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#### VII. ANSWERS TO QUESTIONS

#### A. EUROPEAN COMMUNITIES

7.1. In response to a question concerning levels of cross-price elasticity, the European Communities states that:

- (a) As noted by the Appellate Body in Japan Taxes on Alcoholic Beverages II, how much broader the category of "directly competitive or substitutable products" may be in a given case is a matter for the panel to determine based on all the relevant factors in that case.<sup>285</sup> Accordingly, it would be inappropriate to try and define a standard of general application, and in particular a quantitative one.
- (b) There is no support for Korea's contention that the notion of "directly competitive or substitutable products" must be interpreted "strictly". On the contrary, as demonstrated by the complainants, an examination of the drafting history of GATT and of previous Panel and Appellate Body reports (including the two cases on Japan - Taxes on Alcoholic Beverages II) shows that in practice the "directly" has been given a rather broad interpretation.
- (c) In Japan Taxes on Alcoholic Beverages II, the Appellate Body made it clear that cross-price elasticity is not "the decisive criterion"<sup>286</sup> for establishing whether two products are directly competitive or substitutable. According to the Appellate Body, cross-price elasticity is but one of the means of examining a relevant market. In turn looking at competition in the relevant markets is just "one among a number of means"<sup>287</sup> of identifying the products that are directly competitive or substitutable in a particular case. The other means mentioned by the Appellate Body are the physical characteristics, the end uses and the customs classification of the products.
- (d) Furthermore, the relevance of a particular level of cross-price elasticity may vary according to the circumstances of each case. For instance, if two products have been sold for a long time and under similar conditions on the same geographical market, a "very low rate of cross-price elasticity" could be an indication that they re not "directly competitive or substitutable".
- (e) On the other hand, in a situation where one of the products concerned has dominated a geographical market for a long time and the other product is a new entrant in that market (e.g. because until then it has been excluded therefrom by import and/or tax barriers), it would be unwarranted to conclude from the mere fact that the initial cross-price elasticity is relatively low that the two products are not "directly competitive or substitutable". The more so in the case of products such as spirits, where market penetration is slow and short-term reactions to price changes tend to be relatively low.
- (f) Korea's position in this case appears to be that Article III:2, second sentence, would apply only if and when imported products succeed in establishing themselves in a market. Foreign products would have to achieve first a level of

<sup>&</sup>lt;sup>285</sup> Appellate Body Report, supra., p. 25.

<sup>&</sup>lt;sup>286</sup> Ibid.

<sup>&</sup>lt;sup>287</sup> Ibid.

market penetration such that it is possible to prove statistically a high rate of crossprice elasticity. This approach, however, disregards the obvious fact that protective taxes may be a factor that delays or prevents imported products from ever reaching that level of market penetration. Clearly, such an approach is at odds with the well-established principle that Article III protects "competitive opportunities". There is no reason to limit such "opportunities" to those that are available to a product in the very short term. Article III protects any competitive opportunities that a given product may have by reason of its inherent characteristics.

- (g) In connection with this question, the European Communities further argued that the Dodwell study does not purport to provide a precise measurement of cross-price elasticity. In order to do that, it would have been necessary to carry out an econometric analysis based on historic sales and price data. In the present case, however, that type of analysis was precluded by the fact that western spirits have been virtually excluded from the Korean market until only a few years ago. This means that the available sales and price data are too few to allow a statistically valid analysis.
- (h) The Dodwell study has a more modest purpose. It aims at testing by means of a consumer survey the hypothesis that a reduction in the prices of western spirits

to a more substantial shift from soju to western spirits than the one shown in the Dodwell study.

- (I) Secondly, it must be recalled that western spirits are new entrants in the Korean market and still hold only a small share of that market. This has two implications. The first one is that the respondents are generally less familiar with western spirits than with soju. This leads to a lower response in the survey than in the case of two products which were both well known to the respondents. The second implication is that western spirits still have considerable potential to increase their share of the market through marketing efforts (in advertising, distribution, etc.). The impact of those efforts would be considerably boosted by the price changes envisaged in the Dodwell study. On the other hand, the continued application of protective taxation would discourage such efforts. The interaction of these two factors, however, is not and cannot be addressed by a survey like the Dodwell study.
- (m) Finally, the Dodwell study considers only the price changes that could result directly from the elimination of the existing tax differentials. It does not take into account that the elimination of tax differentials could lead as well to a decrease of the pre-tax prices of western spirits and, consequently, to further substitution.

7.2. In response to a question as to whether there is a de minimis standard in assessing the question of "so as to afford protection", the European Communities states that:

(a) In Japan - Taxes on Alcoholic Beverages II, the complainants expressed different views with respect to the interpretation of the third element of Article III:2, second sentence. The European Communities argued that the measures at issue afforded protection to domestic production because a majority of the sales of the less taxed product (shochu) were domestically produced in Japan. In turn, the United States domestic products, then protection would be afforded to such products, and Article III:2 second sentence is violated.<sup>291</sup>

- (c) Thus, the third element of Article III:2, second sentence, is concerned only and exclusively with the question whether, by taxing one product less than another directly competitive or substitutable product, the measures "favour" domestic production over imports, not with the extent of the "protection" afforded to the less taxed<sup>292</sup> product. In other words, the third element of Article III:2, second sentence, is not about how much protection is afforded, but rather about who is protected.
- (d) The view that in order to establish a violation of Article III:2 it is necessary for the complainants to show that the measures actually afford a certain "degree" of protection by effectively reducing sales of imports above a de minimis level would be in contradiction with the well established principle that GATT Article III is concerned with the protection of competitive opportunities and not of actual trade flows. More specifically, according to the Appellate Body:

[i]t is irrelevant that the "trade effects" of the tax differentials between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent: Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.<sup>293</sup>

(e) In sum, the European Communities is of the view that the third element of Article III:2, second sentence, does not introduce another deminimis threshold, in addition to those which result from the application of the first and the second element. If two products are "directly" competitive or substitutable, any tax differential above the the sales of western spirits. For example, as shown by Annex 1, premium brands account for as much as 70 per cent of all sales of Scotch whisky in Korea. The same Annex shows that in a number of representative export markets with a neutral system of taxation the proportion of premium brands is much lower: 3 per cent in Australia; 6 per cent in New Zealand and 14 per cent in Venezuela. The preponderance of premium brands in the Korean market as compared to other export markets is further confirmed by the fact that whereas in 1997 the average unit price of all exports of Scotch whisky (for 70 cubic litre bottles at 40% volume) was  $\pounds 2.79$ , the average unit price of the exports of Scotch whisky to Korea was  $\pounds 4.42$ .

7.4. In response to a question concerning comparison of legal standards under competition law with standards under Article III, the European Communities states that:

- (a) The basic criteria applied in order to define the relevant product market for the purposes of EC Competition law are the same as those applied in order to establish whether products are directly competitive or substitutable for the purposes of GATT Article III:2, second sentence".<sup>294</sup>
- (b) There is, nevertheless, an essential difference. When applying GATT Article III:2, first sentence, Panels must take into account the "potential" competition which would materialise between the products concerned in the absence of the tax differential in dispute and not the "actual" competition existing under current taxation conditions. In contrast, competition authorities tend to consider tax differentials as a permanent barrier to competition and disregard any additional competition which may arise from removing that barrier.<sup>295</sup> As a result, the scope of the "relevant product" markets defined for competition purposes will generally be narrower than the scope of "directly competitive products" defined for the purposes of Article III:2, second sentence.
- (c) It must also be borne in mind that the notions of "competition" and of "substitutability" are relative ones. From an economic perspective, two products are not either "competitive" or "non competitive". Rather, products are "more or less" competitive. For that reason, as important as the criteria for defining a relevant market or for defining the notion of "directly competitive or substitutable products" is the degree of competition which is deemed relevant in each case. That degree will determine the standard by which the criteria are to be interpreted. That

<sup>&</sup>lt;sup>294</sup> The applicable EC competition regulations define the notion of "relevant product market" for the purposes of EC Competition law as follows:

A relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use.

See the Commission Notice on the definition of relevant market for the purposes of Community competition law (published in OJ of 9.1.97, C 372/5, hereafter "the Notice"), para 7.

<sup>&</sup>lt;sup>295</sup> Ibid. at para 42. The decision in the Case No IV/M 938 - Guinness/Grand Metropolitan mentioned by Korea in one of its questions to the EC provides an excellent illustration of this difference. The parties to the merger had provided to the Commission consumer surveys which suggested that all spirits were within the same relevant market. The Commission, however, disregarded those surveys because:

where those surveys (most of which were originally aimed at addressing taxation issues) employed price-change data, the overall levels of change (which mainly reflected changes in taxation) were much higher than those normally used by competition authorities as an aid to market definition (para 10).

standard may vary depending on the purpose of the legal provision to be applied. It may vary also from one jurisdiction to another.

- (d) This link is expressly recognised in an EC Commission Notice on the definition of relevant markets for Competition law purposes, which states that "the concept of relevant market is closely related to the objectives pursued under Community competition policy".<sup>296</sup> Further, that Notice acknowledges that the definition of the relevant market may vary depending "on the nature of the competition issue being examined."<sup>297</sup>
- (e) In this regard, it is clear that the objective of competition law is very different from the objective pursued by GATT Article III:2, and more generally by the WTO Agreement. The general objective of competition law is to preserve a certain degree of competition against action by the market participants. If the competition authorities of a certain country aim at maintaining a high degree of effective competition, they will apply the relevant criteria strictly, thereby arriving at a narrow definition of the relevant market.
- (f) On the other hand, the purpose of GATT Article III:2, second sentence is to prevent Members from applying internal taxation so as to afford protection to domestic production. Unlike the objective of competition law, the objective of Article III:2, second sentence, is furthered by a broad interpretation of the relevant criteria, rather than a strict one.
- (g) For the above reasons, the EC is of the view that the decisions taken by its competition authorities with regard to the definition of relevant product markets are devoid of relevance for the purposes of applying the notion of "directly competitive or substitutable products" in this dispute.
- (h) In this regard, a parallelism can be drawn to the notion of "like product". The criteria for applying the notion of "like products" are the same in all the GATT provisions where that notion is found. Yet, in Japan Taxes on Alcoholic Beverages II, the Appellate Body confirmed that the notion of "like products" is a relative one which may have a different scope in each GATT provision concerned.<sup>298</sup> In Article III:2, first sentence, it must be construed narrowly. In other GATT provisions, it may be construed more broadly. A fortiori, the notion of "directly competitive or substitutable" may also have a different scope in Article III:2 of GATT and in the competition laws of Members, which pursue an altogether different objective.
- (i) More relevant for the interpretation of GATT Article III:2 is the case law of the European Court of Justice (ECJ) regarding the application of Article 95 of the EC Treaty,<sup>299</sup> whose wording is almost identical to that of GATT Article III:2 and

<sup>&</sup>lt;sup>296</sup> Notice, para 10.

<sup>&</sup>lt;sup>297</sup> Notice, para 12.

<sup>&</sup>lt;sup>298</sup> Appellate Body Report on Japan - Taxes on Alcoholic Beverages II, supra., pp. 21-22

<sup>&</sup>lt;sup>299</sup> Article 95 of the EC Treaty reads as follows in the pertinent part:

No Member State shall impose, directly or indirectly, on the products of other member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.

therefore, unlike EC Competition Law, shares a similar purpose. In a long line of cases, the ECJ has concluded that all distilled spirits are either "similar" (the equivalent concept of "like") or "directly competitive or substitutable".<sup>300</sup>

7.5. In response to a question concerning the relevance of production processes to assessing whether products are like or directly competitive or substitutable, the European Communities states that:

- (a) Similarities or differences in production processes may be relevant only to the extent that they affect the characteristics of the products. This principle flows clearly from the Panel Report on US Standards for Reformulated and Conventional Gasoline.<sup>301</sup> Although that Panel report is concerned with GATT Article III:4, the European Communities is of the view that the same principle applies also with respect to Article III:2.
- (b) In the present case, it is relevant that all distilled spirits are obtained by the same manufacturing process (distillation) because it has the consequence that all of them share the same basic physical characteristics. On the other hand, differences regarding the method of distillation (continuous or pot-still), the method of filtration (through white birch or other methods) or the production volume (artisanal v. industrial) are irrelevant because they have either no impact at all or only a minor impact on the physical characteristics and end uses of the products.

### B. UNITED STATES

7.6. In response to a question whether if two products have a very low cross-price elasticity that is sufficient to consider them directly competitive or substitutable products, the United States asserts that:

(a) The standard that should be used to establish that two products are "directly competitive or substitutable" within the meaning of Article III:2 is a case-by-case examination that may consider a number of factors. There is no one standard that can operate across all cases. Cross-price elasticity is but one factor that may be helpful in conducting an analysis of whether products are directly competitive or

Furthermore, no member State shall impose on the products of other Member States any internal taxation of such nature as to afford indirect protection to other products.

 $<sup>^{\</sup>rm 300}$  The standard reasoning followed by the ECJ in those cases is the following:

<sup>&</sup>quot;There is, in the case of spirits considered as a whole, an indeterminate number of beverages which must be classified as "similar products" within the meaning of the first paragraph of Article 95, although it may be difficult to decide this in specific cases, in view of the nature of the factors implied by distinguishing criteria such as flavour and consumer habits. Secondly, even in cases in which it is possible to recognise a sufficient degree of similarity between the products concerned, there are nevertheless, in the case of all spirits, common characteristics which are sufficiently pronounced to accept that in all cases there is at least partial or potential competition. It follows that the application of the second paragraph of Article 95 may come into consideration in cases in which the relationship of similarity between the specific varieties of spirits remains doubtful or contested" (Judgement of the ECJ of 27 February 1980, Commission of the European Communities v Kingdom of Denmark, Case 171/78, ECR 1980, 447, at par. 12)

<sup>&</sup>lt;sup>301</sup> Panel Report on US - Standards for Reformulated and Conventional Gasoline, adopted on 20 May 1996, WT/DS2/R, para 6.11-6.12

substitutable. It is unlikely that a very low cross-price elasticity in and of itself will be sufficient to make a determination in any particular case.

(b) The quotation from the second US submission expresses the economic point that any shift away from one product to another in response to a relative rise in the first product's price is a sign of cross-price elasticity and therefore substitutability. However, the US response did not purport to establish what degree of substitutability was "direct" within the meaning of Article III:2. Clearly the word "directly" in the Note considered as well. In concluding this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case".<sup>303</sup>

(b) In concluding that the panel had not erred in determining that the tax was protective solely on the basis of the large differentials between tax rates applied to shochu and Western spirits, the Appellate Body appears to have reasoned that the large differences between such physically similar products could not be otherwise explained. The United States considers that the magnitude of the differences in tax rates between such similar products in this case compel the same inference. On the domestic products. The punitive taxes on Western spirits likely contribute to higher pre-tax prices than would otherwise exist under a neutral tax structure".

(b) The majority of imports of distilled spirits into Korea are from the European Community, and accordingly, the United States is not in a position to draw any general conclusions about marketing of obvious brands in the Korean market at this time. Aside from some bulk shipments, the overwhelming majority of US exports

- (a) Pre-mixes first became available in May 1994 with a view to attracting women consumers and consumers in their twenties who preferred low alcoholic beverages.<sup>305</sup> Pre-mixes have 10 per cent to 15 per cent alcoholic content.
- (b) Standard soju has 25 per cent alcoholic content. The salient features which distinguish premixes from standard soju are that the former contains scent, coloration and more than 2 per cent extract. To be precise, pre-mixes do not contain standard soju. The mixture is a combination of various ingredients and joojung (ethyl Alcohol) which is the raw material from which standard soju is produced.
- (c) To make the pre-mixes appeal to women, the producers first eliminated the pungent odour and taste of joojung by adding fruit scents (such as lemon and cherry). Thus, the producers add lemon/cherry juice concentrate, acerola juice concentrate, and lemon/cherry spices which cannot be added to standard soju pursuant to the law. Sweeteners such as stevioside, sugar and fructose are added in higher dosage than standard soju to give the pre-mixes a sweeter taste.

<u>Pre-mixes</u> (Lemon/cherry remixes)

Sugar Citric Acid Co2 Gas Lemon/Cherry concentrate Acerola juice concentrate Lemon/cherry spices Food colours Fructose Stevioside <u>Standard soju</u> (Green, Chungsaek soju)

Sugar Stevioside Citric Acid Mineral Salt Amino acid Solbitol

(d) Korea further stated that standard soju is served in a typical small glass, and is rarely if ever drunk mixed. Standard soju is served "straight", and commonly drunk with meals.

- (e) Pre-mixes, otherwise known as soju-based cocktails, have quite a different, much sweeter taste than standard soju (they are also classified as liqueurs in the liquor tax law). They have a lower alcohol content as well. Their composition is different, as indicated above. Soju-based cocktails are not suited for consumption with meals.
- (f) It is inappropriate to associate pre-mixes with standard soju, in the same way that it would be inappropriate to associate Bailey's (a blend of, inter alia, fresh cream and whisky) with whisky. Bailey's and soju-based cocktails are classified under the same heading, with other liqueurs, in the Korean liquor tax law.

<sup>&</sup>lt;sup>305</sup> See the Sofres report: "In the past Korean women had negative sentiments towards alcohol., However, the current generation of women is drinking more frequently each year. The Korean distillers and producers reflect this trend by offering low alcoholic content drinks like ... "Lemon Soju". Please note that Korean producers do not use the term "soju" in the brand name for these pre-mixes. Some examples of names are "Lemon 15", "Cherry 15", "Lemon Remix" and "Cherry Remix".

(g) Finally, it is easy to overestimate the popularity of soju-based cocktails, as the European Communities has done. As their novelty has worn off, the increases in sales of them have tapered off.

7.12. In response to a question concerning whether Article III:2 covers potential or future competition, Korea states that:

- (a) If "potential competition" refers to competition that would exist "but for" an allegedly discriminatory tax, Korea could imagine that potential competition falls within the scope of Article III:2. Korea's discussion of "pre-tax" prices addressed this argument and shows that even if the effect of the tax were eliminated, the products at issue would not be in direct competition. The pre-tax prices of the products at issue, according to the complainants' own figures, range from 400 per cent more expensive than soju before tax to more than 1 800 per cent more expensive.
- (b) If by "future competition", the panel means competition that would appear at some point in the future if, for example, consumers changed their habits, or if the pre-tax price of whisky fell to the level of soju, then Korea considers that "future competition" is not covered by Article III:2. Complainants cannot base Article III:2 allegations on speculations about future changes in the market. Rather, complainants must wait to bring a WTO case if and when relevant changes appear.

7.13. In response to a question about the possible explanations of apparent inconsistencies in the Dodwell study, Korea states that:

- (a) Choice subject to large random elements
  - (i)

making one choice in one mood, and another choice in another mood, the interview has failed to isolate changes in prices from other factors affecting demand. Its results will give a false picture of the effect of prices on demand.

(b) Mistakes in reporting responses

A simple explanation of the inconsistencies is that respondents are being consistent, but that interviewers are mis-reporting their responses. This hypothesis is included for completeness only.

(c) Possible explanation of unexpected responses

Were the responses in unexpected directions, but consistent, the facts to be explained would be different. We offer below two hypotheses that might in principle explain unexpected results, and also comment on why these seem incapable of explaining inconsistencies in result.

- (d) Gifts and prices
  - Respondents who think they are being asked about a single bottle purchase, may answer questions with the purchase of a bottle of spirits as a gift in mind. In that case, however, they might respond to price changes in ways

- (iii) The problem, though, is that in Dodwell Chart 2, whisky and soju act like substitutes when the price of soju rises from 1 000 to 1 100 won, but like complements when the price of soju rises from 1 100 to 1 200. It is not the latter fact that is hard to explain (at least in principle!) - it is the inconsistency between the two.
- (iv) One might think in terms of a population made up of some drinkers who regard scotch and soju as substitutes, and some who regard them as complements. For some price changes the first group dominates, while for others the second group determines the direction of the net change.
- (v) Before pressing along that theoretical path, however, it is well to recall what is driving the problem. At issue is the effect of a 100-won change in the price of a bottle of soju<sup>306</sup>. But for soju and scotch to be complements, they must be drunk in a tight combination with one another. What then counts is the price of the combination. But with the price of scotch so many multiples of the price of soju, a 10 per cent change in the price of soju will have only a very small effect on the price of a soju-whisky combination. For a 100-won rise in the price of soju to cause the number selecting premium whisky to fall from 41 to 36, and the number selecting standard scotch to fall from 56 to 49 requires a sensitivity to price that is nether plausible nor suggested by anything else in the Dodwell findings.
- (f) Korea concludes by noting that in its first submission, it described the inconsistencies as "troubling", but commented that the Dodwell Study "has much more serious problems".<sup>307</sup> Korea sees no reason to change that assessment.
- (g) Korea also continues to believe that the attention of respondents might have wandered during their progress though the 16 sets of hypothetical prices offered them by Dodwell interviews (to say nothing of that of the interviewers themselves). That hypothesis is the one that seems to best fit the facts.

7.14. In response to a question concerning the water content of distilled and diluted soju, Korea states that:

- (a) For the benefit of the Panel Korea hereby provides an answer related to the water content of both standard and distilled soju and also explains briefly the manufacturing process to better understand the differences.
- (b) In case of standard soju, water is added before and after distillation. Prior to distillation, one steams tapioca and/or sweet potatoes so that they are in a mashed form. Second, water is added. Third, enzymes and yeast are added so that the mashed tapioca and/or sweet potatoes will ferment. This fermentation process will lead to a 10-11 per cent alcoholic content liquid which is in a sludge form. The ingredients constitute 20 per cent, water 79.9 per cent and yeast 0.1 per cent.
- (c) Then the material undergoes continuous distillation until one obtains as pure an alcohol as possible (95 per cent ethyl alcohol). After distillation, water is added

 <sup>&</sup>lt;sup>306</sup> At the current exchange rate, 100 won equals US\$ 0.0691 and ECU 0.0637 (as of 23 March 1998).
 <sup>307</sup> See Attachment 2 of Korea, p.6.

and then six to seven additives are inserted. Ethyl alcohol (joojung) constitutes 26.4 per cent and water constitutes 73.6 per cent at this stage.

- (d) Contrary to the notion that standard soju is simply a diluted form of distilled soju, the latter uses different base materials, primarily rice and sometimes other grains. Water is added only prior to distillation. No water is added after distillation. Producing a 45 per cent distilled soju through single distillation is a know-how developed by Korean producers over several hundred years.
- (e) In case of distilled soju, one takes white rice and steams it. Afterwards, one adds water and yeast which acts as a catalyst to commence the fermentation process. The ingredients take up 40 per cent, water 59 per cent and yeast 1 per cent. After the material ferments, one has a product which has a low alcoholic content. Then the fermented product undergoes a single distillation so that the final product has 45 per cent alcoholic content. No water is added after distillation.

The percentage of water added is illustrated in the following chart:

	Before distillation	After distillation
Standard soju	79.9%	73.6%
Distilled soju	59.0%	0%

7.15. In response to a question about the physical differences between exports of soju and shochu to Japan, Korea states that:

- (a) The three leading brands of standard soju exported to Japan are Jinro, Doosan's Green and Bohae. Jinro and Doosan only use sugar and citric acid in their products exported to Japan. Bohae's standard soju exported to Japan uses no additives. On the other hand, Korean standard soju can use seven additives.
- (b) The difference in additives can be illustrated by the difference in additives by the two products Jinro exports to Japan.

	Jinro Gold	Jinro Export
Alcohol content	25%	25%
Citric acid	x	х
Sugar (natural)		x
Fructose	X	
Oligosaccharide	X	
Stevioside	X	

Refined salt	X	
Amino acid	Х	

- (c) The difference in the number of ingredients leads to different consumption patterns. In Japan, shochu A is almost always consumed with water, either warm or cold, other beverages and on the rocks. In Korea, standard soju is almost always consumed straight.
- (d) The source of this information is enterprises such as Jinro that are engaged in marketing these products on the Japanese market, and who have found it necessary to export soju to satisfy Korean expatriates living in Japan, and to produce a different product to meet the needs of Japanese consumers.
- (e) This can be easily verified by the Panel by looking at the bottles of Jinro Gold (the Korean soju, which targets the Korean residents in Japan) and Jinro export (targeting Japanese consumers) provided by Korea. The labels of Jinro Gold contain Korean characters, whereas those of Jinro Export contain no Korean characters.
- (f) The labels of these bottles also give an indication regarding their tax treatment in Japan. The label on the back of Jinro Gold refers to "spirits", whereas the label on the back of Jinro Export refers to "shochu A".

7.16. In response to a question concerning a hypothetical comparison of an expensive bottle of wine and a cheaper table wine, K orea states that:

(a) For the purposes of Article III:2, in order to find that two products are "like", one must show to begin with, that the two products are "directly competitive or substitutable". According to the panel in the recent Japan - Taxes on Alcoholic Beverages II:

"Like" products should be viewed as a subset of directly competitive or substitutable products.<sup>308</sup>

Accordingly, a finding of "likeness" in Article III:2 presupposes an even stronger competitive relationship between two products than a finding of directly competitive or substitutable products.

(b) Price has an impact upon the competitive relationship between products. Where prices vary greatly, this can mean that two products do not compete. In the example given by the Panel of cheap wine and a rare Bordeaux, it might be that in a particular market the large difference in price means that the two products do not compete, and are therefore neither "like" nor directly competitive or substitutable products. This is so because most consumers will not consider a \$1 000 bottle of wine to be a substitute for a \$5 bottle of wine, notwithstanding apparent similarities concerning physical characteristics between the two products (colour, packaging, alcoholic content).

<sup>&</sup>lt;sup>308</sup> See Panel Report on Japan - Taxes on Alcoholic Beverages II, supra., at para. 6.22.

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- (c) That conclusion is likely to be supported by other divergences. Indeed, the fact that a person chooses to pay more for a rare bordeaux when he or she has the option of buying a cheap table wine is a measure of the differences between the two products. Between a cheap wine and a vintage bordeaux, for example, important differences might be the age of the wines, the type, year, and provenance of the grapes used, the blending, the way the wine was cared for and stored, all of which have an impact on the organoleptic qualities of the wine. The rare bordeaux might come from a famous vineyard or chateau, and the purchaser might not be interested in drinking the wine at all, or at least not with a regular meal. He might see it as an investment or as a wine for very special occasions These types of differences would also support the conclusion that these products are not "like" or directly competitive or substitutable products.
- (d) In the case at hand, Korea has shown that price is an important factor in the directly competitive or substitutable products, and therefore, "like" product analysis. The complainants' own evidence (notably, the Dodwell Study) indicated that there are no overlaps in the prices of standard and premium soju on the one hand, and western-style spirits on the other hand. Thus, the most expensive form of standard soju (i.e., premium) is still much less expensive than the cheapest western-style spirits. In contrast, prices of wine might cover a whole range of prices.

(e)

different product. Such a definition of "nearly identical" would render this question meaningless - if such a definition is used, products that fall under it are likely to be directly competitive or substitutable products.

- (d) Korea believes, however, that many changes that are "small" in a technical sense will lead to products that are very different by the test of market performance. To take one example, the addition to a food or drink product of small amounts of an unpleasant substance, or a substance perceived to be unpleasant, may, if known to consumers, cause demand for the product to fall to zero, even though the substance does not alter taste or threaten health and its presence cannot be detected by consumers. The "small" addition may convert a sought-after product into one that is no longer saleable at any price. Moreover, the elasticity of substitution between the original product and the "nearly identical" product may be zero or insignificant. Korea is far from convinced that "nearly identical products" with different market demands and prices and a low or zero cross-price elasticity of demand should be considered directly competitive or substitutable products.
- (e) Korea believes that products may be physically identical or nearly so but not directly competitive or substitutable products. Korea believes that differences that are small in a technical sense may be important to buyers, and that performance in the market place is the ultimate test of directly competitive or substitutable. Alternatively stated, Korea does not believe that there is any technical short-cut that can determine direct competitiveness or substitutability without reference to market performance.
- (f) The relevant physical distinctions are those that are important to customers. The

"upgraded" version of standard soju. Thus, premium diluted soju could be compared to a Renault's compact car "Clio" with leather seats which, although it is a luxury version, is still a compact car. To proceed with this analogy: imported liquors are Mercedeses, Jaguars and Rolls Royces compared to diluted soju. The price of a Renault Clio, even equipped with leather seats, is substantially lower than the cheapest Mercedes, let alone a Jaguar or Rolls Royce.

- (b) By taking the same criteria by which one distinguishes products in a like-or directly competitive or substitutable products-analysis, the differences resulting from a premium and standard comparison are small. For example, the price difference between standard diluted soju and premium diluted soju amounts to a factor of 1.76, as opposed to a factor of 5 for the cheapest imported liquor (gin), and more than 19 for the most expensive imported liquor (cognac/brandy).
- (c) For one of the leading premium diluted soju brands, Kimsatgat, the primary difference has been that one of the seven possible additives (stevioside) is replaced by honey. In contrast, for the imported liquors at issue (whisky, vodka, gin, brandy, rum) there are differences in taste, physical characteristics, and end-use. The taste of gin, for instance, is quite different from the taste of diluted (including premium) soju, due to the different physical composition. Gin is not drunk with Korean meals, whereas diluted (including premium) soju is, and so on.
- (d) This analysis led Korea to the conclusion that standard diluted soju and premium diluted soju are sufficiently similar and sufficiently competitive that they should be grouped together in the analysis required by this case. To be sure, Korea has treated distilled soju separately from diluted soju, as between these two products the differences are significant (price, use, marketing, raw material, tax classification).
- 7.19. In response to a question about competition between types of whiskies, Korea states that:
  - (a) There is no reason to assume that imported whiskies are not directly competing with or unlike domestic whiskies because of the price differences cited. The prices cited concern individual brands. Both domestic and imported whiskies cover the whole gamut of prices (for instance, cheap whiskies are bottled in Korea, but also expensive ones). Taking into account all sales, domestic whisky is on average somewhat more expensive than imported whisky.<sup>309</sup>
  - (b) There are no other differences (such as physical characteristics or end use) to suggest that imported and domestic whisky are positioned differently on the Korean market. Next to the small difference in price, this is relevant as well. As Korea has emphasized before, the decision of whether products are "like" or directly competitive or substitutable products is a matter of an overall appreciation of their relationship, weighing all the relevant factors. Of course, no distinction is made in Korea's liquor and education tax rates between imported and domestic whisky.

7.20. In response to a question about the negotiating history of Article III and Ad Article III, Korea states that:

<sup>&</sup>lt;sup>309</sup> See Korea's, Attachment 5.

- (a) These examples show that physically different products may be in a sufficiently close competitive relationship for Article III:2 to apply. Whether that is, in fact, the case, depends on a case-by-case analysis, according to the Appellate Body in Japan Taxes in Alcoholic Beverages II.
- (b) It may well be that apples and oranges are directly competitive or substitutable products in certain markets. Then again, one can conceive of a number of reasons why such fruits are not directly competitive or substitutable (e.g., with breakfast it is more common to have orange rather than apple juice; most consumers can make orange juice themselves, but not apple juice; apple pie is more common in many countries than orange pie; in countries where oranges are not grown they are more expensive than apples; etc.). In fact, certain fresh fruits, such as bananas, have been found to be in a market of their own, at least in the EC market.<sup>310</sup> Such determinations, also in respect of the other products cited, cannot be made in the abstract.
- (c) These examples then are relevant to the present case, in that they illustrate that products with different physical characteristics may be directly competitive or substitutable products. This was also shown in the Japan - Taxes on Alcoholic Beverages II, where whisky and certain other spirits were found to be in a directly competitive or substitutable product-relationship with Japanese shochu. That case also shows, however, that such findings depend on a factual analysis of individual markets.

7.21. In response to a question concerning legal requirements for sweetness in soju, Korea states that there is no legal requirement regarding the minimum sugar content for soju in Korea. The sweeter taste of Korean soju can be explained by the use of such additives as stevioside and/or aspartam, which are 150-300 times sweeter than sugar.

7.22. In response to a question about consumption of soju with food, Korea states that the bulk of standard soju is consumed with meals. Other than this, a small proportion is consumed in some other on-premise locations. Some standard soju will also be consumed at home without a meal (finishing a bottle after the meal is over, for instance).

7.23. In response to a question about uses of distilled soju as a gift, Korea states that, as has been emphasized in Korea's first submission, distilled soju is an artisanal product that occupies a "niche" in the Korean market, and is mainly given as a gift. When distilled soju is received as a gift, it is usually consumed with meals on traditional occasions such as New Year's Day and Korean "Thanksgiving" (August 15). Other instances in which distilled soju is consumed are rare. In some very expensive and traditional Korean restaurants and Japanese restaurants, distilled soju is offered, at very high prices.

7.24. In response to a question whether the questions and methodology in the Dodwell study are similar to those used in the ASI study in Japan- Taxes on Alcoholic Beverages II, and whether Korea disagrees with that Panel's use of the ASI study in reaching its conclusions, Korea states that it is confident that the Panel in Japan – Taxes on Alcoholic Beverages II examined the ASI study with appropriate care. Korea, however, has not studied the detail of the ASI report, which was submitted to a different panel in a different case, and is concerned with a market in a different

<sup>&</sup>lt;sup>310</sup> Judgment of the Court of Justice of the European Communities of 14 February 1978, Case 27/76, United Brands Company and United Brands Continental BV v Commission of the European Communities, 1978 ECR 207.

country. It is therefore unable to comment on the merits of the ASI study. Moreover, Korea doubts the value of a post-mortem on either the ASI study itself, or the use of it by the Panel in Japan – Taxes on Alcoholic Beverages II. If the ASI study is free of the flaws of the Dodwell study, its use by the Panel was proper, but that fact cannot provide a sound argument for reliance on the flawed Dodwell study in this proceeding. If the ASI study is as defective as the Dodwell Study, the fact that the Panel relied on it cannot make a sound case for repeating the same mistake.

7.25. In response to a question concerning cross-price elasticity, Korea stated:

(a) Korea agrees with the implied observation that the position of the US on this issue is inconsistent with that of the EC.

(b) To discuss the comments of either party, however, a context is needed. One important element of such a context is the kind of world to which te comments are intended to apply – is it a theoretical world in which information is fully and freely available, or the real world in which accurate information is difficult to get?

(c) The US suggestion that +any shift ... should be interpreted as a sign of positive cross-elasticity and therefore substitution" seems to Korea to cast the Article III:2 net too widely if it is intended to apply to a full-information world, and therefore to be a statement of principle. That criterion would make spirits, beer and wine DSSP, spirits and soft drinks quite possibly DCSP, and beer and soft drinks almost certainly DCSP. It seems unlikely that any WTO member thought that membership entailed an obligation to apply the same rate of tax to such a wide range of products – and few, if any, do.

(d) If the US criterion is intended for application to the real world, however, imperfections of information provide additional reasons to reject it. In the real world, there are problems of error in the construction and organisation of samples and problems of statistical error – to say nothing of the blundering of those "fallible human beings" that have become a feature of recent EC argument in this case. Even if the US criterion were accepted in principle, the existence of such sources of mistakes in estimation would require a substantial margin to allow for errors in estimation – a margin that the US position denies.

7.26. In response to a question about a de minimis standard for the question of "so as to afford protection", Korea stated:

(a) If products that are only very weakly substitutable can be DCSP, a tax on a domestic product that is lower than the tax on a DCSP foreign product may have only a very small effect on the quantity demanded of the foreign product in the country applying the tax. Korea considers that such a small effect should not be sufficient to meet the "so as to afford protection" requirement of the second sentence Article III:2.

(b) Indeed, Korea submits that de minimis protective effects do not trigger the application of the second sentence. This is based on the text and structure of this provision, which is unlike the hard-and-fast prohibitions incorporated in the first sentence of Art. III:2, or such other GATT provisions as Art. I or XI.

(c) To begin with, where DCSP are concerned, not just any tax differential is problematic. Only tax differentials that are more than de minimis can become a problem. WTO members are thus left with some flexibility in designing their tax systems.

(d) Similarly, the insertion of the "so as to afford protection "requirement in the second sentence of Article III:2 must also have been meant to allow governments a measure o flexibility. Article III:2 only interferes in a Member's tax system where an (appreciable) tax discrepancy raises real concerns about protectionism.

(e) Therefore, Korea considers that where the tax differential can only be said to have a minimal protective effect, it should not be considered to have met the "so as to afford protection" threshold.

7.27. In response to a question concerning the product mix of imports, Korea stated:

(a) Under a system of specific taxes, all bottles of scotch, for example, have the same tax whatever their price, so the specific tax raises the price of high-price brands by a smaller percentage than the price of low-price brands. Alternatively stated, the specific tax lowers the price of high-priced scotch relative to low-priced scotch, and therefore provides an incentive to the purchase of high-price brands.

(b) Korean taxes on sprits, however, are ad valorem – they have no effect on the price of one spirit in a particular class (for example, whisky, brandy) relative to another member of that class. Korea therefore sees no basis for the proposition of the EC that the Korean tax system favours the purchase of high-price rather than low-price brands of scotch.

(c) Korea does not know whether its residents import a higher proportion of highpriced scotch than those of similar countries. If it is a fact, however, Korea believes that an explanation for it must be sought elsewhere than in its tax system.

VIII.

### THIRD-PARTY ARGUMENTS

## A. CANADA

8.1. Canada's submission is limited to the issue of the criteria to be taken into account in assessing whether a difference in tax rates is applied so as to afford protection to domestic production.

8.2. Canada asserts that it welcomed the outcome of the Japan - Taxes on Alcoholic Beverages II case and was pleased with the principles for the interpretation and application of Article III of GATT 1994, set out by the Appellate Body in its report. Canada notes that the issues which arise in the context of the Korean liquor tax regime bear strong resemblance to matters which were under dispute in Japan - Taxes on Alcoholic Beverages II and accordingly, the Panel's disposition of the present dispute should be guided by the principles established in the reports of the Panel and Appellate Body in that case.

8.3. Canada notes that all of the participants appear to have embraced the principles of the Appellate Body report in approaching this case and in particular with respect to the interpretation of the second sentence of Article III:2 of GATT 1994. In Canada's view, all participants appear to agree that the phrase "so as to afford protection" in Article III:1, as it applied to the second sentence of Article III:2, should be interpreted only with respect to objective effects and that no subjective element of intent should be taken into consideration. Canada urges the Panel to base its decision in the present case on these principles.

8.4. In that context, having examined the submissions and evidence presented thus far, Canada agrees with the European Communities and the United States that the assessment of whether the measures are applied so as to afford protection to domestic production involves an objective analysis. Canada further agrees that the facts and circumstances regarding the "structure of the measures" as well as their "overall application on domestic as compared to imported products" demonstrate that the Korean measures at issue are applied so as to afford protection to the domestic production of soju in Korea.

8.5. Canada stresses that in examining the "design, architecture and revealing structure" of a measure, only objective factors should be taken into account. For example, as noted by the Appellate Body in Japan - Taxes on Alcoholic Beverages II, the magnitude of dissimilar taxation (which is an objective factor that can be discerned from the structure of a measure) in and of itself can be evidence of protective application.<sup>311</sup> In fact, in Canada's view, given the magnitude of the tax differentials in the dispute at hand, it is unnecessary to examine any other factors.<sup>312</sup>

8.6. Thus, in Canada's view, assessing whether a measure is applied so as to afford protection to domestic production is an analysis to be based on objective criteria, and in this case, the amount of the tax differential is sufficient to make a finding that the measures at issue are applied in a manner that protects domestic production.

<sup>&</sup>lt;sup>311</sup> Appellate Body Report, supra, p. 29.

<sup>&</sup>lt;sup>312</sup> Canada notes that according to the EC and the US, the magnitude of the tax differentials at issue in this dispute appear to be larger than those found to be sufficient evidence of protective application in Japan - Taxes on Alcoholic Beverages II. In Canada's view however, even if the Panel were to find it necessary to take into account additional evidence, the other factors presented by the EC and the US are more than sufficient to establish protective application.

# B. MEXICO

## 1. Background

8.7. Mexico claims that since 1949, the Government of Korea has used various measures to protect its domestic production of soju such as quotas and exceedingly high tariffs. Until 1989, Korea maintained quotas on bulk imports of whisky, and until July of that year, it prohibited the import of bottled whisky.

8.8. Mexico further claims that it was not until the end of the 1980s that Korea began to liberalize these barriers to the import of distilled spirits, and subsequently, in the wake of the Uruguay Round, it committed itself to reduce its tariffs of 100 per cent ad valorem to 30 per cent ad valorem in ten annual periods. Its current bound tariff is 79 per cent ad valorem for almost all spirits of heading 22.08 of the Harmonized Commodity Description and Coding System (HS).

8.9. Mexico asserts that at the beginning of the 1990s Korea reduced some of its internal taxes. In the case of the liquor tax, as of 1 July 1991 Korea reduced the rate applicable to whisky and brandy from 200 per cent to 150 per cent; in January 1994 to 120 per cent; and in January 1996 to 100 per cent. The category "other liquors" benefited from a single reduction from 100 per cent to 80 per cent in July 1991. A tax of 35 per cent was levied on soju<sup>313</sup> until 1991, when soju was divided into two subcategories, "diluted soju" and "distilled soju", taxed at 35 per cent and 50 per cent respectively.

8.10. Mexico further asserts that in 1990 the Korean Government began to apply the Education Tax Law to certain spirits, thus offsetting to a certain extent the reduction in the Liquor Tax. The Education Tax is a surtax applied to the sale of certain products pursuant to the application of the other taxes. In this case it is levied upon the Liquor Tax.

8.11. The application of the Liquor Tax Law in conjunction with the Education Tax Law favours the marketing of soju to the detriment of other spirits, thus affecting the marketing of the latter.

- 2. Legal Aspects
- (a) General
- 8.12. Mexico claims that:
  - (a) The differential between the internal taxes applied to soju and other imported spirits is a prima facie violation of Korea's obligations under Article III.2 of the GATT 1994 and, ultimately, constitutes a case of nullification or impairment of the benefits accruing to Mexico under the said Agreement;
  - (b) because it is a prima facie violation of Korea's obligations under the GATT 1994, it is up to Korea to rebut the charge.

(b)

"the products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products".

8.14. Mexico argues that according to the Appellate Body in Japan - Taxes on Alcoholic Beverages II, for a tax measure to be in conformity with the first sentence of Article III.2 of the GATT 1994, it is necessary to determine, "first, whether the taxed imported and domestic products are 'like' and second, whether the taxes applied to the imported products are 'in excess of' those applied to the like domestic products".<sup>314</sup>

8.15. Mexico considers that Korea has contravened the first sentence of Article III.2 of the GATT 1994 for the following reasons:

- (a) Soju is a like product to the spirits of HS heading 22.08.<sup>315</sup>
  - (i) The notion of "like products" varies according to the provision of the GATT 1994 to which it applies. Thus, in practice, likeness of products is established on a case-by-case basis. With respect to Article III.2, the practice of various panels<sup>316</sup> in the past suggests the application of the criteria of final use of the product in a given market, consumer taste and habits, and the properties, nature and quality of the products.
  - (ii) Spirits of HS heading 22.08, including tequila and mescal, have the same final use as soju in that they are drunk on their own, with spicy food "because the drink's harshness cuts the spiciness of the food." They also correspond to the tastes and habits of consumers of spirits and are equivalent in terms of their properties, their nature and their quality. Mexico states that it should be noted that soju like tequila and mescal, is divided into two categories: white tequila and mescal correspond to diluted soju, while matured tequila and mescal correspond to distilled soju. In both cases, the beverages are normally drunk on their own in small glasses. In Mexico's view, like diluted soju, both tequila and white mescal are clear very common and sold in great quantities, while matured tequila and mescal are more expensive drinks whose production process is more sophisticated and which, in many cases, are packaged in special bottles and offered as gifts.
- (b) Even if the tariff classification does not suffice in itself to determine whether the products are "like products", it should be noted that both tequila and mescal are in the same tariff subheading (six-digit classification) as soju, i.e. HS subheading 2208.90.<sup>317</sup> It should be recalled that the six-digit classification is the maximum

<sup>&</sup>lt;sup>314</sup> Appellate Body Report, supra., para 1 of Section H, page 18-19.

<sup>&</sup>lt;sup>315</sup> This heading includes tequila and mescal, which are Mexican products.

<sup>&</sup>lt;sup>316</sup> See Border Tax Adjustments (L/3464, 18S/97); The Australian Subsidy on Ammonium Sulphate (BISD II/188); EEC - Measures on Animal Feed Proteins, adopted on 14 March 1978, (BISD 25S/49); Spain - Tariff Treatment of Unroasted Coffee, adopted on 11 June 1981 (BISD 28S/102); Japan – Taxes on Alcoholic Beverages I

level of precision in the HS. Moreover, the Appellate Body in Japan - Taxes on Alcoholic Beverages II stipulates that "if sufficiently detailed tariff classification can be a helpful sign of product similarity".<sup>318</sup>

8.16. Mexico asserts that the taxes levied on soju are higher than those levied on tequila. To illustrate this point, Mexico submits to the Panel the following comparative table demonstrating that the taxes levied on tequila and mescal, for example, are much "higher than those levied on soju":

	Distilled soju	Tequila and mescal	Margin of discrimination against tequila and mescal
Liquor Tax	50%	80%	160%
Education Tax	10%	30%	300%
Education Tax (applied)	5%	24%	480%
Total taxes	55%	104%	189.1%

	Diluted soju	Tequila and mescal	Margin of discrimination against tequila and mescal
Liquor Tax	35%	80%	228.6%
Education Tax	10%	30%	300%
Education Tax (applied)	3.5%	24%	685.7%
Total taxes	38.55%	104%	270.1%

#### (c) Article III.2, second sentence

8.17. Mexico notes that the second sentence of Article III.2 of the GATT 1994 stipulates that:

[n]o contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

of the classification of products, and that more specifically, tequila and mescal are like products and directly competitive or substitutable for each other.

<sup>&</sup>lt;sup>318</sup> Report of the Appellate Body on Japan - Taxes on Alcoholic Beverages II,, supra., Section H, para. 1(a). See also: EEC - Measures on Animal Feed Proteins, supra.; Japan - Taxes on Alcoholic Beverages I, supra.; and United States - Standards for Reformulated and Conventional Gasoline, supra.

In this connection, Mexico also notes that paragraph 1 stipulates that:

[i]nternal taxes and other internal charges [...] should not be applied to imported or domestic products so as to afford protection to domestic production.

Furthermore, Mexico notes that according to the interpretative note to Article III.2:

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

8.18. According to Mexico, the second sentence of Article III.2 must be read in conjunction with the interpretative note. Thus, in order to determine the inconsistency of the adopted measure, the following elements must be examined:

- (a) whether the imported and domestic products are "directly competitive or substitutable" and compete with each other;
- (b) whether the directly competitive or substitutable imported and domestic products are not "similarly taxed"; and
- (c) whether different taxes are levied on imported and domestic directly competitive or substitutable products "so as to afford protection to domestic production."

8.19. In Mexico's view, spirits of heading 22.08, including tequila and mescal, are "like products", and hence directly competitive or substitutable products with soju.<sup>319</sup> And even assuming, for the sake of argument, that the Panel considers that spirits of HS heading 22.08 are not "like products" to soju, Mexico maintains that they are nevertheless "directly competitive or substitutable products".

8.20. Mexico also notes that in Japan - Taxes on Alcoholic Beverages II, which presented

8.21. According to Mexico, Korean soju and the other spirits of HS heading 22.08 are not similarly taxed because as stated in the report of the Appellate Body in Japan - Taxes on Alcoholic Beverages II, if a product is not to be considered to have been "similarly taxed," the difference in taxation must be greater than de minimis. In the case at issue, the differences in taxes are so great and so evident that there cannot be the slightest doubt that they exceed any de minimis requirement that the Panel might set.

8.22. Mexico argues that the Liquor Tax and the Education Tax introduced by Korea apply to products imported so as to afford protection to domestic production because:

- (a) Both the Liquor Tax Law and the Education Tax Law divide liquors into various categories; however, that division is arbitrary and cannot be justified under Article III of the GATT 1994. Moreover, the difference between the taxes is so great that it is impossible to argue convincingly that the differentials were not introduced with a view to protecting domestic production, as indeed they were.
- (b) Although Korea's arguments are intended to achieve the opposite result it is interesting to examine the relationship between Korea's internal taxes and its tariffs. While the internal taxes favour soju, the tariffs applied by Korea to imports are considerably higher for soju (30 per cent ad valorem) than for other spirits of HS heading 22.08 (where they vary between 15 and 20 per cent ad valorem). Mexico attributes this particular relationship to a two-stage protection mechanism: First, by levying internal taxes on soju that are considerably lower than for other spirits, Korea is protecting the soju industry in general. However, in Mexico's view, this measure puts Korean soju production in a vulnerable position with respect to other countries which also produce soju/shochu,<sup>323</sup> obliging Korea to impose on its soju imports tariffs 50 to 100 per cent higher than those applied to other spirits. As a result, on the one hand soju imports are practically non-existent, while on the other hand, soju accounts for almost the entire Korean production of spirits.
- 8.23. The Government of Mexico requests that the Panel:
  - (a) find that Korea has contravened its obligations under the first sentence of Article III.2 of the GATT 1994 in that its internal taxes levied on various spirits of HS

# C. KOREA'S RESPONSE TO THIRD-PARTY ARGUMENTS

8.24. Korea's response to the Canadian third-party submission is that the submission is limited to the 'so as to afford protection to domestic production' requirement in the second sentence of Article III.2, second sentence. According to Korea, that submission only addresses the situation where this Panel would find a directly competitive and substitutable relationship between a particular product pair of a western-type liquor and a Korean soju.

8.25. Korea notes that Canada has not at all addressed the arguments Korea has made in its first submission in respect of this particular requirement. Korea adds that Canada's submission raises no new viewpoints.

8.26. Korea, however, takes issue with the third party submission of Mexico. According to

drink Tequila and Mescal with Korea's spicy cuisine; or that Koreans drink Tequila or Mescal straight and not mixed as a cocktail. More generally, according to Korea, Mexico has not shown that Tequila or Mescal directly compete with Korean soju.

8.31. Korea notes that Mexico makes much of the fact that the tariff classification of Mescal, Tequila and soju are the same. According to Korea, this is not true. The sub-classifications, tariff bindings, and applied rates for tequila and soju are different. Moreover, Mexico goes so far as to

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# INTERIM REVIEW

9.1. In letters dated 7 July 1998 the European Communities, the United States and Korea all

paragraphs 10.1, 10.41, 10.42, 10.43, 10.47, 10.51, 10.74, 10.95, 10.97, 10.100 and 10.101, accordingly.<sup>328</sup>

9.7. The United States requested changes in paragraphs 10.18 and 10.23 to the effect that the issues covered in those paragraphs should be decided on the basis that the Korean requests were not within the panels terms of reference. We disagree with the US position. Under the US interpretation, many jurisdictional and other issues affirmatively raised by respondents would by definition be outside the terms of reference of a panel because the terms of reference are defined by the substantive issues raised in the complaining party's request for establishment of a panel. We think any panel has the right and obligation to address fundamental jurisdictional questions and issues relating to the proper functioning of the panel raised by any party to the dispute. Accordingly, we declined to change the basis of our decision in this regard.

9.8. The United States requested we delete paragraph 10.39 relating to discussions during the original negotiating sessions. This paragraph deals with a hypothetical and does not draw any conclusions about the specific products that were discussed in 1947-48. Rather, it was the nature of the discussion and what the discussion itself brought to light about the interpretation of Ad Article III:2 which is of relevance. We do not reach a legal or factual conclusion that "such products could not compete 'directly' under Article III." We have amended the language of 10.39 to provide further clarification.

9.9. The United States requested that the panel eliminate the two sentences at the end of the footnote in paragraph 10.42. In our view, the first sentence is a useful clarification. The second sentence has been eliminated.

9.10. The United States recommended changing the fourth sentence of paragraph 10.48. We assume the United States is referring to the fifth sentence. However, it is obvious from the whole paragraph that we are discussing methodology, not the facts of the Korean market. Therefore, we have declined to amend the paragraph.

9.11. With respect to paragraphs 10.55-10.57, the United States argued that classification under the same tariff heading is in itself evidence that products compete directly. We do not agree with the characterization of the issue proposed by the United States. The products first must be properly identified. As we noted above in regard to the EC's comments, these general statements are very weak evidence at best. The US argument also somewhat begs the question because there is a related issue of what level of detail in the tariff headings is appropriate for such analysis in any given case. The problem in this case is that we were left uninformed about what products constitute the remainder of the category. We declined to make the changes suggested by the United States in this regard beyond the clarification mentioned with respect to the EC comments above.

9.12. With respect to paragraph 10.81, the United States requested several changes for purposes of clarification. We have eliminated one sentence as redundant, but have otherwise kept the original language.

9.13. Korea stated that it had great difficulty accepting the outcome of the case. In Korea's view, the complainants failed to prove the necessary elements to establish a violation of Article III:2. In its General Comments, Korea states, among other things, that soju is consumed "primarily" with meals and that whisky and other spirits are consumed "primarily" as cocktails. We note as a

<sup>&</sup>lt;sup>328</sup> The United States made a reference to paragraphs 10.42-10.43 in one comment. We assume they were referring to paragraphs 10.41-10.42.

general matter that Korea was drawing far too fine a distinction between end-uses for purposes of Article III:2, second sentence. We note that, even in Korea's approach (which we do not accept), it is only a matter of the "primary" use where there are differences. There are overlapping end-uses even within the Korean definition.

9.14. Korea further states that "Korea finds it difficult to accept that the Panel puts into doubt Korea's description of its own market". Korea implies that any party to a dispute has an exclusive authority to assess the facts relating to its domestic market. We find no support for such a proposition in GATT/WTO jurisprudence. Indeed, that is the very function of a panel in a case such as this, to assess the facts and arguments and make findings based on a weighing of the evidence presented.

9.15. In its General Comments section Korea also made the specific comment that it did not argue that western-style liquors were found in "expensive restaurants" but soju was not. However, we note that in writing its comments, Korea in fact described the restaurants referred to by the United States that served whisky as well as soju as "expensive" restaurants.<sup>329</sup> This also is how Korea referred to these establishments during the Second Meeting of the Panel. These establishments were not offered as a representative sample and we did not view them that way. Rather, we reviewed all of the arguments of all of the parties and took account of and balanced all of the evidence presented. Arguments here and elsewhere that the Panel "relied" upon any particular piece of evidence or assessment must be evaluated in that light. Korea examines in too isolated a manner the various other factors assessed by us in reaching our conclusions. Ultimately, we relied upon all of the evidence presented, not any single element. In our view, the arguments at that time and in the Korean comments on the Interim Report were not persuasive, in light of all the evidence, in rebutting the case established by the complainants.

9.16. With respect to paragraph 10.45, Korea emphasized that an analysis of the particular market in question is required. We agree. However, as stated in the Findings, that does not imply that evidence of product relationships from other markets is irrelevant to an assessment of the competitive relationship of the products in the market in question. It is a matter of utilization and weighing of the evidence. Korea then states that it is relevant to look at how Korean manufacturers market shochu and soju in Japan and argues that there are differences. We do not disagree that there are some differences between soju and shochu, but, in our view, the differences are minor and we disagree that such differences contradict our conclusions with respect to the Korean market.<sup>330</sup> We also note that the Korean companies have created products and advertised them in Korean and international markets that emphasize the similarity of soju to western-style beverages which is the question here. We took into account the evidence presented by Korea with respect to soju and shochu. As part of our weighing of the evidence, we also took note of other information from outside of the Korean market for its implications for the situation within the Korean market. We declined to change paragraph 9.45 in this regard.

9.17. With respect to paragraph 10.52, Korea noted that the figures for premium diluted soju should state that it is five percent of the soju market not the distilled beverages market. We have corrected the reference. Korea also noted that premium soju sales currently have slowed. We do

<sup>&</sup>lt;sup>329</sup> Korea referred to the US statements about nine Korean-style restaurants found in the vicinity of the US embassy. However, Korea describes these establishments as "a few very expensive Korean restaurants" and "these nine expensive restaurants". Korean Comments on the Interim Report at p. 1. (emphasis added)

<sup>&</sup>lt;sup>330</sup> We take note that Japan stated in the panel proceedings of Japan – Taxes on Alcoholic Beverages II that soju and shochu were essentially identical products. Japan – Taxes on Alcoholic Beverages II, supra., at para. 4.178.

not think this detracts from the conclusions. As complainants noted, sales of imports have also slowed in recent months due to the current financial crisis in Korea.<sup>331</sup> The higher priced products such as premium diluted soju and imports have fallen off and sales of lower priced products have increased. The parties did not present extensive arguments about the relationship of the sales of the products to events occurring during the recent financial crisis<sup>332</sup> and we did not refer to such a period extensively, but, if anything, the similar trends in sales of imports and premium diluted soju (as well as the differential movement of standard diluted soju) in the situation can be taken to support our Findings. We made clarifications to paragraph 10.52 to reflect these comments.

9.18. In comments regarding paragraphs 10.93 and 10.94, Korea took exception to several statements regarding pricing information. Korea stated that "Korea cannot fathom how such huge price differences can lead to a competitive relationship". Our conclusion was that, overall, there was persuasive evidence of a directly competitive relationship in spite of the price differences. We recall our observation that absolute price ratios are not a good basis upon which to assess whether there is a directly competitive relationship between products. Information as to how consumers behave in the face of relative price changes is more persuasive.

9.19. Korea also stated that it strongly objects to the Panel's alleged approach of narrowing the

9.22. With respect to a footnote to paragraph 10.67, Korea argued that the Findings take their statements regarding differences in bottle sizes and types out of context. Korea states that it was emphasizing that the bottles used for exports of soju to Japan were different from shochu and that shochu bottles were meant to be similar to imports such as whisky. Presumably, Korea wished us to draw the conclusion that soju is marketed differently from shochu and whisky as a point of product distinction. This, in fact, was the issue we addressed. In any event, we clarified the specific reference to bottle size and shape differences made by Korea.

9.23. Korea requested the panel to amend the Findings in paragraphs 10.63 and 10.64 to

### FINDINGS

#### A. CLAIMS OF THE PARTIES

10.1. The European Communities and the United States claim that Korea applies its internal tax laws (the Liquor Tax Law and the Education Tax Law) on vodka in excess of taxes applied to soju and is therefore in breach of its obligations under Article III:2, first sentence, of GATT 1994. The complainants also argue that these internal tax laws are applied in a dissimilar manner to other imported distilled alcoholic beverages so as to afford protection to the domestic industry in breach of Korea's obligations under Article III:2, second sentence. The complainants have identified the imported products as all distilled alcoholic beverages described within Harmonized System classification 2208. They have identified specific examples of such beverages as including whiskies, brandies, cognac, liqueurs, vodka, gin, rum, tequila and "ad-mixtures". The complainants have identified soju as the domestically produced distilled alcoholic beverage which they claim receives preferential tax treatment.

10.2. Korea has responded that its internal tax measures are not inconsistent with its obligations under Article III:2. Korea argues that there are two types of soju, distilled and diluted, and that neither of these products are like the imported products and that the imports and the domestic products also are not directly competitive or substitutable. Korea argues that Article III:2 should be narrowly construed so as not to unduly infringe the sovereign right of Members of the WTO to structure their tax laws as they see fit. Korea claims that the complainants have not proved that with respect to the Korean market the products in question are either like or directly competitive or substitutable.

B. PRELIMINARY ISSUES

10.3. Korea raised the following preliminary issues and requested preliminary rulings with respect to:

- (i) the specificity of the panel requests of the complainants;
- (ii) the complainants' alleged non-compliance with certain provisions of the DSU relating to the conduct of consultations;
- (iii) alleged breaches of the confidentiality of the consultation process;

# 1. Specificity

10.4. Korea argues that the European Communities, in its request for a panel, has referred to a preferential tax rate on soju vis-a-vis certain alcoholic beverages falling within HS heading 2208. Korea states that the European Communities has not, even in its written submission, clarified its position on the category of alcoholic beverages falling within the scope of this dispute.

10.5. Korea states that the US request for a panel lacks specificity as well. Korea notes that the United States, in its request for a panel, refers to higher tax rates on "other distilled spirits", while specifically mentioning "whisky, brandy, vodka, rum, gin, and ad mixtures".

10.6. Korea argues that such vaguely worded complaints violate its rights of defence. According to Korea, HS 2208 is a very broad tariff classification, which covers a wide variety of alcoholic beverages, including non-western liquors such as koryangu, Korean soju, Insam ju, Ogapiju, and Japanese shochu. More precisely, Korea argues that this lack of specificity of the complainants' claims is improper for two reasons:

- (i) it frustrates Korea's right of defense, which Korea argues is a general principle of due process implicit in the DSU;
- (ii) it violates what Korea considers a clear obligation of the DSU, which is that such a request should "identify" the specific measures at issue, and "present the problem clearly", as stipulated in Article 6.

measures at issue: the general Liquor Tax Law and the Education Tax; and provided a brief summary of the legal basis of the complaint.

10.10. The United States refers to European Communities - Regime for the Importation, Sale and Distribution of Bananas (Bananas III), where the Appellate Body, according to the United States, noted that this provision concerning the legal basis requires that the request for a panel must be sufficiently specific with respect to the claims being advanced, but need not lay out all the arguments that will subsequently be made in the party's submission.<sup>337</sup> The United States argues that Korea's request that the Panel limit the proceeding to five specific products (whisky, brandy, vodka, rum, and gin) is equally without basis in Article 6.2. According to the United States, the panel request, which defines the terms of reference of the panel, refers to taxation of "other distilled spirits" -- i.e., distilled spirits other than soju. By using the term "such as," the United States and exclusive list. According to the United States, the extent to which the United States and the European Communities establish that all such products are "like" or "directly competitive or substitutable" is a matter to be determined through the course of these proceedings, beginning with the first written submission to the Panel.

10.11. As regards the question of defining which soju is referred to, the European Communities states that it regards all the varieties of soju as one product, with the necessary result that 'liqueurs' are more heavily taxed than some soju. According to the European Communities, the question of whether soju is or is not a single product is a substantive issue which cannot be decided by the panel in a preliminary ruling. The United States also argues that with respect to the use of the word "soju," its panel request makes it clear that the tax preference for all soju is covered, giving Korea ample objective notice that the entire category was to be challenged.

10.12. We note that Article 6.2 of the DSU provides in the relevant part that:

The request for the establishment of a panel shall be made in writing. It shall indicate whether consultations were held, identify the specific measures at issue and provide a summary of the legal basis of the complaint sufficient to present the problem clearly.

10.13. The Appellate Body noted in Bananas III that:

As a panel request is normally not subjected to detailed scrutiny by the DSB, it is incumbent upon a panel to examine the request for the establishment of the panel very carefully to ensure its compliance with both the letter and spirit of Article 6.2.<sup>338</sup>

10.14. The question of whether a panel request satisfies the requirements of Article 6.2 is to be determined on a case by case basis with due regard to the wording of Article 6.2. The question for determination before us, therefore, is whether the phrases used by the EC ("certain alcoholic beverages falling within HS heading 2208") and the United States ("other distilled spirits such as whisky, brandy, vodka, gin and ad-mixtures") are specific enough to satisfy the letter and spirit of Article 6.2. In other words, the question is whether Korea is put on sufficient notice as to the parameters of the case it is defending. As the Appellate Body noted in Bananas III:

<sup>&</sup>lt;sup>337</sup>Appellate Body Report on European Communities – Regime for the Importation, Sale and Distribution of Bananas (Bananas III), adopted on 25 September 1997, WT/DS27/AB/R, at para. 141.
<sup>338</sup>Ibid., at para, 142.

It is important that a panel request be sufficiently precise for two reasons: first, it often forms the basis for the terms of reference of the panel pursuant to Article 7 of the DSU; and, second, it informs the defending party and the third parties of the legal basis of the complaint.<sup>339</sup>

10.15. Korea argues that each imported product must be specifically identified in order to be within the scope of the panel proceeding. The complainants argue that the appropriate imported product is all distilled beverages. They claim, in fact, that for purposes of Article III, there is only one category in issue. They claim to have identified specific examples of such distilled alcoholic beverages for purposes of illustration, not as limits to the category.

10.16. The issue of the appropriate categories of products to compare is important to this case. In our view, however, it is one that requires a weighing of evidence. As such it is not an issue appropriate for a preliminary ruling in this case. This is particularly so in light of the Appellate Body's opinion in Japan - Taxes on Alcoholic Beverages II,<sup>340</sup> that all imported distilled alcoholic beverages were discriminated against. That element of the decision is not controlling on the ultimate resolution of other cases involving other facts; however, it cannot be considered inappropriate for complainants to follow it in framing their request for a panel in a dispute involving distilled alcoholic beverages. While it is possible that in some cases, the complaint could be considered so vague and broad that a respondent would not have adequate notice of the actual nature of the alleged discrimination, it is difficult to argue that such notice was not provided here in light of the identified tariff heading and the Appellate Body decision in the Japan - Taxes on Alcoholic Beverages II. Furthermore, we note that the Appellate Body recently found that a panel request based on a broader grouping of products was sufficiently specific for purposes of Article 6.2.<sup>341</sup> We find therefore, that the complainants' requests for a panel satisfied the requirements of Article 6.2 of the DSU.

# 2. A dequacy of consultations

10.17. Korea submits that what it considers to be explicit obligations contained in Articles 3.3, 3.7 and 4.5 of the DSU have been violated. Korea in effect alleges that the complainants did not engage in consultations in good faith with a view to reaching a mutual solution as envisaged by the DSU. According to Korea, there was no meaningful exchange of facts because the complainants treated the consultations as a one-sided question and answer session, and therefore, frustrated any reasonable chance for a settlement. Korea considers this non-observance of specific provisions of the DSU as a "violation of the tenets of the WTO dispute settlement system" and requests the Panel for a ruling.

10.18. Both complainants assert that Korea's claim would appear to be that they have infringed Articles 3.3, 3.7 and 4.5 of the DSU because they did not attempt to reach a mutually acceptable solution to the dispute in the course of the consultations that preceded the establishment of this Panel. The complainants refer to the panel decision in Bananas III for the proposition that the conduct of consultations is not the concern of a panel but that the panel need only concern itself with the question whether consultations did in fact take place,<sup>342</sup> and point out that Korea cannot

<sup>&</sup>lt;sup>339</sup> Ibid., para. 142.

<sup>&</sup>lt;sup>340</sup> Appellate Body Report on Japan - Taxes on Alcoholic Beverages (Japan - Taxes on Alcoholic Beverages II), adopted on 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, at pp. 26, 32.

<sup>&</sup>lt;sup>341</sup> Appellate Body Report on European Communities – Customs Classification of Certain Computer Equipment, adopted on 22 June 1998, (WT/DS62/AB/R, WT/DS67/AB/R), at paras. 58-73.

<sup>&</sup>lt;sup>342</sup>Panel Report on Bananas III, supra at paras. 7.18-7.19.

dispute the fact that consultations were in fact held on three separate occasions between itself and both the United States and the EC. The complainants state that, in any event it is not true that they refused to engage in a 'meaningful exchange of facts' during the GATT Article XXII consultations. They allege that it was Korea's attitude during the consultations which prevented such exchange from taking place.

10.19. In our view, the WTO jurisprudence so far has not recognized any concept of "adequacy" of consultations. The only requirement under the DSU is that consultations were in fact held, or were at least requested, and that a period of sixty days has elapsed from the time consultations were requested to the time a request for a panel was made. What takes place in those consultations is not the concern of a panel. The point was put clearly by the Panel in Bananas III, where it was stated:

Consultations are . . . a matter reserved for the parties. The DSB is not involved; no panel is involved; and the consultations are held in the absence of the Secretariat. While a mutually agreed solution is to be preferred, in some cases it is not possible for parties to agree upon one. In those cases, it is our view that the function of a panel is only to ascertain that the consultations, if required, were in fact held. ...<sup>343</sup>

We do not wish to imply that we consider consultations unimportant. Quite the contrary, consultations are a critical and integral part of the DSU. But, we have no mandate to investigate the adequacy of the consultation process that took place between the parties and we decline to do so in the present case.

# 3. Confidentiality

10.20. Korea alleges that both complainants have breached the confidentiality requirement of Article 4.6 of the DSU by making reference, in their submissions, to information supplied by Korea during consultations.

10.21. The European Communities argues that Korea's interpretation of Article 4.6 of the DSU is wrong. According to the European Communities, the confidentiality requirement of Article 4.6 of the DSU concerns parties not involved in the dispute and the public in general. The European Communities stresses that the requirement cannot in any way be read as referring to the panel itself. In the EC view, Article 4.6 cannot be interpreted as a limitation on the rights of parties at the panel stage.

10.22. The United States argues that to the extent Korea is alleging a violation of the DSU, such a claim is not within the terms of reference of the Panel. The United States further argues that Korea's complaints about the alleged inadequacy of the complainants' attempts to settle the dispute or engage in good faith consultations have no bearing on the authority of the Panel or the progress of this proceeding.

10.23. We note that Article 4.6 of the DSU requires confidentiality in the consultations between parties to a dispute. This is essential if the parties are to be free to engage in meaningful consultations. However, it is our view that this confidentiality extends only as far as requiring the parties to the consultations not to disclose any information obtained in the consultations to any parties that were not involved in those consultations. We are mindful of the fact that the panel proceedings between the parties remain confidential, and parties do not thereby breach any

<sup>&</sup>lt;sup>343</sup>Ibid., para. 7.19. The issue was not appealed.

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confidentiality by disclosing in those proceedings information acquired during the consultations. Indeed, in our view, the very essence of consultations is to enable the parties gather correct and relevant information, for purposes of assisting them in arriving at a mutually agreed solution, or failing which, to assist them in presenting accurate information to the panel. It would seriously hamper the dispute settlement process if the information acquired during consultations could not subsequently be used by any party in the ensuing proceedings. We find therefore, that there has been no breach of confidentiality by the complainants in this case in respect of information that they became aware of during the consultations with Korea on this matter.

#### 4. Late submission of evidence

10.24. Korea complains that its rights of defense were violated by the late submission of a market study (the Trendscope survey) by the European Communities. Korea had submitted a study done by the AC Nielsen Company as part of its responses to questions arising from the first substantive meeting of the Panel. The European Communities responded to this with, among other things, the Trendscope survey presented at the Second Meeting of the Panel. The Panel gave Korea a week to respond to this and critique the results, methodology and questions used in the Trendscope survey. Korea argues that this time was insufficient, that it did not have copies in Korean of all the questions -asked, and that it did not have time to provide further questions or comments based upon the answers.

10.25. We do not consider that Korea's rights under the DSU were violated. The European Communities submitted its rebuttal survey at the next available opportunity after receiving Korea's Nielsen survey. Had Korea chosen to submit its survey at the first substantive meeting and the European Communities failed to respond at the next opportunity (in such a case, it would have been in the rebuttal submission), there obviously would have been more merit to the claim because then the European Communities, it could have been argued, delayed submitting their evidence. As it transpired, the European Communities submitted a new piece of evidence at the next available opportunity which Korea then was able to examine for a week in order to provide comments. The survey was not of a particularly complex type and, in our view, Korea had adequate time to

Korea adds that the Appellate Body also noted that representation by counsel of a government's own choice in proceedings before it (the Appellate Body) might well be a matter of particular significance to enable WTO Members to participate fully in WTO dispute settlement proceedings. According to Korea, the same holds true with respect to delegations presenting a case before a Panel. Korea further submits that under customary international law, it has the sovereign right to determine the composition of its delegation to panel hearings.<sup>345</sup> Korea also believes its right to counsel of its choice is consistent with what it considers to be basic due process principles implicit in the DSU. Korea indicated that it appreciated that the Panel might have concerns about the confidentiality of the proceedings. Korea assured the Panel that it would ensure that any member of its delegation, including private counsel, will fully respect the confidentiality of the proceedings in accordance with applicable rules.

10.28. The European Communities indicates that it has no objection, in principle, to the presence of private counsel as part of Korea's delegation during substantive meetings of the Panel. The European Communities states, however, that they attach great importance to the preservation of confidentiality of panel proceedings. The EC acceptance was, therefore, made conditional upon Korea assuming full responsibility for any breach of confidentiality which may result from the presence at the Panel meetings of non-governmental persons. The European Communities take regard of the assurances given by Korea to the effect that its private counsel, like any other member of its delegation, would fully respect the confidentiality of the proceedings.

10.29. The United States notes that the Members of the WTO have agreed to abide by the rules

of Korea, and that they will fully respect the confidentiality of the proceedings and that Korea assumes full responsibility for confidentiality of the proceedings on behalf of all members of its delegation, including non-government employees.

10.32. We note that written submissions of the parties which contain confidential information may, in some cases, be provided to non-government advisors who are not members of an official delegation at a panel meeting. The duty of confidentiality extends to all governments that are parties to a dispute and to all such advisors regardless of whether they are designated as members of delegations and appear at a panel meeting.

and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.<sup>346</sup>

10.35. Thus, the first sentence of Article III:2 examines whether products of an exporting country are taxed in excess of the taxes on the "like" domestic product. The second sentence examines whether products of an exporting country are taxed similarly to domestic products which are "directly competitive or substitutable." Both sentences first examine the relationship between the domestic and imported products; however, the second sentence involves additional and different inquiries with respect to two other elements; namely, an examination of the extent of the difference in taxation<sup>347</sup> and whether the taxation differences are applied so as to afford protection to the domestic industry.

10.36. The general approach in past Article III:2 cases has been to examine first whether any of the products at issue are "like." However, previous cases have found that the category of like products is a subset of those products which are directly competitive or substitutable.<sup>348</sup> It therefore seems more logical to us to approach the issue by examining the broader category first.

10.37. Before beginning to analyze the evidence presented, we must first decide how the term "directly competitive or substitutable" should be interpreted. Article 31 of the Vienna Convention summarizes the international law rules for the interpretation of treaty language. It provides in paragraph 1 that terms shall be interpreted in good faith in accordance with the ordinary meaning of the terms in their context and in light of the object and purpose of the treaty. According to paragraph 2, the context includes the full text, the preamble, the annexes and any mutually agreed interpretive language. Paragraph 3 provides that account shall also be taken of any subsequent practice or interpretations as well as relevant rules of international law.

10.38. The Appellate Body in Japan – Taxes on Alcoholic Beverages II stated that "like product" should be narrowly construed for purposes of Article III:2. It then noted that directly competitive or substitutable is a broader category, saying: "How much broader that category of 'directly competitive or substitutable products' may be in a given case is a matter for the panel to determine based on all the relevant facts in that case."<sup>349</sup> Article 32 of the Vienna Convention provides that it is appropriate to refer to the negotiating history of a treaty provision in order to confirm the meaning of the terms as interpreted pursuant to the application of Article 31. A review of the negotiating history of Article III:2, second sentence and the Ad Article III language confirms that the product categories should not be so narrowly construed as to defeat the purpose of the anti-discrimination language informing the interpretation of Article III. The Geneva session of the Preparatory Committee provided an explanation of the language of the second sentence by noting that apples and oranges could be directly competitive or substitutable.<sup>350</sup> Other examples provided natural rubber.<sup>352</sup> There was discussion of whether such products as tramways and busses or coal

and fuel oil could be considered as categories of directly competitive or substitutable products. There was some disagreement with respect to these products.<sup>353</sup>

10.39. This negotiating history illustrates the key question in this regard. It is whether the products are directly competitive or substitutable. Tramways and busses, when they are not directly competitive, may still be indirectly competitive as transportation systems. Similarly even if most power generation systems are set up to utilize either coal or fuel oil, but not both, these two products could still compete indirectly as fuels.<sup>354</sup> Thus, the focus should not be exclusively on the quantitative extent of the competitive overlap, but on the methodological basis on which a panel should assess the competitive relationship.

10.40. At some level all products or services are at least indirectly competitive. Because consumers have limited amounts of disposable income, they may have to arbitrate between various needs such as giving up going on a vacation to buy a car or abstaining from eating in restaurants to buy new shoes or a television set. However, an assessment of whether there is a direct competitive relationship between two products or groups of products requires evidence that consumers consider or could consider the two products or groups of products as alternative ways of satisfying a particular need or taste.

10.41. The Panel in Japan – Taxes on Alcoholic Beverages II noted that the 1989 Japanese tax reform had eliminated the distinctions between various grades of whisky. The result was that domestic whisky production declined relatively. Its market share fell and both shochu and foreign-produced whisky's market share rose. The Panel stated:

In the Panel's view, the fact that foreign produced whisky and shochu were competing for the same market share [held by domestic whisky] is evidence that there was elasticity of substitution between them.<sup>355</sup>

Imported whisky and shochu may each have been competing independently with domestic whisky. We would agree with that panel that showing such indirect competition may provide evidentiary support for a finding of direct competitiveness. However, such a showing is insufficient on its own. To use a hypothetical case for illustration, it is possible that in some markets distilled beverages could be shown to compete with wine; beer could also be shown to compete with wine. However, such evidence does not reveal whether the relationship is direct or indirect. More would need to be shown in such a case to establish that distilled beverages and beer are directly competitive or substitutable with respect to each other in that market.

10.42. In our view, it is also the case that quantitative analyses, while helpful, should not be considered necessary. In examining the Korean market, a determination of the precise extent of the competitive overlap is complicated by the fact that, as the 1987 and 1996 panels noted in the Japan – Taxes on Alcoholic Beverages I and II, the intervention of government policies can cause distortions, including understatement, of the quantitative extent of the competitive relationship. Indeed, there must be some concern that a focus on the quantitative extent of competition instead of the nature of it, could result in a type of trade effects test being written into Article III cases.

<sup>&</sup>lt;sup>353</sup> E/Conf.2/C.3/SR.40 at p. 2.

<sup>&</sup>lt;sup>354</sup> To follow on from these hypotheticals, it can be noted that some large power generation facilities may be convertible from coal to fuel oil or a series of power stations in a particular market could be set for replacement and alternative fuel sources might be under consideration. In such instances there may be direct competition. Hence the statements of the delegates that a review of the specific market structure is necessary to determine the nature of the competition.

<sup>&</sup>lt;sup>355</sup> Panel Report on Japan -- Taxes on Alcoholic Beverages II, supra., at para. 6.30.

That is, if a certain degree of competition must be shown, it is similar to showing that a certain amount of damage was done to that competitive relationship by the tax policies in question. The Appellate Body stated:

Moreover, it is irrelevant that the "trade effects" of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent, Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products. WT/DS75/R WT/DS84/R Page 176

direct? It is for this reason, among others, that quantitative studies of cross-price elasticity are relevant, but not exclusive or even decisive in nature.

(ii) Evidence from outside the Korean market

10.45.

10.48. Korea's arguments in this regard are not persuasive. We, indeed, are not in the business of speculating on future behaviour. However, we do not agree that any assessment of potential competition with a temporal aspect is speculation. It depends on the evidence in a particular case. Panels should look at evidence of trends and changes in consumption patterns and make an assessment as to whether such trends and patterns lead to the conclusion that the products in question are either directly competitive now or can reasonably be expected to become directly competitive in the near future. It is not evident why such an assessment is any more speculative in nature than the "but for" analysis itself. Such an analysis also requires making an assessment about what would happen in the theoretical case of the tax differentials being removed. In our view, the approach suggested by Korea is too static. It would be a profoundly troubling development in GATT/WTO jurisprudence if Members were forced to return to dispute settlement on the same laws over and over only because the market in question had not yet changed enough to justify a finding at a particular moment. Such an interpretation would be contrary to the settled law that competitive expectations and opportunities are protected.<sup>361</sup> As noted above, the Appellate Body in Japan -- Taxes on Alcoholic Beverages II stated:

Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.<sup>362</sup>

According to the 1949 Working Party Report on Brazil Internal Taxes:

[The majority of the working party] argued that the absence of imports from contracting parties during any period of time that might be selected for examination would not necessarily be an indication that they had no interest in exports of the product in affected by the tax, since their potentialities as exporters, given national treatment, should be taken into account.<sup>363</sup>

10.49. Similarly, the panel in the 1987 case of United States -- Taxes on Petroleum and Certain Imported Substances stated:

For these reasons Article III:2, first sentence, cannot be interpreted to protect expectations on export volumes; it protects expectations on the competitive relationship between imported and domestic products.<sup>364</sup>

The Shorter Oxford English Dictionary defines "potential" as follows:

potential 1. possible as opposed to actual; capable of coming into being; latent.<sup>365</sup>

The same dictionary defines "expectation" as follows:

<sup>&</sup>lt;sup>361</sup> We also note that a requirement of substantial current market presence would be a particularly high hurdle for less wealthy exporters.

<sup>&</sup>lt;sup>362</sup> Appellate Body Report in Japan Alcoholic Beverages II, supra., at p. 16 (emphasis added).

<sup>&</sup>lt;sup>363</sup>Brazilian Internal Taxes, BISD II/181 at p. 185, para. 16 (emphasis added).

<sup>&</sup>lt;sup>364</sup>United States -- Taxes on Petroleum and Certain Imported Substances, BISD 34S/136, at p. 158, para. 5.1.9 (emphasis added). We do not consider it a meaningful distinction on this issue that this quote refers to the first sentence of Article III:2 rather than the second sentence. To find otherwise would be to imply that one could refer to expectations with respect to determining the market conditions for examining like products but not for examining whether products are directly competitive or substitutable. Given that like products are a subset of directly competitive or substitutable products, this would be illogical.

<sup>&</sup>lt;sup>365</sup>L. Brown (ed), The New Shorter Oxford English Dictionary (Clarendon Press, 1993), Vol. 2 at p. 2310 (emphasis in the original).

expectation 1. The action of waiting for someone or something. . . .4. A thing expected or looked forward to.  $^{\rm 366}$ 

10.50. The interpretation proposed by Korea is not consistent with the standard meaning of the terms in question both of which clearly have a temporal element to their definitions. We will not attempt to speculate on what could happen in the distant future, but we will consider evidence pertaining to what could reasonably be expected to occur in the near term based on the evidence presented. How much weight to be accorded such evidence must be decided on a case-by-case basis in light of the market structure and other factors including the quality of the evidence and the extent of the inference required. To try to limit T\*in tch d s Tc 00 -it -12.s i Ththe Tf 0ere0 1/2ali

soju made from a mix of additives, water and grain solution (or distilled soju solution -- the Liquor Tax Act classifies soju as being 'diluted' soju where the ratio of the grain solution or the distilled soju solution amounts to 20% or less of the total volume of alcohol), blended into an alcohol solution extracted by a method of "continuous distillation".<sup>370</sup>

10.53. Korea has argued that distilled soju and diluted soju are two separate product categories for purposes of analysis under both sentences of Article III:2. Korea argues that the complainants must prove the imported products are like or directly competitive with or substitutable for each of the two domestic products separately and provide a comparison with each on a product-by-product basis. Complainants, on the other hand, argue that the two types of soju are nearly identical and therefore all soju is a single product for purposes of analysis in this case.

10.54. The distinction between distilled and diluted soju is more relevant to a discussion of like products where the product categories are narrower. The Korean Fair Trade Commission has stated that:

the basic difference between those two types of soju is whether the alcohol was extracted by means of single-step distillation or continuous distillation.<sup>371</sup>

We are not convinced that this difference is significant. Moreover, in our view, to the extent there are differences between the two types of soju, distilled soju is more similar to the imported products than diluted soju. Distilled soju is higher priced than diluted soju; distilled soju (40-45 percent) has a higher alcohol content than diluted soju (20-25 percent); distilled soju often is used as gifts, an end-use identified by Korea as one also pertaining to imports; distilled soju is aged as is the case with many of the imports. As is discussed further below, we do not think that these types of differences are sufficiently important to meaningfully distinguish between two products. We will proceed with an examination primarily of the competitive relationship of the imported products with diluted soju is directly competitive with and substitutable for the imported products, it will follow that this is also the case for distilled soju because distilled soju is intermediary between the imported products than diluted soju. Indeed, distilled soju is, on the one hand, more similar to the imported products.

10.55. With respect to the imported products, there is a fundamental and important disagreement between the parties to the dispute. Complainants argue that all distilled beverages are directly competitive or substitutable with each other. They have presented evidence with respect to several categories of such imported products, but not all products within the tariff heading 2208 which constitutes the parameters of the terms of reference. They have argued that they have presented evidence with respect to the primary imported products as examples of the broader category. The EC, in particular, argued that to present information on each and every type of distilled beverage would put too much of a burden on complainants have argued that the Appellate Body ruled that all imported distilled beverages were directly competitive with or substitutable for shochu in the case of Japan -- Taxes on Alcoholic Beverages II. They argue that we should take guidance from the Appellate Body's decision in that case.

of sales, if anything, can be taken as further support for the relationship of the products. See EC Answers to Questions, Question 1 from the Panel at pp. 1-2, and accompanying chart.

<sup>&</sup>lt;sup>370</sup> Korea First Submission, Attachment 1, supra., at 3.

<sup>&</sup>lt;sup>371</sup> Ibid.

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10.56. The Japan – Taxes on Alcoholic Beverages II case provides unclear guidance for the present case. The panel in that instance made findings with respect to the western-style alcoholic beverages for which specific evidence was provided. However, the panel did not explicitly state that it was not making a determination with respect to the other products within HS 2208. The Appellate Body ruled that, as a matter of law, the panel erred in not making determinations with respect to all of the products within the terms of reference. The Appellate Body went on to find that all imported products identified by HS 2208 were directly competitive with or substitutable for the domestic product, shochu. In that case, the Appellate Body did not further explain its reasoning. We are unaware of the specifics of the

vodka, whiskies, rum, gin, brandies, cognac, liqueurs, tequila and ad-mixtures.<sup>373</sup> The complainants have not carried their burden of establishing a prima facie case with respect to the remainder of the products under HS 2208.<sup>374</sup>

10.58. We include tequila for which evidence was presented. We note that a third party, Mexico, provided arguments with respect to both tequila and mescal. The complainants provided specific evidence for tequila, but not mescal. We consider it appropriate to take into consideration information provided by a third party. In this case, mescal was mentioned without positive evidence of the actual or potential competitive nature of the product in the Korean market. Tequila was included in the Dodwell study where there was evidence of the response of consumers to the relative changes in the prices of soju and tequila. Tequila is a white alcoholic beverage which is also used, among other things, to accompany spicy foods.

10.59. While we have declined to find all products identified by HS 2208 are included in our determination, we also do not accept the Korean argument that we are required to make an item by item comparison between each imported product and both types of soju. Relying on product categories is appropriate in many cases. Indeed, in this case parties generally referred to the category of "whiskies" which included several subcategories of types of whisky such as Scotch (premium and standard), Irish, Bourbon, Rye, Canadian, etc, all of which have some differences. The question becomes where to draw the boundaries between categories, rather than whether it is appropriate to utilize categories for analytical purposes.

10.60. In our view, it is appropriate to group together all of the imported products for which evidence was presented. We note that Korea in its arguments often referred to western-style beverages. The "high-class" restaurants and bars that allegedly did not serve soju, were said to sell western-style beverages. There are some physical differences between the various imported beverages but, as discussed below, we do not find these differences sufficient to make it inappropriate to group them together as imported products. The prices of the imported products show a spread over a certain range, but as with the relationship to soju, we do not think the prices so distinct as to prohibit us from examining the identified imports as a group. The imports appear to be distributed in similar manners for similar purposes. Therefore, based on the evidence, including that discussed more fully in section 4 below, we find that, on balance, all of the imported products specifically identified by the complainants have sufficient common characteristics, end-uses and channels of distribution and prices to be considered together.

#### 4. Product comparisons

10.61. We next will consider the various characteristics of the products to assess whether there is a competitive or substitutable relationship between the imported and domestic products and draw conclusions as to whether the nature of any such relationship is direct. We will review the physical characteristics, end-uses including evidence of advertising activities, channels of distribution, price relationships including cross-price elasticities, and any other characteristics.

# (i) Physical characteristics

10.62. Complainants argue that the defining physical characteristic of both imported and domestic products is the fact that they are distilled beverages. Other differences such as colouring or flavouring have no relevance in an analysis of whether products are directly competitive or substitutable. As summarized by the complainants:

The basic physical properties of soju and other categories of liquors concerned in this dispute are essentially the same. All distilled liquors are concentrated forms of alcohol produced by the process of distillation. At the point of distillation, all spirits are nearly identical, which means that the raw materials and methods of distillation have almost no impact on the final product. Post-distillation processes such as ageing, dilution with water or addition of flavourings, do not change the basic fact that the product sold is still a concentrated form of alcohol.<sup>376</sup>

10.63. Korea argues that the different physical characteristics are substantial. They argue that distilled liquors can be derived from a variety of sources and that the selection of raw materials can play an important role in determining the ultimate qualities of the finished product. Korea argues that there is a distinction between brown spirits such as whisky and white spirits such as soju and gin. The brown colouring generally comes from aging in barrels whereas white spirits are not aged before bottling. Korea argues that even very minor differences in physical characteristics can be determinative if consumers perceive them as important. To put it another way, in response to a question from the panel, Korea argues that two products which are nearly physically identical can be found not directly competitive or substitutable if consumers perceive them differently. According to Korea the question's reference to nearly physically identical begs the question, because "nearly" must be defined in terms of consumer perception rather than comparison of physical characteristics by non-consumers such as chemists.

10.64. We do not agree with Korea's narrow interpretation. The Panel is examining the nature of the competitive relationship and determining whether there is an actual or potential relationship sufficiently direct to come within the strictures of Article III:2, second sentence. The physical characteristics themselves must be reviewed for if two products are physically identical or nearly so, then it obviously means that there is a greater potential for a direct competitive relationship. The United States argued that there can be two products of identical physical properties such as name brand and generic aspirin which are marketed somewhat differently and perceived somewhat differently by consumers. Nonetheless, they would be considered directly competitive or substitutable and the identical or nearly identical physical characteristics would be a significant factor in the analysis. We find this analogy useful.

approach should be revised. In this case, however, we note that the results of the inquiry described in the following sections confirm the appropriateness of grouping the imports together for purposes of analysis. <sup>376</sup> EC First Submission at para. 97; US First Submission at para. 68. 10.65. The panel on Japan – Taxes on Alcoholic Beverages II referred to the usefulness of examining marketing strategies.<sup>377</sup> Marketing strategies that highlight fundamental product distinctions or, alternatively, underlying similarities may be useful tools for analysis. However, marketing strategies sometimes aim to create distinctions that are primarily perceptual between products with very similar physical characteristics. The existence of such perceptions based on

note that soju may also contain various sweeteners and flavourings. Indeed, the premium soju that has entered the market recently, corresponding to the entry of the imported products, has increased amounts of these additives.<sup>381</sup> While there are some differences in the physical characteristics of the products, weighing the evidence presented, we find that there are fundamental physical similarities between the imported and domestic products that would support a finding that the imported and domestic products in question are directly competitive or substitutable.<sup>382</sup>

# (ii) End-uses

10.68. The issue of end-uses for these products has drawn much attention from the parties in this case. The complainants have argued that all distilled beverages have common end-uses. They have identified these as follows:

1.

style beverages. The survey concluded that while all Korean restaurants, Chinese restaurants and mobile street vendors deal in standard soju, most cafes/western-style restaurants and bars deal in whisky. The survey also found that 29.3% of the respondents consumed alcoholic beverages at home with meals, while 81% were found to have consumed such beverages with meals at restaurants. The authors of the report claimed that diluted soju was the predominantly consumed alcoholic beverage with meals. Drinking diluted soju with meals was most popular at Korean restaurants (73%), followed by Japanese restaurants (18.7%). Of the 7 beverages offered to the respondents, none of them were consumed with meals at cafes/western style restaurants, bars and hotel bars. Finally, the survey found that soju is predominantly consumed straight (98.6%), while whisky is usually consumed on the rocks (63.8%).

10.72. The complainants responded to this survey by pointing out that there were several categories of overlapping end-uses. For instance, all Japanese restaurants served soju and 40% of them served whisky; a further 6.7% served brandy or cognac. Of the responding Western-style restaurants and cafes, 90% served whisky and a lesser number served other types of western-style beverages. However, 21.7% served soju. Also, the complainants noted that while only 1.7% of the individual respondents drank whisky at home with meals, only 29.3% of all respondents consumed any alcoholic beverages at home with meals. Therefore, the proper comparison was of the 1.7% with the 29.3 %, thus leaving 5.8% of all respondents who consumed alcoholic beverages with meals at home as drinkers of whisky as the accompaniment. Complainants have questioned some of the findings of the Nielsen survey, but also have argued that these results are actually indications of overlapping end-uses.

10.73. Complainants have noted that there were almost no western-style beverages in Korea until the last five years following changes in the duty rates on imported distilled beverages. Furthermore, they argue, alcoholic beverages, like many foods and beverages, are experience based products. People tend to purchase what they are familiar with and change their tastes only over a period of time. They will only make minor substitutions for the familiar product at first and higher frequency will tend to occur over a period of time until a fairly stable rate is achieved.<sup>384</sup> The

10.75. The EC submitted a market survey conducted by Trendscope during the second substantive meeting of the Panel. It was of the same general type as Korea's Nielsen survey. It examined end-uses but did not go into specific price comparisons as did the earlier submitted Dodwell study. Korea requests that we disregard the Trendscope survey. As discussed above, we decline to disregard the survey; however, we do not, in fact, accord much weight to the submission by the EC. It adds little of probative value to the extensive prior submissions of the parties. What was of more interest was the nature of some of the substantive disagreements of the parties concerning information contained in the Trendscope survey. Among other things there was a disagreement over the correct Korean terms and whether the questioners adequately distinguished between "meals" and "food." Korea apparently puts a great deal of store in this distinction, arguing that one must look exclusively at "meals" where Korean soju predominates rather than at mere "food" which might include snacks where western-style beverages might be consumed.

10.76. We do not consider this a meaningful distinction between end-uses of products, certainly not enough to establish separate and non-competing product categories for purposes of Article III:2, second sentence. Neither this nor other panels should be required to draw such fine distinctions permitting significant differences in the application of the law based upon such differences as saying one beverage is used for snacks and another for meals. In reviewing the evidence of this case, we are not convinced that such a distinction, even assuming Korea's argument that it exists is correct, is sufficient. If a distilled alcoholic beverage is drunk with snacks, the nature of the competitive relationship is that it can be drunk with meals, either as marketing campaigns change or persons become more familiar with products new to the market.

in the surveys and the trends in consumption patterns, it does appear that some Koreans at some times prefer other beverages and that these trends towards substitutability are likely to continue, even with respect to end-use categories we consider overly narrow.

10.77. We also are of the view that the presence of ad-mixtures in the Korean market lends credence to the conclusion of the substitutability of the imported and domestic products. Korea argued that the domestic ad-mixtures are not soju, but as soju is defined in the Liquor Tax Law as essentially diluted ethyl alcohol with some flavorings and additives, it is unclear what point Korea is making with this alleged distinction. If alcoholic beverages can be and often are drunk mixed, either as pre-mixes or mixed after purchase, it shows the potential for substitution between the base drinks and the lack of importance of the distinction which Korea attempts to draw based on alcohol strength.<sup>387</sup>

10.78. End-uses constitute one factor which is particularly relevant to the issue of potential competition or substitutability. If there are common end-uses, then two products may very well be

called barley soju which clearly is intended to be comparable to imported products such as whiskies.<sup>390</sup> Evidence was also produced from various sources including Korean Air's in-flight magazine showing very similar advertising strategies for distilled soju and western-style beverages.<sup>391</sup>

10.80. Korea argued that advertisements in Korean Air's in-flight magazine should not be considered as aimed at the broad domestic market. Similarly, according to Korea, information from the website of the largest Korean soju producer, Jinro, in English or other advertisements in Japanese would be aimed at the export market not at the Korean domestic market, which is the only relevant one here. We take note of Korea's criticisms of these materials. However, we continue to disagree that the only relevant market for collecting data is the Korean domestic market.<sup>392</sup> Rather the Korean market is the one that is the subject of our decision. In assessing the

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of Justice ("ECJ").393

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section. Similarly, the complainants have shown that there are some similarities in other presumably more minor outlets such as duty free sales.

10.84. The primary area of disagreement is with respect to the channels of distribution for onpremise consumption. Korea argues that soju is sold primarily for use with Korean food in Korean-style restaurants. This was broadened and further explained by Korea through the Nielsen survey, which Korea argues provides evidence that most soju for on-premise consumption was sold to traditional Korean-style restaurants, as well as Japanese and Chinese restaurants and mobile vendors. Conversely, western-style beverages were sold for on-premise consumption primarily to cafes/western-style restaurants and bars.

10.85. As discussed above, the complainants have noted that there was overlapping distribution in the Japanese-style restaurants and cafes/western-style restaurants in Korea's Nielsen survey. We also noted from the Nielsen survey that, with respect to sales to cafes/western-style restaurants, while only 13 of the 60 survey respondents said they sold soju compared with 54 of the 60 saying they sold whisky, they sold 22,710 ml per month of soju compared with 11,702 ml of whisky. That is, more soju was sold than whisky in this allegedly western-style beverage channel of distribution. This seems to detract from the Korean claim that this type of on-premise channel of distribution overwhelmingly favoured whisky.

10.86. Korea asserted that western-style beverages are limited for on-premise consumption to "classy" establishments such as "high-class" bars, karaoke bars and expensive restaurants.<sup>401</sup> In response to these arguments, the United States sent its embassy personnel in Seoul in search of large, traditional Korean-style restaurants to test the hypothesis. They claim to have found nine such establishments in the vicinity of the US Embassy that sold both whisky and soju. This prompted a discussion among the parties as to whether the identified restaurants would be typical or more expensive than normal. The resolution of the question of whether these restaurants were representative or were too expensive to qualify as "traditional Korean-style" is less important than the nature of the discussion itself. We do not think that a product distinction in a dispute under Article III:2. second sentence, can turn on such a thin and changeable distinction as Korea has attempted to make based on whether a restaurant is "high-class" or "expensive" or not. The only meaningful distinction in channels of distribution and points of sale that came to light in this case was the distinction between on-premise and off-premise distribution, but that distinction does not appear to distinguish between the imported and domestic products at issue. We find that, overall, there is considerable evidence of overlap in channels of distribution and points of sale of these products and such evidence is supportive of a finding that the identified imported and domestic products are directly competitive or substitutable.

(iv) Prices

10.87. Complainants have submitted a study of Korean consumer behaviour (the Dodwell study) related to relative price movements of soju and various western-style beverages, including premium Scotch whisky, standard whisky, cognac, vodka, gin, rum, tequila and liqueurs. The Dodwell study purports to show what happens when either the price of soju increases or the price of western-style beverages decreases, both done in specific increments. The survey also attempted to determine whether there was any evidence of cross-price elasticity. In response to Korea's challenges to the data and methodology, the complainants responded that the study was not attempting to show actual calculations of cross-price elasticity ratios because of difficulties inherent in the situation. Complainants said that the imported products had not been available in

<sup>&</sup>lt;sup>401</sup> Statement of Korea at First Meeting of the Panel at p. 8; Statement of Korea at Second Meeting of the Panel at p .20.

sufficient quantities to provide adequate consumer familiarity with the products and, furthermore, the Korean tax measures at issue also skewed the pricing and product availability structure such that it would be difficult to calculate actual cross-price elasticity ratios. As noted above, the complainants argued that alcoholic beverages were experience goods. People tend to consume what they are familiar with. Brand and product loyalty are strong and consumers will change their patterns only slowly over a long period of time following significant marketing activity and dependent upon plentiful product availability. Complainants emphasized the statement in the study that it was intended to "determine whether any evidence exists of cross-price elasticity between different spirits categories" rather than actually calculating such elasticities. Complainants referred to this as a more modest goal that was achievable and all that was possible in the circumstances.

10.88. Complainants stated that the evidence of substitutability was quite strong when the two separate trends of lowering import prices and raising soju prices occurred. The United States summarized this in charts which showed the Dodwell results concluding that the respondents would chose imported brown spirits rather than soju 15.22% of the time under current price conditions, but 28.4% of the time when the price of diluted soju was raised 20% and the price of brown spirits was lowered to its lowest point in the survey. Similarly, with respect to white spirits the choice went from 13.8% for imports at current levels to 23.8% when soju was again increased 20% in price and imports were at their lowest survey levels.<sup>402</sup>

10.89. Korea provided considerable criticism of the Dodwell study. Citing a EC Commission notice on submissions related to EC competition law, Korea argued that any market study done for the purposes of influencing decision makers must be suspect. Korea also noted that surveys based on asking consumers hypothetical questions about opinions rather than direct factual questions are inherently untrustworthy because, among other things, there may be ambiguity in the questions and there was a need to infer factual results from opinions. Korea also noted that the firm retained to do such a survey has an incentive to try to provide answers consistent with the clients desires so that it might be retained again in the future. Specifically, Korea criticized the complexity of the questions and the unrepresentative nature of the respondents. Korea pointed out a number of anomalies in the results such as increases in soju consumption when the price increased from 1,100 won to 1,200 won. Korea also complained that premium diluted soju was included in the alternative samples along with imported beverages rather than included along with standard diluted soju as the base for comparison. According to Korea, this skewed the results. Finally, Korea was critical of the formulation of the questions, which Korea argued could be taken by the survey respondents to mean that they were being asked if they would try a bottle of imported beverages as a one-time purchase if offered a special cut rate price.

10.90. The complainants repeated that the Dodwell study had much more modest purposes than calculating cross-price elasticities for alcoholic beverages in the Korean market. Complainants noted that the Korean market had only been even partially deregulated for a few years and cited the findings of both panels examining Japanese alcoholic beverage taxes to the effect that government regulations and taxes often can freeze consumer preferences. In light of this, according to complainants, it stands to reason that the Dodwell study must be based on a selection of persons who have tried western-style beverages in order that they might have a frame of reference. Because of the recent arrival of western-style beverages in the market, they had to be asked a series of hypothetical questions rather than asking merely for factual information about current behaviour. Also, given the nature of alcoholic beverage purchases as on-going decisions on relatively low cost consumables, it was correct to ask whether the respondents to the survey would be willing to

anomalies in any survey, but that in the case of the Dodwell study the overall trends were clear even if there was an occasional negative correlation in the data. Finally, complainants have noted that the Dodwell study used the same research methods as the ASI study cited by the panel in Japan – Taxes on Alcoholic Beverages II.<sup>403</sup>

10.91. Korea correctly identifies some of the weaknesses and anomalies in the Dodwell study. The responses move in unexpected directions in some instances. However, on balance, we consider that the Dodwell study provided useful information regarding at least the potential competitiveness of the imported and domestic products. We also do not agree that some of the issues highlighted by Korea are detrimental to the results. We do not find it a flaw that the chosen respondents were not an accurate cross-section of all of Korean society. The surveyors selected 500 men between the ages of 20 and 49 from 3 Korean cities who had purchased soju in the past month and whisky in the past 3 months.<sup>404</sup> The age, gender and geographic profiles make sense. It

Complainants offered some evidence to support their claim by showing consumption patterns of various brands in other selected markets where there was a heavier relative weighting of sales towards lower priced brands than in Korea.<sup>406</sup>

10.94. In examining the evidence before us, we found that, while there currently are significant price differences between the imported and domestic products, overall the differences were not decisive. Korea presented prices as weighted averages which obscured the higher prices for premium diluted soju, which was the small but fast growing category created specifically by Korean manufacturers to be most competitive with imports. The price of premium diluted soju appears to be approximately two times the price of standard diluted soju, while vodka was four times the price and standard whisky four and a half times the price of premium diluted soju.<sup>407</sup> Distilled soju was twice the price of standard whisky.

success of premium diluted soju. There clearly is an attempt to develop an image of certain types of soju that shows a direct competitive relationship with imported alcoholic beverages. It is probable that there are different marketing focuses (e.g., whether identifying accompaniment with food as a favored mode of consumption) by the importers compared to standard diluted soju; however, marketing strategies alone should not be the basis for finding products not potentially competitive. Marketing strategies can be changed quickly and if there is substantial other evidence that products are potentially directly competitive, it would be incorrect to find them otherwise based on transitory factors such as marketing strategies especially when such strategies can be shaped by the very government policies in question. On the other hand, when two products which have some present market differentiation begin to be marketed in similar fashions, as is happening in the case of the Korean soju makers, it is strong evidence of potential competition. Again, the purpose of Article III is to protect competitive opportunities, not protect actual market shares. Competitive opportunities should encompass the ability to change marketing strategies without the need for beginning a new dispute settlement case. A mere change in marketing strategy cannot be all that distinguishes success from failure of a complaint pursuant to Article III:2. That clearly would be an overly narrow interpretation of the term directly competitive or substitutable.

10.96. The levels of overlapping end-uses are currently relatively low if end-uses are defined as narrowly as suggested by Korea. However, even within such overly-narrow end-use categories, the evidence must be viewed in light of the relatively recent introduction of the western-style beverages to the market. Furthermore, we do not agree with Korea's argument about the

# 5. Not similarly taxed

10.99. The Appellate Body in Japan – Taxes on Alcoholic Beverages II summed up its findings with respect to this element of the decision as follows:

Thus, to be "not similarly taxed", the tax burden on imported products must be heavier than on "directly competitive or substitutable" domestic products, and that burden must be more than de minimis in any given case.<sup>411</sup>

10.100.

# 7. Like Product

10.103. The complainants in this case argued that vodka is like soju.<sup>415</sup> Korea disagreed.<sup>416</sup> We note that there are many similarities between vodka and soju and that these are sufficient to establish that the products are directly competitive or substitutable. However, as the Appellate Body found in Japan – Taxes on Alcoholic Beverages II, the concept of "likeness" in Article III:2, first sentence, is to be narrowly construed.<sup>417</sup> The question is whether the products are sufficiently close in nature that they fit within this narrow category.

10.104. We find that there is insufficient evidence in this case to make a determination that vodka and soju are like products. We do not find that they are "unlike". Rather we find that there is insufficient evidence in the record of this case to establish that they are like. In making this finding, we recall that the Appellate Body also noted that a determination of whether vodka was like shochu or was instead only directly competitive or substitutable did "not materially affect the outcome of [the] case."<sup>418</sup> We find this conclusion equally valid in the facts of the case at hand. Thus, while we have found that vodka and the other identified imported distilled alcoholic beverages and the domestic products are directly competitive or substitutable, we are unable to conclude that the imported products, or any subcategory of them, are like the domestic products.

XI.

<sup>&</sup>lt;sup>415</sup> See para. 5.100et. seq.

<sup>&</sup>lt;sup>416</sup> See para. 5.264et. seq. and para. 5.296 et. seq.

<sup>&</sup>lt;sup>417</sup> Appellate Body Report on Japan – Taxes on Alcoholic Beverages II, supra., at p. 21. <sup>418</sup> Ibid.

# CONCLUSIONS

11.1. In light of the findings above, we reached the conclusion that soju (diluted and distilled), whiskies, brandies, cognac, rum, gin, vodka, tequila, liqueurs and ad-mixtures are directly competitive or substitutable products. Korea has taxed the imported products in a dissimilar manner and the tax differential is more than de minimis. Finally, the dissimilar taxation is applied in a manner so as to afford protection to domestic production.

11.2. We recommend that the Dispute Settlement Body request Korea to bring the Liquor Tax Law and the Education Tax Law into conformity with its obligations under the General Agreement on Tariffs and Trade 1994.

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