countries tended to obtain lower shares—with estimates of the share of the rent ranging from a low of 13 percent in Malawi to a high of 53 percent in Mauritius.³

Finally, numerous researchers have argued that for preferences to have value, the beneficiary countries need to have an export capacity in the products for which preferential access is granted (e.g., Page and Kleen, 2005). Many low-income countries simply do not have the capacity to exploit preferences, either not having productive facilities at all or not being able to compete even with the price advantage offered by the preference due to internal transactions and operating costs. Preferences were conceived as instruments to assist countries with supply capacity to diversify and expand their exports. They have little value for countries that do not have such capacity yet.

Estimates of the Impact of Erosion due to a Doha Round

The available research suggests that erosion of all remaining preferences, both GSP and the deeper, more recent, preference programs such as EBA and AGOA, would have a substantial impact on some countries, especially those with high concentration of exports in heavily protected commodities. Relatively big impacts are concentrated in small island economies and a number of countries specialized in sugar, bananas and to a lesser extent garment exports (IMF, 2003; Stevens and Kennan, 2004). These are the commodities where protection and therefore preference margins are high. Of the LDCs, Cape Verde, Haiti, Malawi, Mauritania, and São Tomé and Príncipe have been argued to be most vulnerable to preference erosion (IMF, 2003). Alexandraki and Lankes (2004) conclude that a small number of middle-income countries—Belize, Fiji, Guyana, Mauritius, St. Kitts and Nevis, St. Lucia—would also be significantly affected, with predicted export declines ranging from 11.5 percent for Mauritius to 7.8 percent for Fiji.⁴

³ See Ozden and Sharma (2004) for a similar analysis of the US CBI program. Francois and Wooton (2005) obtain similar size-dependent results in an analysis of the incidence of markups along the distribution chain.

⁴ The only large country expected to suffer from preference erosion is Bangladesh, which has benefited significantly from the textile quota restrictions imposed on other large competitive developing countries such as China, and which were removed at the end of 2004 under the WTO Agreement on Textiles and Clothing. However, as discussed below, these costs are already “sunk” in that the shock has already occurred.

The costs of preference erosion need to be set against gains from MFN liberalization—both for the recipient country and other developing and least developed countries. While preferred countries stand to lose from tariff reductions in sectors or products where preferences matter, they also stand to benefit from improved access to global markets—including restrictive developing country markets. Thus, preference erosion will be offset by the compensatory effect of broad-based multilateral liberalization. In addition, however, research suggests that what matters most in terms of own reform by recipient countries is the pursuit of complementary reforms and public investments that enhance the productivity of firms and farmers (World Bank and IMF, 2005). Finally, implementation and transition periods also matter, as does the depth and scope of global reforms. Erosion will take time—any MFN reforms will be implemented gradually over several years.

What follows briefly discusses some recent studies that quantify the potential income effects of preference erosion. It is helpful to start with an assessment of the value of the transfers being generated by preferential regimes.⁵ The simplest measure of these transfers is the difference between the applied tariffs facing a country and the MFN tariffs that would apply on its exports in the absence of a preferential agreement. This measure is an upper bound on the transfers since many countries may receive preferences, implying that the true preference margins for a country should be adjusted for the preference margins being received by other countries (Low et al. 2005). Unfortunately, little analysis has been done on these “true” preference margins, forcing one to rely on the “non-adjusted” simple margin of preference as an indicator of the overall per unit value of preferences (Table 1).

There are some important conceptual differences between the measures presented in Table 1. Those calculated by Brenton and Ikezuki (2005) give the margin relative to the overall value of exports from the country to the granting market. By contrast, Low, Piermartini and Richtering (2005) refer to the margin only on those exports for which there is a non-zero duty and a positive apparent preference. Despite these methodological differences, Table 1 suggests substantial consistency between the alternative measures. The average margins generally tend to be higher in Europe relative to the other markets, while average preference margins are lower in Japan than in the EU or the US. There are surprisingly small gaps between the preference margins granted to LDCs and to developing countries as a whole (i.e., the GSP) in the EU, the US and Japan. In contrast, Canada and Australia appear to give substantially higher margins of preference to the LDCs, with the margin more than twice as

⁵ What follows draws on Hoekman, Martin and Primo Braga (2005).

high for LDCs as for developing countries as a whole. A similar result was found in World Bank and IMF (2005) using a measure of the overall tariff equivalent of the trade policies. The latter measure includes nontariff measures such as health and safety standards (sanitary and phyto-sanitary measures) applied by the OECD countries – policies that are not affected by preference programs.⁶

Table 1. Estimated preference margins for developing countries, percentage points

<i>Granting countries</i>	EU	EU	US	US	Japan	Japan	Canada	Aust	Quad + Aust
<i>Beneficiaries:</i>									
LDCs	6.6 ^a	4.1 ^d	3.2 ^a	2.6 ^d	2.6 ^a	10.9 ^d	4.2 ^d	3.6 ^d	4.6 ^d
Sub-Saharan Africa	4.0 ^b		1.3 ^b		0.1 ^b				
African LDCs	2.3 ^b		2.1 ^b		0.4 ^b				
LIX	3.8 ^c		0.5 ^c						
All	3.8 ^a	3.4 ^d	2.6 ^a	2.6 ^d	2.0 ^a	3.4 ^d	1.6 ^d	1.5 ^d	3.4 ^d

Notes: Aust: Australia. LDCs refer to the UN list of Least Developed Countries. LIX refers to World Bank Low Income Countries excl. India. All refers to all potential recipients of GSP; Quad = Canada, EU, Japan and US. Sources: a. Subramanian (2003, p8); b. Brenton and Ikezuki (2005, p.27); c. van der Mensbrugge (2005); d. Low, Piermartini and Richtering (2005).

A measure of the overall value of preferences corresponding with the preference margin numbers in Table 1 can be obtained by multiplying the margins by the value of imports to which they apply. Table 2 reports such figures, using the Low, Piermartini and Richtering (2005) margins and associated trade numbers, as that study has both disaggregated and up-to-date estimates of the imports subject to preferential treatment.

Table 2. Estimated ‘value’ of preferences to developing countries, US\$ million

	EU	US	Japan	Canada	Australia	Quad+
LDCs	287	131	49	14	0.4	587
All	4,945	3,953	743	215	46	11,565

Table 2 provides some perspectives on the source of potential gains from preferences. Of the total of \$587 million estimated potential value of the preferences to LDCs, \$287 million, or almost half, is provided by the EU. The US is the next largest provider, at \$131

⁶ Indeed, the analysis of overall OECD trade restrictiveness concludes that nontariff measures account for over half of total trade restrictiveness, suggesting that this should be a much more prominent focal point for policy.

million per year. Japanese preferences amount to almost \$50 million per year, while Canada and Australia are much smaller at \$14 million and \$0.4 million per year. The comparison of the preferences received by LDCs and other developing countries shows that the bulk of preferences accrue to non-LDCs, reflecting the small share of LDCs in total developing country exports.

Such simple trade value calculations provide little information on the impacts of preference programs on economic variables such as real income or welfare. Focusing on the LDCs and using a global general equilibrium model and the latest version of the Global Trade Analysis Project (GTAP) database that incorporates data on the major OECD preference programs (Bouet et al. 2004), Francois, Hoekman and Manchin (2005) conclude that complete preference erosion due to MFN reforms in the EU—including in agriculture—would impose a welfare (real income) loss of some \$460 million on African LDCs and an additional \$100 million on Bangladesh. This assumes away the fact that compliance costs reduce the effective value of preferences for manufactured products. Limão and Olarreaga (2005) also undertake an analysis of the welfare effects of complete preference erosion. They calculate what the income transfer to LDCs would need to be so as to be equivalent to the transfer implied by existing preference programs. They conclude that for LDCs the figure is \$266 million. This is a one-year, short-run effect—all else equal the net present value will be several times higher. This brings their results in line with those of Francois, Hoekman and Manchin (2005), although the results are not strictly comparable given that Limão and Olarreaga use partial equilibrium methods.

Using a variety of techniques, Grynberg and Silva (2004) estimate the losses in income transfers to producers in trade-preference-dependent economies at \$1.7 billion annually. They argue that producers will require 14 to 20 years to adjust, implying a total net present value of losses ranging from \$6 billion to \$13.8 billion. An important feature of this analysis is that it includes the impacts of abolishing quotas on exports of textiles and clothing. This accounts for \$1.1 billion of the total of \$1.7 billion loss estimate. Van der Mensbrugge (2005) concludes that existing preferences generate an additional \$1.6 billion in income for low-income developing countries, as compared to a counterfactual MFN-only regime. Here also the inclusion of ATC quota rents accounts for a major portion of the benefits. In contrast, the erosion of ATC quota rents is included in the baseline scenario in Francois, Hoekman and Manchin (2005). Francois et al. note that if the ATC abolition is included, this imposes erosion costs on negatively affected developing countries that are some ten times larger than the potential overall erosion of remaining preferences under a Doha Round. The estimated

losses reflect a combination of greater competition from China and loss of quota rents. To some extent this erosion has already been incurred, as liberalization of quotas started at the end of the Uruguay Round.⁷

If the analysis centers on preference erosion in the broader context of potential tariff reduction by all OECD countries—or all WTO members, including developing countries—the magnitude of the total erosion loss is generally reduced. This reflects the fact that the EU has been the most intensive user of preferences and that it is also the entity that has the most extensive trade-distorting policies in a key sector for poor countries: agriculture. Preference programs in other OECD countries have tended to be subject to more exceptions in terms of product coverage (an example is the non-inclusion of apparel in US GSP programs). Thus, the gains associated with MFN tariff reductions by non-EU OECD countries will partially offset losses due to MFN liberalization by the EU. In the case of Sub-Saharan Africa, Francois, Hoekman and Manchin (2005) conclude that overall losses could be reduced by a factor of four—to \$110 million, with low-income countries in Asia standing to gain substantially.

If compliance costs are also considered in the analysis, the incidence and magnitude of preference erosion changes further, as such costs vary across commodities. For Bangladesh, which is specialized in high tariff categories like clothing that are subject to restrictive rules of origin, including compliance costs substantially reduces the magnitude of potential erosion. For some countries such as Madagascar, potential losses turn into potential gains, reflecting the substantial export capacity in apparel. For countries specialized in agriculture, however – Malawi and Zambia for example – the effects of accounting for compliance costs are much smaller as such costs are not a big issue for relatively unprocessed products (Stevens and Kennan, 2004; Bouet et al., 2006; Candau et al. 2004).

Ignoring compliance costs and the incidence of the distribution of rents, estimates of total preference erosion losses for low-income countries therefore are in the range of \$500-\$1.7 billion, with much depending on whether the ATC is included in the analysis or not.⁸ The magnitude of estimates of preference erosion from even an ambitious Doha round tend to be less than the erosion that is associated with elimination of textile and clothing quotas on

⁷ ATC restrictions implicitly favoured smaller, higher-cost developing country suppliers at the expense of exports from China. While implementation of the ATC was staged, the major importing countries heavily back loaded implementation, resulting in a much greater than necessary adjustment shock at the end of the 10-year transition period than was necessary.

⁸ Figures are higher if the focus extends to middle income countries, some of which—e.g., Mexico—stand to suffer potentially substantial losses as preferential access to the US and Canada is eroded. The focus in this paper is primarily on low-income, weak and vulnerable economies.

developing country exports. For example, Francois, Spinanger and Woertz (2005) find that the removal of ATC textile restrictions is detrimental for sub-Saharan Africa, although the impact is smaller than for Asian countries such as India and Vietnam. However, the ATC-induced negative impact on Africa is smaller than the estimates of the potential magnitude of Doha Round preference erosion found by Francois, Hoekman and Manchin (2005) if no account is taken of compliance costs. If such costs are considered—which they estimate to average 4 percent—the potential Doha trade preference losses are smaller than those associated with lifting of ATC textile and clothing quotas. One reason is that the rents associated with the latter were equivalent to tariffs well above any realistic threshold value of compliance costs.

A key conclusion that emerges from the literature is that future losses will largely be due to the elimination of rents that were created by quota-determined access to specific markets (sugar, bananas). The magnitude of the transfers associated with these products for preferred countries is a multiple of the value of preferences on other goods for most countries. The quota-driven benefits to those countries that get them are essentially equivalent to a financial transfer – there are no export diversification effects associated with these preferences.

2. Possible Policy Responses

Taking into account supply capacity constraints, the costs of satisfying documentary requirements, the fact that rents will be shared with intermediaries in the importing country, recent studies conclude that the aggregate (net) magnitude of erosion for poor countries will be limited. However, the stand-alone impact of the removal of preferential access to the most distorted markets (mostly those in the EU) will be significant for a relatively small number of countries. This then raises the policy question whether the focus should be on the overall economic net effects taking into account possible (feasible) policy responses, or whether the focus should be on the loss incurred in those markets where preferences matter, ignoring any possible offsetting effects. From a narrow ‘compensation’ perspective the second focal point is arguably the more appropriate metric of the magnitude of erosion of benefits that stem from removal of a specific policy put in place by OECD countries. The work summarized briefly above suggests that the magnitude of losses to LDCs is on the order of \$600 million, with perhaps a similar amount for preference-dependent middle-income countries.

Abstracting from the important issue of how to determine the amounts involved – a question that clearly must be negotiated⁹ – various approaches can be identified in responding to preference erosion losses. One is to seek compensation *within* the trade negotiating agenda or trade regime—i.e., negotiate measures that will improve market access and the terms of trade of the countries affected by preference erosion. Another is to address this matter *outside* the WTO and to rely on non-trade instruments.

‘Within’ Solutions

Possible solutions within the ambit of the trade regime include non-liberalization of products that are of greatest value from a preference point of view. While no doubt an approach that will resonate with the vested interests in the OECD that are seeking to maintain the status quo, clearly this would impose a significant opportunity cost from a global efficiency perspective – essentially substantially reducing the potential global gains from a Doha Round. Other options “within” the trading system are to expand preferential access to major emerging markets, to reduce the costs of rules of origin—through harmonization towards the most liberal common denominator (Commission for Africa, 2005)—or to provide discriminatory access in other areas—e.g., better access for service suppliers through mode 4 under the GATS. The latter is already occurring on a bilateral basis, outside the WTO, as reflected in special arrangements or relationships between OECD members and specific developing countries.

Arguably efforts to move down such discriminatory paths in the WTO are not desirable, the exception being an immediate and substantial simplification and liberalization of rules of origin.¹⁰ A major rationale for seeking to shift away from using preferential trade as a form of aid is that it undermines the fundamental principle of non-discrimination as well as create incentives to impede MFN liberalization.¹¹ Of course, non-discriminatory solutions could also be pursued within the trading system. An example would be to target MFN liberalization on goods and services developing countries have a comparative advantage in. Another is to ensure that MFN liberalization proceeds gradually to allow for adjustment to

⁹ Hoekman and Prowse (2005) discuss several options that could be used as the basis for quantification of erosion.

¹⁰ This would be of transitional value to beneficiaries, and could for a period of time act to maintain *effective* preference margins insofar as the relaxation of rules of origin lowers the threshold under which it is too costly to comply with origin requirements thereby offsetting the reduction in MFN tariffs that are agreed in the Doha Round. However, as MFN rates fall to zero, rules of origin will become irrelevant. In the WTO negotiations agreement on relaxed rules of origin could be sought through the WTO rules group (as part of a revision of Article 24) or the special session of the Committee on Trade and Development (as part of the talks on SDT).

¹¹ See Limão (2005) for some recent empirical evidence for such a stumbling block effect.

occur of a number of years. Yet another would be to rewrite rules so that that they benefit poor countries more, even if it comes at the expense of rich country interests. Much of what is discussed in the WTO under the heading of “special and differential treatment” and implementation of negotiated commitments revolves around perceptions that the existing rules are not fully supportive of development prospects. As discussed later in this paper, a willingness to address these concerns could help to offset preference erosion losses. While this would be beneficial – and indeed desirable in its own right to make the WTO more ‘development friendly’ – it is not easy to identify trade-based solutions that are consistent with the MFN principle while appropriately targeting those countries that are most affected by the erosion of preferences. Solutions within the trade area therefore will generally have to be premised on continued acceptance by WTO members of discrimination across trading partners.

The adoption by all OECD countries as well as larger emerging markets of an analogue to the EU’s Everything But Arms (EBA) initiative to grant duty and quota free access to all goods exported from all LDCs illustrates this. It is a ‘within-trade’ solution that has been put forward by a number of WTO members and has been endorsed by the international community as a target to be achieved in the pursuit of the Millennium Development Goals. While it would be of some value to the LDCs, many of the poorest countries today have not managed to diversify and expand exports *with* the preferences they already receive as a result of supply capacity or competitiveness constraints. This suggests that granting preferences to additional markets for the poorest countries is unlikely to yield much benefit. Moreover, such an expansion will not do much to offset the loss in rents associated with the quota-guaranteed access to highly distorted EU markets for products such as sugar and bananas, as emerging markets do not maintain such programs.¹²

Solutions ‘outside’ the trading system

The major alternative solution to erosion is to use a non-trade instrument—financial transfers (development assistance). One reason for pursuing this avenue is that the research summarized above finds that in monetary terms the primary negative impact of erosion follows from the removal of specific trade barriers in specific OECD countries. That is, the

¹² As mentioned previously, if the country reach of preferential access programs is expanded, it is important that they be associated with simple, liberal rules of origin. Here again, however, it should be borne in mind that these are only important for processed goods – not the commodities that many LDCs export.

erosion problem is primarily a bilateral issue that should therefore be resolved on a bilateral basis, in the sense that those imposing the costs should bear the burden of offsetting them.

A number of initiatives have been taken in recent years to assist countries to better exploit trade opportunities and deal with adjustment pressures. These include the Integrated Framework for Trade-Related Assistance (IF) and the IMF's Trade-Integration Mechanism. In addition to these trade-specific initiatives, multilateral development banks support trade-related investments and provide technical assistance when requested by client governments. While such assistance has been expanding in both absolute and relative terms—see World Bank and IMF (2005)—these institutions do not provide earmarked funding for trade adjustment purposes.

The one exception is the IMF's Trade Integration Mechanism (TIM). It was developed to help countries expecting short-term balance of payments difficulties in coping with the effects of multilateral liberalization (IMF, 2004). The TIM is intended to address not only preference erosion but also covers balance of payments shortfalls as a result of removal of apparel export quotas under the WTO Agreement on Textiles and Clothing and the possible impact on net food importing developing countries of higher food import prices following agricultural policy reforms in OECD countries. The TIM is not a new facility but operates through existing IMF instruments. This ensures that the impact of possible adjustment costs resulting from specific shocks such as preference erosion is considered and placed in the context of a country's overall macroeconomic policy framework. The usual IMF policy conditionality and terms and costs of lending apply. Therefore the impact of assistance on a country's external debt burden would need to be taken into account.

The Integrated Framework for Trade-Related Technical Assistance (IF) focuses much more on the "structural" agenda as opposed to dealing with short-term macroeconomic impacts of external shocks. Limited to the LDCs, the IF brings together the key six multilateral agencies working on trade development issues—the IMF, the International Trade Centre, UNCTAD, the UN Development Programme, WTO and the World Bank—and seventeen bilateral donors (including Canada, the EU, Japan and the USA). The basic purpose is to embed a trade agenda into a country's overall development strategy, usually the Poverty Reduction Strategy paper (PRSP). The process starts with a diagnostic analysis. This assessment looks at a number of issues, including the complementary policy agenda necessary to support successful trade reform, and generates a proposed action matrix of trade-related capacity building and assistance needs. Funding for the trade capacity building priorities is sought through the Consultative Group and Round Table meetings associated with the PRSP

process where donors (both multilateral and bilateral) are asked to make financing pledges for specific projects/programs. Given that trade-related priorities must compete with other priority sectors, financing is not ensured.

These existing mechanisms do not directly address the concerns of developing countries regarding preference erosion. The TIM involves loans, and implies therefore that the costs of adjustment to erosion will be borne by the countries that lose preferential access to markets. Moreover, the focus is on the short term, macroeconomic effects—that is the *net* effects taking into account all policy changes and responses, not just the removal of preferential access. Thus, there is no element of “offsetting” the losses incurred—the bilateral nature of the problem is ignored. The IF focuses purely on the national trade-related agenda of LDCs, whatever to underlying source or causes.

The most direct and simplest solution to erosion concerns would be for donor countries to agree to directly transfer resources to address preference erosion losses incurred as a result of MFN trade reforms (Page, 2004; Page and Kleen, 2005). The rationale for doing so is that this would help realize the potential global efficiency and welfare gains associated with an ambitious Doha Round outcome by offsetting the associated impact losses for developing countries. Page and Kleen (2005) argue that as global liberalization is a public good, it would be incorrect to consider the compensation as aid. They therefore propose that a compensation fund be housed at the WTO and not with development institutions. How donor countries would provide resources would be a matter of “choice”, although the level of contributions would be determined by various criteria (for example share of trade, income, past commitments and use of preferences). Given that the funds would be regarded as compensation for the removal of a prior benefit, funding should be allocated without conditions to beneficiary countries according to the estimation of loss of preferences. The fund would need to be secure, leading Page and Kleen to argue that voluntary commitments need to be made ‘legally irrevocable’ i.e., constitute a binding (WTO) commitment.

Grynberg and Silva (2004) have made a similar proposal. They suggest the establishment of a Special Fund for Diversification (SFfD) to mitigate the impact of the erosion of preferences due to MFN liberalization. A distinct feature of this proposal is that financing (from pooled donor funds) “commensurate with preference losses” would be provided for private sector-led export diversification investments. A share of SFfD funds would be set aside for a private sector window to facilitate investment start-up expansion by small and medium-sized enterprises (SMEs), restructuring or rehabilitation in non-traditional sectors. Remaining funds would be provided for a public sector window for enabling

infrastructure investments, as well as for optional technical assistance and social safety net windows. The emphasis on the private sector as a recipient of preference loss compensation funds would go some way to addressing a specific aspect of preference programs—that they directly benefit exporters. Under their proposal this constituency would have the prospect of some direct compensation.

Another option has been suggested by the UN Millennium Taskforce on Trade (2005), which argues that one element of a solution could involve income support programs for farmers and producers of specific goods that have benefited from high rates of protection. While such programs are targeted at the *domestic* producers of preference granting countries and are intended to be a vehicle to facilitate a shift away from production support, negatively affected producers in developing countries that benefited from preferential access could also be assisted by including them in the support program. Elements of this approach could be extended to other highly distorted markets where preferences matter and where producers will confront adjustment costs as market price supports are lowered. There is an obvious political economy rationale for such programs, and extending support to affected producers in developing countries would also take seriously the arguments made by groups in OECD countries that continued preferences (and thus market price support) are needed to assist producers in developing countries.¹³

All of these types of programs raise concerns in that those who have benefited the most from preferences are not necessarily the poorest or most vulnerable. Indeed, by definition the assistance will be granted to those who have been most able to benefit from preferences. Within recipient countries, some of these beneficiaries will be located among the higher income groups in society, raising equity considerations. In addition, the suggestions for a dedicated preference erosion compensation mechanism of some kind go against principles of aid effectiveness and enhancing international policy coherence (IMF and World Bank, 2004). Approaches along these lines were explicitly rejected in IMF and World Bank (2005), a paper discussed at the 2005 annual meetings of the governors of these institutions. The view taken there was that existing mechanisms should be used to address the adjustment costs of erosion, on the basis of a case-by-case assessment.

As a development tool stand-alone specific funds and associated mechanisms are unlikely to find widespread support among donors and development institutions insofar as

¹³ A small step in this direction was taken by the EU in its most recent reform of its sugar regime, under which ACP producers were allocated €40 million in income transfers. This compares to €1.5 billion in compensation payments to EU producers.

they are not integrated into national poverty reduction and development strategies. This suggests funding for adjustment and to enhance competitiveness should be provided within the context of an overall country development program – as is the case under the IF (for the LDCs). However, from a trading system (and Doha negotiation) perspective, a counter-argument is that if concerns about the erosion of trade preferences are not addressed explicitly and credibly, non-discriminatory trade liberalization by WTO members may become less feasible and be less deep than it otherwise might be and/or that “solutions” will be sought elsewhere within the trading system. Thus, there may be a significant opportunity cost associated with not dealing with this issue up front. Given that global liberalization has some of the characteristics of a global public good – everyone benefits in the medium term from the increase in efficiency that results from the removal of global distortions in prices – there is a case for taking action to facilitate the realization of this outcome.

Zedillo et al. (2005) suggest that the foregoing considerations justify transfers from preference-giving countries/trading blocs to each recipient that are equivalent to the assessed value of their current preference programs. Specifically, a binding commitment could be sought through which preference-giving countries/trading blocs accept to transfer the assessed value of current preference programs in the form of financial aid. This implies that assistance would be specific for each beneficiary country. Although such earmarking is generally not regarded as good aid policy, the global public good dimension of deep global reforms provides a justification in the case of preference erosion.

If such an approach is pursued, an alternative to establishing a separate fund and a parallel institutional structure would be to disburse commitments for each beneficiary country through the existing mechanisms through which aid is allocated, on the basis of a framework that places trade needs within a country’s overall development program. In the case of ACP countries the possibility exists of integrating the required compensation from the EU – which the research suggests will account for a large share of total potential erosion – into negotiations on the magnitude and structure of the 10th EDF – which is to cover the post 2007 period. In terms of quantifying the value of preferences, there is a (political economy) case that the transfers should be the equivalent of the bilateral “partial equilibrium” value of preferences received, that is, one that ignore the general equilibrium effects of other policy changes in other countries or the country itself (Hoekman and Prowse, 2005).

Whether there should there be stand-alone funding mechanisms to address specific areas of concern is a question that extends beyond preference erosion. Another example is trade facilitation – a negotiating area where an explicit link has already been established in the

Doha Round between implementation of new commitments by developing countries and the provision of financial and technical assistance. The latter could also be addressed via an expanded IF-type mechanism as long as this is extended to go beyond the LDCs, but specific funds may address the technical issues concerned in a more timely manner, as well as be more effective (credible) in addressing political (negotiating) concerns.

It is important to recognize that industries and households around the developing world confront adjustment costs as a result of both policy decisions and changes in tastes and technologies. The associated shocks often are/will be of greater magnitude than erosion. Adjustment to MFN liberalization will affect many countries, not just those that have benefited from preferences. The need to diversify is not unique to economies that have benefited from preferences but is common to numerous countries. Moreover, compensation will do little for those countries that have not been able to benefit from preferences. Any bilateral compensation will by necessity target only those countries that have successfully exploited preferential access opportunities. This last point suggests that whatever may be decided on compensation for preference erosion, countries that have proved unable to benefit much from such programs – which include many of the poorest countries – should be assisted through expanded aid for trade. The assistance needs of these countries in the trade area clearly are much greater than any estimate of the value of current preferences.

3. Aid for trade and complementary policies

Export diversification and development was the primary motivation for preferences. Many countries in the past have benefited from preferential access and have graduated from bilateral programs, and others continue to benefit. But many of the poorest countries have not managed to use preferences to diversify and expand exports. Given the systemic downsides, limited benefits, and historical inability of many poor countries in Africa and elsewhere to use preferences, a decision to shift away from preferential trade as a form of aid towards more efficient and effective instruments to support poor countries could both improve development outcomes and help strengthen the multilateral trading system. Tariffs are just a part of the overall set of factors constraining developing country exports—other variables include transport costs and nontariff measures that are often much higher (more costly) per unit of output than those confronting firms located in more developed countries. The same is true with respect to internal transactions and operating costs in these countries, which reduce competitiveness of firms. With or without preferences, benefiting more from integration into the trading system requires instruments aimed at improving the productivity and

competitiveness of firms and farmers in the poorest countries. Supply constraints are the primary factors that have constrained the ability of many African countries to benefit from preferences.¹⁴ This suggests that one need is to improve trade capacity and facilitate diversification. In part this can be pursued through a shift to more (and more effective) development assistance that targets domestic supply constraints as well as measures to reduce the costs of entering foreign markets.

A Doha reform package can be expected to generate sizeable gains to both industrialized and developing countries. The overall magnitudes of such gains are difficult to assess accurately—much depends on what is agreed and how it is implemented, and how much of the gains are transferred to compensate domestic losers—through expanded income support, for example. However, even under the most conservative estimates, the aggregate global gains will be significant. In absolute terms, high-income countries will gain more than developing countries, providing the means to engage in increased support and development assistance. What is important is recognition of need (additional resources for trade adjustment and integration) against the potential global benefits arising from further multilateral liberalization.

In undertaking trade reform and to participate effectively in the global trading system, poorer countries are faced with a gamut of economic and political concerns. On the economic side, adjustment costs will arise before offsetting investments are realized in other (new) sectors. Preference erosion is just one element of these costs. Some countries may confront deterioration in their terms of trade (e.g., some net food importers). Countries where tariff revenues make up a significant proportion of total fiscal resources will need to undertake tax reform. Adjustment costs are a function of policy changes—as mentioned previously, those associated with preference erosion will be gradual and tariffs are just a part of the hurdles facing exporters. A fundamental issue is that many of the poorest developing countries are ill equipped to take full advantage of (new) trade opportunities due to supply side, administrative capacity and institutional constraints. Improved market access without the ability to supply export markets competitively is not much use. Gains from trade liberalization are conditional on an environment that allows the mobility of labor and capital to occur, that facilitates investment in new sectors of activity—requiring, among other factors, an efficient financial system, good transportation/logistics services, etc. Inevitably for

¹⁴ See, e.g., Commission for Africa (2005), Page (2004), and Stevens and Kennan (2004).

most poor countries this requires complementary reforms prior to and in conjunction with the trade reforms.

On the political side, even accepting that trade is likely to generate global gains, the distributive and re-distributive dimensions of trade integration need to be taken into account if the political viability of the process is to be assured. Providing sizeable assistance has historically been of considerable importance in helping persuade countries of the benefits of integration. It played a significant role in building support for the liberalization measures undertaken as part of the creation of the European Economic Community. The post-war Marshall Plan was instigated in large measure to neutralize the forces moving Western Europe away from multilateral trade and to thereby facilitate global economic recovery.

Recognizing the importance of complementary policy actions and the need for support for adjustment and integration to achieve successful trade reform in low-income economies does not imply that the Doha Round should be any less ambitious or deliberately slowed. The reverse is true. Moving ahead multilaterally on a non-discriminatory basis will do most to help development. Trade reform undertaken in conjunction with concomitant “behind the border” policy measures and investments has significant potential to generate additional trade opportunities that would help lift a large number of people out of poverty (UN, 2004; World Bank and IMF, 2005). But it should be complemented by actions to redistribute some of the global gains to help address to trade and growth agenda in the poorest countries and make this more of a priority in aid programs—in the process helping to attain the original objective motivating preferential access regimes.

G8 countries have committed themselves to provide additional aid for trade. The issue now is to determine how such an expansion of resources will be managed and assistance delivered. At the September 2005 IMF/World Bank annual meetings agreement was reached on expanding the Integrated Framework for Trade-Related Technical Assistance by providing it with additional resources to undertake analyses of trade needs and to ensure that these trade needs are considered by governments and donors through existing development assistance mechanisms – the PRSP and consultative groups/donor roundtables. There was also agreement to consider extending the approach to span additional countries and the need to consider whether there should be a mechanism to address regional integration-related needs, not just country-specific actions.

There are several important open questions here that need to be considered:

- How to expand the IF approach to non-LDCs? There is a general recognition that aid for trade must go beyond the LDCs. In the case of ECOWAS, for example, there are

several non-LDC members – it makes no sense for these to be excluded. Whether the IF is the right instrument must be determined by WTO members given that the IF is a “WTO instrument” (it was set up by WTO members, and targets the only general sub-grouping of developing countries that is defined in the WTO – the LDCs). In practice a similar, parallel mechanism for non-LDCs may be the most straightforward way forward.

- Related to this is whether there should be a mechanism to address regional integration priorities. This is an important issue in many regions given that such integration has become a trade policy objective of many countries. Should this be made a part of an expanded IF – through the creation of regional window? Or is it more appropriate to develop stand-alone regional funds managed by the relevant regional bodies, in the process making it easier to extend aid for trade to non-LDCs?
- Whether there should be greater dedicated grant based funding for trade needs – to ensure that trade priorities will be financed on a timely basis. That is, should the process continue to rely on existing mechanisms (the Consultative Group/Roundtable donor process and multilateral lending)?

Addressing such questions must be pursued in parallel with the Doha negotiations, so that by the time the round is concluded there are effective mechanisms in place through which additional resources are made available to developing countries to help them implement their trade strategies and benefit from trade opportunities.

4. WTO rules and procedures: towards helping to meet development goals

Although it was argued above that seeking to address preference erosion costs within the WTO system is not desirable, there are actions that could be taken to enhance the development relevance of WTO rules. One of the important questions facing policymakers in the Doha Round concerns the circumstances, if any, under which developing countries should be allowed to use trade policies to pursue development (for example by using import barriers to protect domestic industries). While the basic trade policy rules of the WTO arguably make good sense for all countries, high-income and developing alike, these rules ignore the fact that governments may be forced to use trade policy because more efficient instruments are not available (for example, a country’s weak tax base may preclude the government from using subsidies). Compliance with basic WTO rules is also more costly for low-income than

for high-income WTO members, insofar as the negotiated rules reflect the status quo prevailing in industrialized countries.

Providing exemptions for the use of trade policies by developing countries—the traditional WTO approach and the focus of much of the Doha negotiations on special and differential treatment—is not the best way to help achieve development objectives. Instead of focusing exclusively on exemptions to allow the use of trade policy instruments, the trading system can be made more supportive of development by the provision of independent monitoring of the development impact of trade and trade-related policies, together with the proposed aid-for-trade integration mechanism. What is needed is to more actively assist developing countries attain their trade-related objectives, and to move away from the exclusive reliance upon negotiating exceptions and exemptions for developing countries.

This could be achieved by creating a mechanism in the WTO that focuses on a country's trade agenda and priorities and establishes linkages between this to the enhanced aid-for-trade integration program noted above. The objective would be to reduce governments' perceived need to use costly trade policy tools, to place the implementation of WTO disciplines in a national context and to monitor the effects of trade and related policies. Different, complementary options can be considered to operationalize this idea. The most limited is to build on the agreement that was reached in the area of trade facilitation, with implementation (enforcement) of negotiated disciplines being conditional on adequate assistance having been given by industrialized countries to developing countries. More ambitious is to establish a multilateral mechanism to help developing countries to pursue national objectives through instruments that do not distort trade. One specific proposal that would do this would be for WTO members to agree to a set of "core" disciplines that apply to *all* members, and allow developing countries to invoke a 'development defense' in disputes alleging violation of non-core rules (Hoekman, 2005a). Agreement to consider options that would move in this direction is one way in which the WTO can help achieve the goal of greater policy coherence for development.

Such a general mechanism could complement specific rule changes of the type being sought by developing countries in negotiations on WTO rules and special and differential treatment (SDT). Unfortunately, to date many if not most of the proposals put forward by developing countries will arguably do little to promote development prospects as they will do little to address binding trade constraints. This is not to say specific rules changes cannot be identified that would make a difference. Two examples of direct relevance to the preference erosion issue are rules of origin and the rules on regional integration. On the first, as already

mentioned, there is a case for substantial relaxation of such rules to allow goods to benefit from existing preference programs as long as a minimal amount of labor value has been added. Current rules of origin for processed goods tend to require too high local content in terms of intermediates, or else require that such inputs are sourced from the country granting the preference. This works against the exploitation of comparative advantage and the need to specialize in narrow parts of the value chain – a key feature of the current pattern of trade (global production sharing etc.) that has emerged over the last 20 years. The experience with AGOA for those countries benefiting from relaxed rules of origin has illustrated that such rules can be a binding constraint on the development and expansion of manufactured exports.

The second example concerns the design/requirements for North-South regional integration. Here a rule change that would require Southern members of such agreements to pursue MFN liberalization but not move to free trade would be beneficial (Hoekman, 2005b). This is preferable to complete preferential (discriminatory) liberalization by avoiding trade diversion costs while also attenuating the fiscal impacts – giving more time to put in place alternative tax collection mechanisms. To my knowledge neither proposal is being actively considered in the Doha talks, illustrating the importance of moving towards an approach that allows for greater case-by-case policy flexibility when it comes to WTO rules—in practice, the challenge for developing countries of identifying *ex ante* what types of rules or exemptions to rules are beneficial is significant.

5. Concluding Remarks

Preference erosion is a significant economic issue for a relatively small number of developing countries. It is also a bilateral issue, suggesting that the countries and trading blocs that reduce the value of past preferential access commitments should use transfers to offset losses that will be incurred by the affected countries. Such compensation for losses should take place outside the WTO so as to help make the trading system less distorted. Avoiding additional new preferences and distortions in the trading system is a compelling reason to address preference erosion explicitly and separately. This will not imply the end of discrimination—many low-income countries will benefit from continued assistance to achieve export development and diversification objectives. The view taken in this paper is that the key objective should be to reduce the use of trade-distorting policy instruments and to promote MFN-based global trade reform and that discriminatory trade policy should not be used as a form of aid. Instead, the emphasis should shift to other mechanisms, including

financial assistance to target more directly the factors that constrain trade capacity and a greater willingness to consider the reasons why developing country governments may use second-best (trade) policies.

Binding commitments could be sought—as part of a Doha Round agreement—to assess the magnitude of preference erosion and to transfer equivalent financial resources to the affected countries. Whether it is desirable to create a stand-alone fund to compensate for erosion of preferences—whether inside or outside the WTO—or instead integrate such funding into the broader “aid for trade” effort is something that must be determined by WTO members. A good case can be made from an aid effectiveness perspective that the associated resources should be allocated through existing mechanisms that have been established to provide funds for trade-related priorities identified by developing countries, with the ultimate uses of the funds determined by the governments concerned, based on a policy agenda for trade and growth that is consistent with a country’s development strategy (Hoekman and Prowse, 2005). This does not preclude country-specific transfers that are motivated on the basis of erosion losses.

Own trade reforms and complementary investments and measures to reduce transactions costs, improve the investment climate, and enhance productivity and competitiveness of farmers and firms are needed to deal with the adjustment costs associated with erosion losses. But, more assistance is needed more generally to bolster the capacity to exploit trade opportunities. In the process, those countries that have proven unable to benefit from existing or past programs could be assisted in attaining the original objective of trade preference programs—export development and diversification. A broader “aid for trade” effort would allow the objectives of preferences to be pursued more effectively and across a broader group of countries—by recognizing that market access is not the most important variable constraining export growth in many developing economies. Dealing with the supply side constraints will require not just financial resources but also the adoption of policies that address specific government and market failures that prevent a supply response from emerging. As argued in the recent literature, although the case for trade policies in this context is very weak, what types of domestic policies might be most appropriate and effective may not be obvious, suggesting that experimentation and learning should be encouraged (Rodrik, 2004). This suggests there is a link between the aid for trade agenda and the issues of “policy flexibility” and “special and differential treatment” in the WTO (and regional) trade agreements. Given the presumption that trade policy cannot do much to address the sources of market and government failure that impede supply responses, international

cooperation (trade agreements) can help by creating institutional mechanisms to help identify what policies would be effective and efficient in attaining specific goals set by governments, and by increasing the transparency of policies and their effects (outcomes) through multilateral monitoring.

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