1. At its meeting on 12 May 1989, the Negotiating Group requested the Secretariat to prepare a background paper on the concept of compensation in the context of GATT dispute settlement rules and procedures. This note has been prepared in response to that request.

2. The Negotiating Group began its discussion of the compensation issue prior to the mid-term review and agreed to revert to this issue at a later date. The issue of compensation was not specifically addressed in the "Improvements to the GATT Dispute Settlement Rules and Procedures", adopted by the TNC on 8 April 1989. However, the TNC did address the compensation issue in its Decision of 8 April 1989 on the future work programme of the Group, wherein it stated: "Such work would include, inter alia, further examination of improved and strengthened procedures concerning the implementation of recommendations or rulings of the CONTRACTING PARTIES, as well as of the definition, determination and modalities of compensation..."

I. Existing GATT Texts on Compensation

3. The following are the existing GATT texts relating to the issue of compensation:

"The aim of the CONTRACTING PARTIES has always been to secure a positive solution to a dispute. A solution mutually acceptable to the parties to a dispute is clearly to be preferred. In the absence of a mutually agreed solution, the first objective of the CONTRACTING PARTIES is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the General Agreement. The provision of compensation should be resorted to only if the immediate withdrawal of the measure is impracticable and as a temporary measure pending the withdrawal of the measures which are inconsistent with the General Agreement. The last resort which Article XXIII provides to the country invoking this procedure is the possibility of suspending the application of concessions or other obligations on a discriminatory basis vis-à-vis the other contracting party, subject to authorization by the CONTRACTING PARTIES of such measures. Such action has only rarely been contemplated and cases...

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taken under Article XXIII:2 have led to such action in only one case."
(1979 Understanding - Annex, para. 4; MTN.GNG/NG13/W/29/Rev.1, p. 38)

"The further action taken by the CONTRACTING PARTIES in the above circumstances might include a recommendation for compensatory adjustment with respect to other products or authorization for the suspension of such concessions or other obligations as foreseen in Article XXIII:2, as the CONTRACTING PARTIES may determine to be appropriate in the circumstances." (1982 Declaration, para. ix; MTN.GNG/NG13/W/29/Rev.1, p. 40)

4. The following GATT texts do not specifically refer to compensation but may have relevance to the Group's discussion of the compensation issue:

"Within a period of ninety days from the date of the decision of the CONTRACTING PARTIES or the Council, the contracting party to which a recommendation is directed shall report to the CONTRACTING PARTIES or the Council on the action taken by it in pursuance of the decision." (1966 Decision, para. 8; MTN.GNG/NG13/W/29/Rev.1, p. 38)

"If on examination of this report it is found that a contracting party to which a recommendation has been directed has not complied in full with the relevant recommendation of the CONTRACTING PARTIES or the Council, and that any benefit accruing directly or indirectly under the General Agreement continues in consequence to be nullified or impaired, and that the circumstances are serious enough to justify such action, the CONTRACTING PARTIES may authorize the affected contracting party or parties to suspend, in regard to the contracting party causing the damage, application of any concession or any other obligation under the General Agreement whose suspension is considered warranted, taking account of the circumstances." (1966 Decision, para. 9; MTN.GNG/NG13/W/29/Rev.1, p. 38)

"In the event that a recommendation to a developed country by the CONTRACTING PARTIES is not applied within the time-limit prescribed in paragraph 8, the CONTRACTING PARTIES shall consider what measures, further to those undertaken under paragraph 9, should be taken to resolve the matter." (1966 Decision, para. 10; MTN.GNG/NG13/W/29/Rev.1, p. 38)

"The CONTRACTING PARTIES shall keep under surveillance any matter on which they have made recommendations or given rulings. If the CONTRACTING PARTIES' recommendations are not implemented within a reasonable period of time, the contracting party bringing the case may ask the CONTRACTING PARTIES to make suitable efforts with a view to finding an appropriate solution." (1979 Understanding, para. 22; MTN.GNG/NG13/W/29/Rev.1, p. 42)

"If the matter is one which has been raised by a less-developed contracting party, the CONTRACTING PARTIES shall consider what further action they might take which would be appropriate to the circumstances." (1979 Understanding, para. 23; MTN.GNG/NG13/W/29/Rev.1, p. 42)
"Where a decision on the findings contained in a report calls for a ruling or recommendation by the Council, the Council may allow the contracting party concerned a reasonable specified time to indicate what action it proposes to take with a view to a satisfactory settlement of the matter, before making any recommendation or ruling on the basis of the report. The recommendation or ruling made by the CONTRACTING PARTIES shall be aimed at achieving a satisfactory settlement of the matter in accordance with GATT obligations." (1982 Declaration, paras. vii, viii; MTN.GNG/NG13/W/29/Rev.1, p. 38)

"The recommendation or ruling made by the CONTRACTING PARTIES shall be aimed at achieving a satisfactory settlement of the matter in accordance with GATT obligations. In furtherance of the provisions of paragraph 22 of the Understanding the Council shall periodically review the action taken pursuant to such recommendations. The contracting party to which such a recommendation has been addressed, shall report within a reasonable specified period on action taken or on its reasons for not implementing the recommendation or ruling by the CONTRACTING PARTIES. The contracting party bringing the case may also ask the CONTRACTING PARTIES to make suitable efforts with a view to finding an appropriate solution as provided in paragraph 22 of the Understanding." (1982 Declaration, para. viii; MTN.GNG/NG13/W/29/Rev.1, p. 40)

II. Proposals Made in the Group To Date

5. The following proposals relating to the issue of compensation have been presented in the Group:

A. Proposals of General Applicability

The failure to implement rulings or recommendations made under Article XXIII:2 gives rise to a right to compensation or, if compensation is not granted pending the withdrawal of the measures which are inconsistent with the General Agreement and if the circumstances are serious enough, to the authorization by the CONTRACTING PARTIES of suspension of concessions or other obligations as foreseen in Article XXIII:2. The Council may reconvene the panel, establish a working party, or request the Director-General to examine a request for compensation or for an authorization to suspend the application of obligations pursuant to Article XXIII:2. The CONTRACTING PARTIES affirm that, as an interim measure, compensation is to be given preference over the suspension of concessions or other obligations under this Agreement. The granting of compensation and the authorization to suspend GATT obligations do not relieve the contracting party concerned of its obligation to remove GATT-inconsistent trade measures. (MTN.GNG/NG13/9, para. 35; MTN.GNG/NG13/10; MTN.GNG/NG13/W/14/Rev.2, para. 76; MTN.GNG/NG13/W/29/Rev.1, para. 24, p. 41)

The "Understanding on Notification, Consultation, Dispute Settlement and Surveillance", adopted on 28 November 1979, should be supplemented so
as to include in future the estimation of the "retroactive prejudice" caused by a measure applied by a contracting party, once the CONTRACTING PARTIES have taken the decision on the basis of the panel's report. This retroactive prejudice should be evaluated from the time when the measure in question in the case entered into force, and not from the time when the dispute was referred to the CONTRACTING PARTIES. It is suggested that, during the panel's discussion, the affected contracting party should carry out an evaluation of the prejudice so that the panel may make a recommendation on this point, for decision by the CONTRACTING PARTIES. (MTN.GNG/NG13/10; MTN.GNG/NG13/W/17, p. 2; MTN.GNG/NG13/W/29/Rev.1/Add.1)

Failure to remove a measure found to be inconsistent with the GATT and/or to nullify or impair benefits under the GATT within a reasonable time shall give rise to compensation or the suspension of concessions or other obligations under the General Agreement. Compensation or the suspension of concessions or other obligations under the General Agreement shall be temporary measures pending the withdrawal of the measure found to be inconsistent with the General Agreement and/or to nullify or impair benefits under the General Agreement. (MTN.GNG/NG13/W/30, p. 7)

After the expiry of a reasonable period of time in which to implement the recommendations of a panel report and upon the request of a Contracting Party to the dispute, a technical group shall be established to determine the amount of impairment. The Contracting Parties involved in the dispute shall be guided by the amount so determined to negotiate compensation. The Contracting Party that requested the establishment of the procedures may use the amount as a basis for the suspension of concessions or other obligations for approval by the Contracting Parties. (MTN.GNG/NG13/W/30, p. 8)

Where applied, compensation shall be on a most-favoured-nation basis and shall be aimed at the restoration of the proper balance between the rights and obligations of all Contracting Parties. To this end, the Contracting Party that has not yet removed an inconsistent measure and/or one that nullifies or impairs benefits under the General Agreement shall aim, in proposing compensatory measures, to restore the balance of rights and obligations for all Contracting Parties affected by the measure. (MTN.GNG/NG13/W/30, p. 8)

In cases where a Contracting Party, after a reasonable period of time, does not comply with the Panel's recommendation, the date from which calculation of the amount of impairment for which compensation shall be negotiated or the suspension of concessions or other obligations under the General Agreement authorized shall be determined as from when the panel report was adopted by the Council. (MTN.GNG/NG13/W/30, p. 8)
B. Proposals Relating to Differential and More Favourable Treatment

In the event that a recommendation of the CONTRACTING PARTIES is not implemented within the prescribed period (of ninety days), the CONTRACTING PARTIES shall consider what measures, further to suspension of concessions by the party affected, should be taken to resolve the matter. In the case of a matter raised by a less-developed contracting party, those measures may be of a collective nature. (MTN.GNG/NG13/W/15, para. 13; MTN.GNG/NG13/W/29/Rev.1, p. 41)

At the request of a less-developed contracting party which has only limited retaliatory power vis-à-vis major trading partners, panel reports may include an appropriate recommendation on the amount of compensation due in case the main panel findings are not implemented by a developed contracting party within the prescribed time-limit. (MTN.GNG/NG13/W/19, para. 3b; MTN.GNG/NG13/W/29/Rev.1, p. 41)

When a developing contracting party cannot comply with the recommendations of a panel, the interim solution adopted shall be based on the compensation offered by the developing contracting party to the affected party, and not on the suspension of concessions and/or obligations by the latter. The aim is that the developing contracting party should be able itself to choose the form and products by which it can grant compensation restoring the balance of benefits for the affected party, taking into account its own trade, finance and development needs. (MTN.GNG/NG13/W/26, p. 8, para. 5; MTN.GNG/NG13/W/29/Rev.1, p. 41)

When a developed contracting party cannot immediately comply with the recommendation of a panel in a dispute in which the affected party is a developing contracting party, the interim solution adopted should be based as far as possible on the compensation sought by the developing contracting party. Furthermore, such compensation should be calculated retroactively from the time when the measure that is the subject of the dispute began to be applied. (MTN.GNG/NG13/W/26, p. 8, para. 6; MTN.GNG/NG13/W/29/Rev.1, p. 41)

Retroactive compensation could cover also the prejudice originating from a threat of retaliation, especially against a less-developed contracting party. (MTN.GNG/NG13/6, para. 10; MTN.GNG/NG13/W/29/Rev.1, p. 43)

As an interim measure pending the withdrawal of the measure found to be inconsistent with the GATT and/or to nullify or impair benefits under the GATT, compensation shall be preferred over the suspension of concessions or other obligations under the General Agreement. In negotiating compensation in disputes involving less developed contracting parties, account shall be taken of the trade, finance and development needs of the less developed contracting parties. (MTN.GNG/NG13/W/30, p. 8)
There may be instances, especially for less developed contracting parties, in which the date from which the calculation of the amount of impairment for which compensation should be negotiated or the suspension of concessions or other obligations under the General Agreement authorized may be the date of the introduction of the measure found to be inconsistent with the General Agreement and/or to nullify or impair benefits under the General Agreement. (MTN.GNG/NG13/W/30, p. 8)

III. GATT Practice Relating to the Compensation Issue

6. Article XXIII does not authorize the CONTRACTING PARTIES to make legally binding recommendations on compensation, either in violation or non-violation cases. A 1965 Secretariat note discussed this issue in relation to residual quantitative restrictions affecting developing countries:

"... Where a proposal for compensation has been made, it would appear that it is open to the Contracting Parties to make an assessment of the loss sustained ... and to make a recommendation that pending elimination of these restrictions the country applying such restrictions should consider the establishment of other appropriate concessions which would serve to compensate this loss. There are, however, two points which need to be noted in this connection. Firstly, any such recommendation under the provisions of the present Article XXIII can be implemented only to the extent that it proves acceptable to the contracting party to whom it is addressed. If such contracting party is not in a position to accept the recommendation, the final sanction must remain the authority for withdrawing equivalent obligations as provided in paragraph 2 of Article XXIII. Secondly, the nature of the compensatory concessions and the items on which these are offered would have to be determined by the contracting party to whom the recommendation is directed and would have to be a matter of agreement between the parties concerned. It would not be possible for a panel or other body set up by the Contracting Parties to adjudicate on the specific compensations that should be offered." (COM.TD/5 (1965))

7. In GATT practice, panel reports have not specified the amount of compensation due under Article XXIII:2. The issues of compensation and retaliation have been raised in the Council only at the request of the complaining country.

8. The issue of compensation, including a request that compensation cover "retroactive prejudice", was considered in the Report by the Panel on the "European Economic Community - Restrictions on Imports of Dessert Apples - Complaint by Chile" (L/6491), adopted in June 1989. The Panel observed that there was no provision in the General Agreement obliging contracting parties to provide compensation, and that the Annex to the 1979 Understanding Regarding Notification, Consultation, Dispute Settlement and
Surveillance indicated that "[t]he provision of compensation should be resorted to only if the immediate withdrawal of the measure is impracticable and as a temporary measure pending the withdrawal of the measures which are inconsistent with the General Agreement" (BISD 26S/216). The Panel further recalled and endorsed the views contained in the 1965 Secretariat note (COM.TD/5) cited above. The Panel "recognized that it would be possible for the EEC and Chile to negotiate compensation consistent with the provisions of the General Agreement; however the Panel did not consider that it would be appropriate for it to make a recommendation on this matter" (L/6491, p. 49).

9. The issue of trade effects was discussed in the Report of the Panel on "United States - Taxes on Petroleum and Certain Imported Substances" (L/6175), adopted in June 1987. The Panel decided not to examine the submissions of the parties on the trade effects of the US tax differential, concluding that it was "logically not possible to determine the difference in trade impact between the present tax and one consistent with Article III:2, first sentence, and hence to determine the trade impact resulting from the non-observance of that provision" (L/6175, p. 23). In so concluding, the Panel emphasized that the benefits protected under Article III:2, first sentence, were not expectations on trade volumes but expectations regarding certain competitive conditions (L/6175, p. 23).

Following a delay in the implementation of the adopted Panel recommendations, the European Community requested authorization to suspend the application of concessions "equivalent to the injury caused to the Community" (C/W/540 (1988)). The Secretariat was asked to provide technical advice to the Community and the United States regarding the Community's assessment of damages and the appropriate amount of damages in the case. The Secretariat Note responding to this request discussed the difficulties associated with estimating the trade effects of the Superfund tax differential (Spec(88)48 (1988)). These difficulties related, inter alia, to ascertaining the product coverage, choosing the most appropriate equilibrium analysis, determining demand and supply elasticities, weighing the relative value of short-term effects versus long-term effects, and considering the impact on the Community versus the impact on other countries exporting petroleum to the United States. The Secretariat Note also observed that Article XXIII did not require equivalence between the amount of injury and the amount of retaliation. It was suggested, therefore, that "[t]he contracting parties may wish to consider what other factors to take into account in examining the appropriateness of the proposed retaliatory measure" (Spec(88)48 (1988), p. 11).

10. The CONTRACTING PARTIES have so far not regarded the protection of expectations on trade volumes to constitute a benefit in terms of Article XXIII. The only benefit accruing under the General Agreement -- beyond the rights it explicitly confers -- which the CONTRACTING PARTIES have recognized to exist is the protection of reasonable expectations emerging from tariff negotiations as to the maintenance of the conditions
of competition prevailing at the time of the negotiations, or as to the agreed balance of reciprocal tariff concessions.

11. The trade impact of a change in competitive conditions found to nullify or impair benefits accruing under a tariff concession is likely to be the decisive element in negotiating compensation. In one case in which contracting parties could not agree on the amount of compensation to be granted after the formal withdrawal of a tariff concession they asked the Council to establish an ad hoc panel to render an advisory opinion to them on the value to be ascribed to the unbound tariff. The Council established such a Panel and the parties complied with its conclusions ("US/EEC Negotiation on Poultry", BISD 12S/15). The parties to the dispute agreed beforehand to accept the Panel findings as binding, and the Panel report was not submitted to the Council for adoption by the CONTRACTING PARTIES.

12. In connection with the drafting of the Decision of 5 April 1966 on Procedures under Article XXIII, Brazil and Uruguay made a proposal to the effect that

"... where it has been established that measures complained of have adversely affected the trade and economic prospects of less-developed countries and it has not been possible to eliminate the measure or obtain adequate commercial remedy, compensation in the form of an indemnity of a financial character would be in order; ..." (BISD, 14S/139).

This proposal however was not retained in the 1966 Decision.

13. The calculation of compensation (in terms of compensatory trade concessions) comes up in all negotiations under Article XXVIII and in some Article XIX cases. The CONTRACTING PARTIES have considered the issue of compensation in this context. During the Review Session of 1955, Brazil proposed in this regard that the CONTRACTING PARTIES establish certain rules for measuring concessions in tariff negotiations. The proposals were not adopted. The relevant discussion is reproduced below:

"38. The representatives of Brazil invited the Working Party to discuss . . . the proposals which had been put forward by his delegation. His delegation wished to establish certain rules for the conduct of tariff negotiations and, in particular, for the measurement of concessions. The Working Party considered that governments participating in negotiations should retain complete freedom to adopt any method they might feel most appropriate for estimating the value of duty reductions and bindings. The representative of Brazil pointed out that the recommendation proposed for adoption by the CONTRACTING PARTIES merely asked for recognition that the measurement of concessions in monetary terms might not be equitable when the economic effects of customs duties are unequal because of differences in the economic structures of the countries concerned; therefore, whenever statistical data are available, governments participating in
negotiations for tariff concessions or in renegotiations of bound duties should be free to use, if they should so desire, the formula proposed by the Brazilian delegation in determining the equivalence of compensatory concessions. The Working Party noted that there was nothing in the Agreement, or in the rules for tariff negotiations which had been used in the past, to prevent governments from adopting any formula they might choose, and therefore considered that there was no need for the CONTRACTING PARTIES to make any recommendation in this matter" (BISD 3S/219-220).

IV. Issues for Consideration

14. The Negotiating Group might wish to consider the following questions relating to compensation in the context of GATT dispute settlement rules and procedures:

(a) At present, a contracting party not implementing panel recommendations is not obliged to grant compensation. Compensation may however be voluntarily granted to forestall a request for an authorization to retaliate under Article XXIII. Should it become obligatory to grant compensation during the period of non-implementation of panel reports? Would such an obligation in the context of GATT dispute settlement procedures be consistent with the absence of a corresponding obligation in the context e.g. of Articles XIX and XXVIII?

(b) At present, all compensation must be granted consistently with the provisions of the General Agreement, including Articles I and XIII. This means that compensation must normally be granted on a most-favoured-nation basis. Should it be possible to grant compensation only to adversely-affected contracting parties? Would it further the effectiveness of the GATT legal system if an infringement of the General Agreement could be offset by another inconsistency with the principles of that Agreement? If compensation must be granted on a non-discriminatory basis: How should it be granted in those cases in which several contracting parties are affected by an infringement but to a different extent?

(c) Should any additional GATT rules on compensation in the context of GATT dispute settlement rules and procedures provide for differential and more favourable treatment of developing countries? Would the granting of compensatory benefits deviating from the non-discrimination requirements of GATT law require a "waiver" pursuant to Article XXV:5?

(d) The CONTRACTING PARTIES have recognized that the basic provisions of the General Agreement (Articles II, III and XI) protect expectations on conditions of competition, not expectations on trade volumes, and that the benefit accruing under these
provisions to the CONTRACTING PARTIES is consequently impaired when conditions of competition have been changed in a manner proscribed by Articles II, III and XI, whatever the effects on trade volumes. Would a rule according to which compensation is to be granted to offset the trade impact of an infringement of Articles II, III and XI be consistent with the benefit recognized to accrue under these provisions?

(e) At present, there are no rules to determine the value of concessions and of other obligations assumed under the General Agreement, and consequently also no rules to determine the damage caused by an impairment of such concessions and obligations. Should such principles, rules or an indicative checklist of criteria to be taken into account in the calculation of compensation be developed? If so:

- How should the damage caused by an impairment be calculated? And how should the advantages resulting from the compensation be calculated (e.g. whether temporary compensatory trade concessions can generate "trade-creating effects" despite their temporary nature)?

- Should the effect on the balance of payments, on the size of trade flows, on the profits of exporters, the investment decisions of producers, or other factors be decisive?

- To what extent should any advantages resulting for the exporting country from a measure inconsistent with the General Agreement be taken into account, such as quota rents generated by an import quota allocated among supplying countries?

- Is the damage caused by an illegal measure to be determined by comparing the consequences of the illegal measure with the consequences of its elimination or the consequences of its replacement by an alternative legal measure?

- Should compensation be calculated retroactively to the date of introduction of the measure, the date of the request for an Article XXIII panel, or the date of adoption of the panel report by the CONTRACTING PARTIES?

- Should there be differing criteria for determining appropriate levels of compensation depending upon whether the case is one of violation or non-violation? If the main function of Article XXIII:1(b) is to protect and supplement rights under Article XXVIII: Is the amount of compensation based upon Article XXIII:1(b) limited by what the complaining country could claim under Article XXVIII:3 in case of a formal modification or withdrawal of the concession?
What would be the overall impact of rules on compensation on the effectiveness of the GATT legal system? Would such rules encourage the non-implementation of panel recommendations by creating vested interests in the maintenance of measures inconsistent with the General Agreement?

Would requesting panels in violation cases to make recommendations on compensation detract from the primary objective of panel proceedings, i.e. to settle the dispute and secure the withdrawal of inconsistent measures on the basis of legal findings on the GATT-consistency of the trade measures concerned? Should such a request for a Panel finding on compensation be separated from the legal Panel findings on the GATT-conformity of the trade measures concerned so as not to render the adoption of the legal Panel findings more difficult (e.g. in case of controversy over the appropriate amount of compensation)? Should requests for Panel recommendations on compensation be admissible only after the Panel report with the legal findings has been adopted by the GATT Council? Should the calculation of the impairment and appropriate amount of compensation be entrusted to a specialized technical group or working party rather than to the Panel concerned?

Should the recommended amount of compensation also serve as a basis for an alternative authorization to suspend the application of obligations, if "appropriate" in terms of Article XXIII:2?