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## Preference Erosion: The Terms of the Debate

28

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**N**ondiscrimination is the cornerstone of the multilateral trade system. As expressed in the most-favored-nation (MFN) clause embodied in Article I of the General Agreement on Tariffs and Trade (GATT), it was the defining principle of the trading system that emerged in the post–World War II era—largely as a reaction to the folly of protectionism and preferential trading arrangements that had contributed to the global economic depression of the 1930s. However, GATT allowed for exemptions to the MFN rule: reciprocal preferential agreements and unilateral preferences granted to developing countries.<sup>1</sup>

The rationale for grants of preferential access to the markets of industrialized countries emerged from arguments in favor of special and differential treatment (SDT) for developing countries under GATT. The underlying justification for SDT, in turn, reflected development thinking in the early 1960s, notably the theory of import-substitution industrialization. That theory was premised on the argument 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 terms of trade over the long term (and often also affected by short-term price volatility). The practical expression of that argument was the policy of erecting trade barriers to protect infant industries. At the same time it was recognized that exports were important as a source of foreign exchange and that the local market might be too small for local industry to be able to capture economies of scale. The second plank of the SDT agenda, therefore, was preferential access—a general system of preferences that would give developing countries better treatment in the major markets of the world. The Generalized System of Preferences (GSP), the framework for providing such preferences, was established in 1968 under the auspices of the United Nations Conference on Trade and Development (UNCTAD).

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 preferred countries, whether developing or other industrialized countries covered under regional free trade agreements. Conversely, the least developed countries (LDCs) and non-LDC countries in the Africa, Caribbean, and Pacific (ACP) group worry that general, MFN-based liberalization of trade will erode the value of the preferential access they presently enjoy. Matters are compounded by the fact that for many of the poorest countries

preference programs have become more valuable at the margin as OECD countries have granted duty- and quota-free access for a larger number of products (and sometimes all products). Preference-receiving countries are also concerned that multilateral liberalization may affect their terms of trade and raise the price of imports that currently are subsidized in OECD markets.

### The value of preferences

But how valuable are the preferences available to developing countries? OECD preference programs explicitly differentiate between developing countries (by region, level of development, and export capacity) and impose significant “conditionality” in the determination of eligibility and product coverage, including rules of origin and nontrade requirements. In addition to the GSP, high-income countries maintain a variety of schemes. The European Union has preferences for ACP members as well as a separate program for the LDCs (Everything But Arms). The United States has maintains several regional schemes (for example, for the Caribbean and Africa). This plethora of preferences makes empirical assessments of their effects difficult, a task further complicated by the difficulty of identifying the specific impact of preferences as opposed to other factors. The observed growth rate of exports from recipients to the countries granting trade preferences, for example, is not informative without controlling for other factors.

The policy literature has tended to rely on descriptive indicators to assess the impact of preferences. Four indicators are particularly common:

- *Preference margins*: the difference between MFN and preferential tariffs for products
- *Potential coverage*: the ratio between products covered by a scheme and the dutiable imports originating in beneficiary countries
- *Utilization*: the ratio between imports that actually receive preferential treatment and those that are in principle covered
- *Utility*: the ratio of the value of imports that get preferences to all dutiable imports from that exporter (the lower this number, the less generous the preference scheme).

Such indicators provide at best a partial perspective of the economic value of preferences. To get a more precise estimate of the value of preferences one has to take into account: (i) the cost of compliance with documentary requirements; (ii) the economic costs of rules of origin insofar as these require sourcing inputs from more expensive sources; (iii) other limitations and constraints embodied in preferential schemes; and (iv) the distribution of any rents that are created (part of these rents may be captured by importers).

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. This means that MFN tariffs must be about 4 percent higher than preferred rates, on

average, for preferential access to be meaningful. Given that the average MFN tariff in the OECD is close to 4 percent, preferences can only matter where there are tariff peaks or quotas.

The simplest measure of the transfers generated by a preferential regime is to calculate the difference between the applied tariffs facing a country and the MFN tariffs that would otherwise have applied. This measure is an upper bound on the value of the transfers, since many countries receive preferences. Thus, the true preference margins for a country should be adjusted for the preferences being received by other countries. Unfortunately, the literature does not currently provide a number of estimates of these “true” preference margins. We therefore focus on the simpler, traditional, margin of preference as an indication of the overall per unit value of preferences (table 1).

There are some important conceptual differences among the various 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 nonzero duty and a positive apparent preference. Despite these methodological differences, table 1 suggests substantial consistency across alternative measures. The average margins tend to be higher in Eu-

**Table 1. Nonreciprocal preference margins for developing country exporters**  
(percent)

| Beneficiary countries | Granting Countries |                  |                   |                  |                  | Quad + Australia |
|-----------------------|--------------------|------------------|-------------------|------------------|------------------|------------------|
|                       | EU                 | U.S.             | Japan             | Canada           | Australia        |                  |
| LDCs                  | 6.6 <sup>a</sup>   | 3.2 <sup>a</sup> | 2.6 <sup>a</sup>  | —                | —                | —                |
| Sub-Saharan Africa    | 4.1 <sup>d</sup>   | 2.6 <sup>d</sup> | 10.9 <sup>d</sup> | 4.2 <sup>d</sup> | 3.6 <sup>d</sup> | 4.6 <sup>d</sup> |
| African LDCs          | 4.0 <sup>b</sup>   | 1.3 <sup>b</sup> | 0.1 <sup>b</sup>  | —                | —                | —                |
| LIX                   | 2.3 <sup>b</sup>   | 2.1 <sup>b</sup> | 0.4 <sup>b</sup>  | —                | —                | —                |
|                       | 3.8 <sup>c</sup>   | 0.5 <sup>c</sup> | —                 | —                | —                | —                |
| All                   | 3.8 <sup>a</sup>   | 2.6 <sup>a</sup> | 2.0 <sup>d</sup>  | —                | —                | —                |
|                       | 3.4 <sup>d</sup>   | 2.6 <sup>d</sup> | 3.4 <sup>d</sup>  | 1.6 <sup>d</sup> | 1.5 <sup>d</sup> | 3.4 <sup>d</sup> |

— No data.

*Note:* LDCs = United Nations' list of least developed countries. LIX = World Bank low-income countries excluding India. GSP = all potential recipients of GSP. Quad = Canada, European Union, Japan, United States.

*Sources:* a. IMF (2003: 8); b. Brenton and Ikezuki (2005: 27); c. van der Mensbrugge (2005).; d. Low, Piermartini, and Richtering (2005).

rope relative to the other markets, while average preference margins are lower in Japan than in the European Union or the United States. There are surprisingly small gaps between the preference margins granted to LDCs and to developing countries as a whole under the GSP in the European Union, the United States, and Japan. In contrast, Canada and Australia appear to give substantially higher margins of preference to the LDCs. A similar result was found in World Bank and IMF (2005) using a measure of the overall tariff equivalent of trade policies. The latter measure includes nontariff measures such as health and safety standards (sanitary and phytosanitary measures) applied by the OECD countries—policies that are not affected by preference programs.<sup>2</sup>

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 margins and associated trade numbers of Low, Piermartini, and Richtering (2005), because that study uses disaggregated and up-to-date estimates of the imports subject to preferential treatment. Of the total of \$587 million in estimated potential value of preferences to LDCs, \$287 million, or almost half, is provided by the European Union. The United States is the next largest provider, at \$131 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 is total developing-country exports.

Independent of their estimated aggregate value, preferences have been an important factor in stimulating diversification into manufactures for certain developing countries, as illustrated by the case of apparel. For example, the U.S. African Growth and Opportunity Act (AGOA) has led to substantial increases in

**Table 2. Estimates of the value of preferences to LDCs and all developing countries**

(US\$ million)

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

*Note:* Quad = Canada, EU, Japan and U.S. Quad + = Quad + Australia

*Source:* Authors' compilations based on data from Low, Piermartini, and Richtering (2005).

imports from a number of Sub-Saharan Africa countries. However, the scope for preferences to facilitate diversification into the apparel sector is limited by the lack of consistency across the different preference schemes. Manufactured products from a country that can enter under one preference scheme often will not be able enter under another due to differences in rules of origin. Harmonization of preferential schemes around liberal rules of origin—in effect moving back to the idea of one umbrella framework for preferences as originally envisaged by the GSP—would help enhance the value of preference programs.<sup>3</sup>

### **The magnitude of potential preference erosion**

Preference erosion is not a new concern. Until recently, however, it was not a particularly strong constraint on MFN-based reforms because GSP programs typically offered a *preference*, and not duty- or quota-free access. Thus, even if MFN rates were lowered, it was possible to maintain a given preference margin by lowering the preferential tariff or expanding the coverage of the scheme. But new programs such as EBA and AGOA feature duty- and quota-free access for virtually all products; therefore *any* reductions in MFN tariffs lower the preference margin.

Using a partial equilibrium framework, IMF (2003) examined the potential overall impact on the exports of LDCs of preference erosion arising from a 40 percent cut in protection by the Quad. Assuming that LDCs have free access to these markets (a strong assumption given the evidence on rules of origin and other constraints), the study concludes that the potential loss at the aggregate level amounts to 1.7 percent of total LDC exports. Individual LDCs may suffer a more significant loss from preference erosion if their exports consist chiefly of products that enjoy deep preferences. By this measure, Malawi, Mauritania, Haiti, Cape Verde, and São Tomé and Príncipe are the most vulnerable to preference erosion. Malawi would experience a loss of 11.5 percent of total exports from the hypothetical cut in Quad protection. The next four countries would suffer a loss of between 5 and 10 percent. Another 10 countries would lose between 3 percent to 5 percent. The total (aggregate) value of lost export revenue would be around \$530 million (two-fifths accounted for by Bangladesh alone). Note that these are small numbers from a macro perspective—equivalent to only 1 percent of annual official development assistance—but they may mean substantial adjustment for some of the economies involved.

Alexandraki and Lankes (2004) complement this analysis by focusing on middle-income economies, including in their analysis of sugar, textiles, and bananas. Their study, as well as that of Stevens and Kennan (2004), suggests that the potential erosion problem is heavily concentrated in small island economies that are dependent on quota-type preferences and the associated rents in these sectors (sugar, beef, and bananas). The problem is therefore also commodity-specific—concentrated in

areas where OECD protection and preference margins are the highest—including bananas and sugar. As the sugar and banana regimes are reformed in the European Union, such countries will have to adjust.

Grynberg and Silva (2004) report that the losses in income transfers for producers of sugar, beef, bananas, and textiles and clothing in economies dependent on trade preferences would come to \$1.7 billion per year. These estimates are heavily influenced by the weight of disappearing quota rents associated with the phaseout of the Agreement on Textiles and Clothing which account for \$1.1 billion of the loss estimate and was a consequence of the Uruguay Round, rather than of potential future negotiation outcomes.

Computable general equilibrium (CGE) estimates of the value of preference erosion provide additional insights. CGE techniques make it possible to account for

**Table 3. Estimates of losses from tariff preference erosion**

| Authors                              | Affected countries       | Granting countries | Reform                     | Change, US\$ millions |                   | How measured?       |
|--------------------------------------|--------------------------|--------------------|----------------------------|-----------------------|-------------------|---------------------|
|                                      |                          |                    |                            | Exports               | Real income       |                     |
| Hoekman, Ng, and Olarreaga (2002)    | Developing countries     | Quad               | Tariff peak elimination    | -71                   | —                 | Partial equilibrium |
| IMF (2003)                           | LDCs                     | Quad               | 40% cut in tariffs         | -530                  | -265 <sup>a</sup> | Partial equilibrium |
| Alexandraki and Lankes (2004)        | Middle-income            | Quad               | 40% cut in preference      | -914                  | -457              | Partial equilibrium |
| Grynberg and Silva (2004)            | Developing countries     | Quad               | Elimination of preferences | —                     | -570              | Partial equilibrium |
| Francois, Hoekman and Manchin (2005) | African LDCs             | EU liberalization  | Full MFN liberalization    | —                     | -458              | General equilibrium |
| Ibid.                                | African LDCs             | OECD               | Full MFN liberalization    | —                     | -110              | General equilibrium |
| Ibid.                                | African, Asian LDCs      | OECD               | Full MFN liberalization    | —                     | -198              | General equilibrium |
| van der Mensbrugge (2005)            | East Asia                | All                | Full MFN liberalization    | —                     | 12,000            | General equilibrium |
| Ibid.                                | South Asia               | All                | Full MFN liberalization    | —                     | 500               | General equilibrium |
| Ibid.                                | Middle East and N.Africa | All                | Full MFN liberalization    | —                     | 4,800             | General equilibrium |
| Ibid.                                | Sub-Saharan Africa       | All                | Full MFN liberalization    | —                     | 2,200             | General equilibrium |
| Ibid.                                | Latin America            | All                | Full MFN liberalization    | —                     | 8,200             | General equilibrium |

—No data.

Note: a. Because the elasticity of supply of exports is 1.0, the real income effect is exactly half the change in the value of exports.

Source: Hoekman, Ng, and Olarreaga (2002); Alexandraki and Lankes (2004); Grynberg and Silva (2004); Francois, Hoekman and Manchin (2005); van der Mensbrugge (2005).

terms-of-trade effects, better market-access for nonpreferential trade following MFN liberalization, and the asymmetrical effects of preference erosion in different markets (reflecting different hierarchies of preference in OECD markets, not only because of different rules of nonreciprocal programs, but also the impact of free trade agreements). In general, CGE analyses tend to provide lower estimates of the preference-erosion effect. Francois, Hoekman, and Manchin (2005), for example, estimate that EU liberalization would translate into income losses of \$460 million for African LDCs. That figure drops to \$110 million when the experiment is extended to include OECD-wide liberalization.

Key results from a number of recent studies of preference erosion are summarized in table 3. The initial results associated with the nonreciprocal schemes alone generally produce results that are less than the full potential value of preference estimates presented in table 2. The major exception is van der Mensbrugge (2005), a study that includes the effects of reciprocal, as well as nonreciprocal, preferences. He adopts a counterfactual MFN-only scenario to estimate that current preferences generate an additional \$1.6 billion for low-income countries (excluding India). His results suggest that the effects of reciprocal preferences are much larger than the nonreciprocal preferences. Another important result shown in the table is that these preferences reduce the benefits to be attained from further liberalization, but do not change the sign of such a movement. Liberalization still generates substantial gains for all regions.

These estimates are not strictly comparable, not only because of the different methodologies used (partial equilibrium versus CGE) and the differences in focus (welfare effects versus trade effects), but also because they tend to operate with distinct liberalization scenarios to estimate the potential for preference erosion (Doha-related forecasts, full liberalization before the ATC phaseout, or full liberalization after the ATC phaseout, and so on). It is also important to underscore that these figures tend to overestimate the value of existing preferential regimes because they typically do not take into account the costs of compliance with preferential regimes (an exception is Francois and others 2005).

These estimates do make clear, however, that preferences are very small, in aggregate, as a means of transferring revenues from industrial to developing countries. Relative to the potentially enormous gains to developing countries from comprehensive trade reform—estimated at \$86 billion per year in Anderson, Martin and van der Mensbrugge (2005)—the transfers in the order of \$500 million from nonreciprocal transfers estimated above pale into insignificance. The net benefits to developing countries of these transfers are, of course, even smaller since a major share of these benefits comes at the expense of trade diversion from other developing countries. However, as has been emphasized by many authors, including IMF (2003) and Alexandraki and Lankes (2004), the benefits of preferences remain important for particular developing countries and products.

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**Dealing with preference erosion: potential policy responses**

Two major approaches can be taken to address preference erosion losses—one within the World Trade Organization (WTO) (a “trade solution”) and the other outside the WTO (an “aid solution”). Potential trade-based solutions include the following:

- Enhancing existing preference programs by widening access (for example, by harmonizing preferential regimes around liberal rules of origin and reducing compliance costs) or extending of their coverage, leveraging utilization rates, and increasing their effectiveness. Such enhancements could partially counterbalance the economic impact of preference erosion.
- Implementation of new preferential trade regimes by non-OECD importers.
- Multilateral trade concessions designed to shield preference-dependent countries (by delaying the liberalization schedules for “sensitive” products, for example) or to address negotiating priorities in other areas of the round (whether market access or rules).

Solutions undertaken from within the trading system may impose a significant opportunity cost from the perspective of global efficiency if they result in additional discrimination and have the effect of substantially reducing the overall level of ambition of MFN reforms in the Doha Round. A trading system that continues to rely on extensive discrimination in trade policy is not desirable. That said, there is a case for granting low-income countries preferential access to all OECD and large middle-income markets and pursuing an immediate and substantial simplification and liberalization of rules of origin. Doing so would attenuate short-term losses from preference erosion created by the Doha Round by maintaining for some period *effective* preference margins. However, as countries around the world continue to reduce levels of trade protection and conclude reciprocal trade agreements, it is unavoidable that the value of preferential access will be eroded. This suggests the need to concentrate on improving productivity and lowering transaction costs in beneficiary countries so as to enhance the competitiveness of their firms and farm sector. Here, much can and should be done through additional aid for trade.

Possible aid-based solutions for preference erosion include:

- Relying on existing financial mechanisms for adjustment financing such as the IMF’s Trade Integration Mechanism (IMF 2004); and
- Establishing new stand-alone, grant-based compensation funds; and
- Addressing preference erosion as part of a broader aid-for-trade effort.

The limited number and small size of most of the economies that could be significantly affected by preference erosion suggest that measures to help mitigate the problem should be targeted closely on the countries at risk. An appropriate response might be for the OECD countries to convert the implicit “preference transfers” (the value of current preferences) into equivalent development assistance. Aid transfers have the advantages of not distorting trade flows and being able to target the countries concerned.

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The specific vehicle for any such compensating transfers must be negotiated. Each has advantages and disadvantages. The advantage of existing financial mechanisms is that the assistance will be placed in the context of a country's overall macroeconomic and development policy framework. This may be beneficial as there are many other sources of shocks and adjustment pressures (in addition to preference erosion) that confront countries. However, the instrument used will generally be (concessional) loans as opposed to grants.

A specific compensation fund, as proposed by Grynberg and Silva (2004) and Page (2005), has the advantage of directly addressing the matter at hand but raises questions, notably ensuring that financing commitments are credible, that the associated aid is additional to existing flows, and that it is used effectively to address the adjustment burden in recipient economies. In the case of farmers in beneficiary countries who stand to lose from reforms in specific product areas (such as sugar and bananas), an option might be to integrate them into OECD farm policies by extending decoupled income support to them as well as to national farmers.

Adjustment to MFN liberalization will affect many countries, not just those that have benefited from preferences. They, too, will require assistance to adjust. But in most cases the shocks that regularly confront countries can be expected to exceed those associated with preference erosion. The need to diversify is not unique to economies that have benefited from preferences but is common to many countries. This suggests that funding for adjustment and to enhance competitiveness should be provided within the context of an overall country development program. Doing so is particularly important for countries—including many of the poorest—that have proved unable to benefit much from preference programs. The trade-related assistance these countries need is clearly much greater than any estimate of the value of current preferences.

### **Concluding remarks**

The debate about how best to address preference erosion in the context of multilateral negotiations will continue to be an important component of the negotiations on the development dimension of the Doha Round. While the overall benefits of nonreciprocal preferences to developing countries are clearly small relative to the potential gains from trade reform, they are important for a number of countries whose interests must be considered. Although the jury is still out on the overall developmental impact of trade preferences, support is growing for delinking development assistance from trade policy by shifting from “trade as aid” to “aid for trade” (Hoekman and Prowse 2005; IMF and World Bank 2005).

This growing consensus, however, is challenged by parallel efforts to deepen existing preferential regimes and to introduce new ones. Multilateral trade negotiations add additional ferment to the debate to the extent that they foster

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alliances between protectionist interests in OECD countries and preference-dependent industries in developing economies.

#### Notes

1. Bernard Hoekman is Senior Advisor, Development Research Group and International Trade Department, William J. Martin is Lead Economist, Development Research Group and International Trade Department, Carlos A. Primo Braga is Senior Adviser, International Trade Department, The World Bank. This chapter relies extensively on papers prepared for the International Symposium on "Preference Erosion: Impacts and Policy Responses" organized by the World Bank with the support of CIDA and DFID in Geneva, June 13-14. Comments and assistance from C. Tully are gratefully acknowledged.

2. Indeed, the analysis of overall OECD trade restrictiveness concludes that nontariff measures account for more than half of total trade restrictiveness (World Bank and IMF, 2005), suggesting that they should receive greater policy attention.

3. For details see Brenton and Ozden (2005).

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