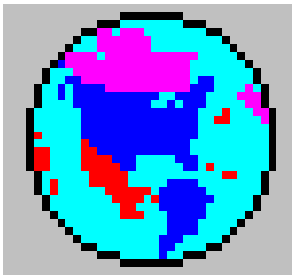
THE LAW OF
REGIONAL ECONOMIC INTEGRATION
IN THE AMERICAN HEMISPHERE



J.H.H. Weiler
University Professor, NYU
Joseph Straus Professor of Law and European Union Jean Monnet Chair,
NYU School of Law

AND

Sungjoon Cho
Assistant Professor of Law,
Chicago-Kent College of Law,
Illinois Institute of Technology

Unit III

Non-Discrimination (Taxation)

Table of Contents

Guiding Questions

1. *Japanese Shochu II*

    a. *This is one of the early WTO Appellate Body Reports. Think of the significance that the Appellate Body incorporated an important element of public international law, i.e., the Vienna Convention of the Law of Treaties, into its own jurisprudence.*

    b. *What would be merits and demerits of the "aim and effect" test in terms of market access and state regulation?*

    c. *In the interpretation of Article III:2 (Taxation), wouldn't the second sentence be enough? Ruminate on the Appellate Body's ruling that the distinction between the first and second sentences is "discretionary" and yield no "material" outcome.*

2. *Chilean Pisco*

    a. *What aspects in the questioned measure would be common and different vis-à-vis those found in the Japanese Shochu II?*

    b. *What interpretive approach is the most remarkably different from the Japanese Shochu II?*

    c. *In interpreting "so as to afford protection" which seems to be the most decisive factor(s): the subjectivity (legislative intent) of a questioned measure, its policy rationale, rational (or necessary / compelling) relationship between means and end?*

3. *Argentinean Leather (Optional Reading)*

    a. *This is the first Article III:2 case that actually involved the interpretation of Article XX. Would certain factual aspects drive such interpretive approach? Or would be there any noticeable transformation in the GATT Article III:2 jurisprudence?*

    b. *Pay attention to the "chapeau" test.*

I. Legal Text

Chapter 3 (NAFTA)

Section A - National Treatment

Article 301: National Treatment

1. Each Party shall accord national treatment to the goods of another Party in accordance with Article III of the General Agreement on Tariffs and Trade (GATT), including its interpretative notes, and to this end Article III of the GATT and its interpretative notes, or any equivalent provision of a successor agreement to which all Parties are party, are incorporated into and made part of this Agreement.

2. The provisions of paragraph 1 regarding national treatment shall mean, with respect to a state or province, treatment no less favorable than the most favorable treatment accorded by such state or province to any like, directly competitive or substitutable goods, as the case may be, of the Party of which it forms a part.

3. Paragraphs 1 and 2 do not apply to the measures set out in Annex 301.3.

Article III* (GATT 1994)

National Treatment on Internal Taxation and Regulation

1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.*

(…)

Paragraph 1

(…)

2. 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. Moreover, no 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.*

Paragraph 2 (Ad *Article III)*

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. (*emphasis added*)

II. Japanese Shochu II (1996)

WORLD TRADE ORGANIZATION

RESTRICTED

WT/DS8/R
WT/DS10/R
WT/DS11/R

11 July 1996

(96-2651)

Original: English

JAPAN - TAXES ON ALCOHOLIC BEVERAGES

Report of the Panel

To download the original report, consult http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm

(…)

II.Factual Aspects

A.The Japanese Liquor Tax Law

2.1 This dispute concerns the Japanese Liquor Tax Law (Shuzeiho), Law No.6 of 1953 as amended ("Liquor Tax Law"), which lays down a system of internal taxes applicable to all liquors, which are defined as domestically produced or imported beverages having an alcohol content of not less than one degree and which are intended for consumption in Japan.

2.2 The Liquor Tax Law currently classifies the various types of alcoholic beverages into ten categories and additional sub-categories: sake, sake compound, shochu (group A, group B), mirin, beer, wine (wine, sweet wine), whisky/brandy, spirits, liqueurs, miscellaneous (various sub-categories).

(…)

2.Tax Rates

2.3 Pursuant to the Liquor Tax Law, liquors are taxed at the wholesale level. In the case of liquors made in Japan, the tax liability accrues at the time of shipment from the factory, and in the case of imported liquors, at the withdrawal from a customs-bonded area. As explained above, the Liquor Tax Law divides all liquors into ten categories, some of which are divided into sub-categories. Different tax rates are applied to each of the various tax categories and sub-categories defined by the Liquor Tax Law. The rates are expressed as a specific amount in Japanese Yen ("¥") per litre of beverage. For each category or sub-category, the Liquor Tax Law lays down a reference alcohol content per litre of beverage and the corresponding reference tax rate. For whisky, the reference rate uses an alcohol strength of 40 per cent; for spirits the alcohol strength is 37 per cent; for liqueurs the alcohol strength is 12 per cent; for both shochu sub-categories, an alcohol strength of 25 per cent is used. As a result, the liquors covered by the present dispute are subject to the following tax rates:

Shochu A

Alcoholic Strength	Tax Rate (per 1 kilolitre)
(1) 25 to 26 degrees	¥155,700
(2) 26 to 31 degrees	¥155,700 plus ¥9,540 for each degree above 25
(3) 31 degrees and above	¥203,400 plus ¥26,230 for each degree above 30
(4) 21 to 25 degrees	¥155,700 minus ¥9,540 for each degree below 25 (fractions are rounded up to 1 degree)
(5) below 21 degrees	¥108,000

Shochu B

Alcoholic Strength	Tax Rate (per 1 kilolitre)
(1) 25 to 26 degrees	¥102,100
(2) 26 to 31 degrees	¥102,100 plus ¥6,580 for each degree above 25
(3) 31 degrees and above	¥135,000 plus ¥14,910 for each degree above 30
(4) 21 to 25 degrees	¥102,100 minus ¥6,580 for each degree less than 25 (fractions are rounded up to 1 degree)
(5) below 21 degrees	¥69,200

Whisky

Alcoholic Strength	Tax Rate (per 1 kilolitre)
(1) 40 to 41 degrees	¥982,300
(2) 41 degrees and above	¥982,300 plus ¥24,560 for every degree above 40
(3) 38 to 40 degrees	¥982,300 minus ¥24,560 for each degree below 40 (fractions are rounded up to 1 degree)
(4) below 38 degrees	¥908,620

Spirits

Alcoholic Strength	Tax Rate (per 1 kilolitre)
(1) below 38 degrees	¥367,300
(2) 38 degrees and above	¥367,300 plus ¥9,930 for each degree above 37

Liqueurs

Alcoholic Strength	Tax Rate (per 1 kilolitre)
(1) below 13 degrees	¥98,600
(2) 13 degrees and above	¥98,600 plus ¥8,220 for each degree over 12

(…)

III.Claims of the Parties

The three complaining parties, namely the Community, Canada and the United States submitted the following claims against Japan:

3.1. The **Community** claimed that since "spirits" (in particular vodka, gin, (white) rum, genever) are like products to the two categories of shochu, the Liquor Tax Law violates GATT Article III:2, first sentence, by applying a higher tax rate on the category of spirits than on each of the two like products, namely, the two sub-categories of shochu. In the alternative, in the event that all or some of the liquors falling within the category of spirits (mentioned above) were found by the Panel not to be like products to shochu within the meaning of the first sentence of Article III:2, the Community claimed that the Liquor Tax Law violates Article III:2, second sentence, by applying a higher tax rate on all or some of the liquors falling within the

category of spirits than on each of the two directly competitive and substitutable products, the two sub-categories of shochu. The Community further claimed that since whisky/brandy and liqueurs are also "directly competitive and substitutable products" to both categories of "shochu", the Liquor Tax Law violates Article III:2, second sentence of GATT 1994, by applying a higher tax rate on the categories of whisky/brandy and liqueurs than on each of the two sub-categories of shochu.

(…)

3.3 The **United States** claimed that the Japanese tax system applicable to distilled spirits has been devised so as to afford protection to production of shochu. For this reason and because "white spirits" and "brown spirits" have similar physical characteristics and end-uses, the United States claimed that "white spirits" and "brown spirits" are "like products" in the sense of the first sentence of Article III:2, and therefore the difference in tax treatment between shochu and vodka, rum, gin, other "white spirits", whisky/brandy and other "brown spirits" is inconsistent with Article III:2, first sentence. If the Panel were not able to make such a finding, the United States requested, in the alternative, that the Panel find that all "white spirits" are "like products" in terms of Article III:2 first sentence, and that all distilled spirits are "directly competitive and substitutable" in terms of Article III:2, second sentence for the same reasons. . . .

3.4 The defending party, **Japan**, responded to the claims from the three complaining parties. Japan claimed that the purpose of the tax classification under the Liquor Tax Law is not to afford protection and does not have the effect of protecting domestic production. Therefore, Japan argued that the Liquor Tax Law does not violate Article III:2. According to Japan, spirits, whisky/brandy and liqueurs are not "like products" to either category of shochu, within the meaning of Article III:2, first sentence, nor are they "directly competitive and substitutable products" to shochu, within the meaning of Article III:2, second sentence. Consequently, Japan claimed that the Liquor Tax Law cannot violate Article III:2.

(…)

IV.Arguments of the Parties

(…)

D.Article III:2, First Sentence

2. Application to the Present Case of the Legal Analysis Suggested by the Community for Article III:2, First Sentence.

a) The First Step of the Test: Like Products

4.51 In referring to the first step of the legal test it suggested for the first sentence of Article III:2 -- the like product assessment, the **Community** argued that the physical characteristics and manufacturing process of spirits and shochu A and B are similar: The

two categories of shochu and most of the liquors falling within the category "spirits" are white/clear beverages with a relatively high alcoholic content made by distillation from the same large variety of raw materials (e.g., grains, potatoes ...). A comparison of the legal definitions of shochu and of the category of "spirits" contained in articles 3.5 and 3.10 of the Liquor Tax Law demonstrates that the only differences between these two categories are that shochu cannot (1) be made from sugar cane and distilled at less than 95 per cent of alcohol (such as rum); (2) have other ingredients added at the time of distillation (such as gin); (3) be filtered with charcoal of white birch (such as vodka); (4) have an alcoholic content in excess of 45 per cent, in the case of shochu B, or 36 per cent, in the case of shochu A. In practice, as mentioned above, both types of shochu typically have an alcoholic strength of 20 per cent to 35 per cent, with 25 per cent being the most common strength. The legal definition of the category of "spirits" does not provide for a maximum alcohol content but in practice, the average alcohol content of the liquors falling within this category is 40 per cent. For the Community, the above differences between shochu and each of the main types of "spirits" are clearly minor and do not prevent all of them from qualifying as like products. Similar differences (if not more significant ones) exist also among the various types of western-style distilled spirits, despite of which all of them have been included into a single category of "spirits" and taxed at a uniform rate. The Community submitted that the differences in alcoholic strength are moreover rendered irrelevant by the drinking habits of the Japanese consumers: both shochu and the liquors falling within the category of "spirits" tend to be drunk heavily diluted with water or other non-alcoholic beverages and end up at roughly the same strength.

4.52 In support of its allegation, that shochu and spirits are like products, the **Community** also argued that shochu and spirits have essentially the same consumers' uses and customs classification. Shochu and "spirits" have essentially the same end-uses. All of them are drunk "straight", "on the rocks" or, more frequently, diluted with water or other non-alcoholic beverages. Moreover, both shochu and "spirits" are widely drunk by all categories of consumers, regardless of age, sex or occupation. In support of its argument, the Community submitted two market studies.[1] Moreover, shochu and all "spirits" other than gin and rum fall within the same HS sub-heading (HS 2208.90). This confirms that the differences between shochu and the category of "spirits" may be less significant than the differences among the various types of liquors falling within the category of "spirits".

4.53 The **Community** then submitted that a striking illustration of the "likeness" between shochu and "spirits" and, at the same time, of the arbitrariness and artificiality which are inherent to the criteria on the basis of which the Liquor Tax Law attempts to distinguish them, has been recently provided by the change in the tax categorization of the brand "Juhyo". This brand had been traditionally sold by the local manufacturer Suntory as vodka and accounted for almost half of the Japanese production of that liquor. However, as from June 1993, Suntory started

[1]A market survey conducted by the Japan Market Research Bureau in December 1994 and a market survey conducted by an ependent research company in May 1994.

to market the same product as "Juhyo shochu". All that was required in order to obtain this change in tax category was to discontinue the use of charcoal of white birch as a filtering material.[2] The Community argued that the change was made with the aim of escaping the higher taxes levied on "spirits" and was followed by an immediate and substantial reduction in the retail prices of "Juhyo". . . .

4.54 **Japan** argued that in its view the Community acknowledged that the differences in physical characteristics between whisky/brandy and shochu are sufficiently large to prevent the two categories from qualifying as like products. It also noted that the Community's claim of likeness applies only between the category of "spirits" and shochu A and B. Japan argued that, in examining the "likeness" of "spirits" and shochu, the Community looked at the following four criteria: (i) the product's properties, nature and quality, (ii) its end-uses, (iii) consumers' tastes and habits, and (iv) the HS classification. Japan argued that if the Community's four criteria were correctly applied to the facts, "spirits" and shochu A and B would not be "like products", because:

as to (i) the product's properties, nature and quality:

- The alcoholic strength of shochu (mostly 20 to 25 per cent) is closer to wine and sake (12 to 15 per cent) than to "spirits" (around 40 per cent).
- Most shochu does not undergo a post-distillation value-adding process (over 99 per cent is not aged in wooden casks) while "spirits" are characterized by value-addition through flavouring, purification with white birch charcoal or aging; picking a few examples from the vast array of shochu brands should not cloud the overall picture.
- Bulky plastic, glass and paper bottles over 1.8 litres are the most popular containers for shochu while 0.7 litre glass bottles are common for "spirits".

as to (i) end-uses and (ii) consumers' tastes and habits:

- 60 per cent of consumers drink shochu during meals but 63 per cent drink "spirits" after meals.
- 42 per cent of shochu consumers, but only 4 per cent, 1 per cent, and none of vodka, gin, and rum consumers, respectively, drink the product in question with hot water; and none of shochu consumers but 26 per cent, 32 per cent, and 15 per cent of vodka, gin and rum consumers, respectively, drink the product in question with tonic water, according to the data submitted by the Community.
- The study by ASI Market Research Inc. submitted by the complaining parties concludes that "(s)hochu is not seen as so much of a competitor (i.e., substitutable product) in the eyes of the consumers".

[2]In addition, barley and rice were added as raw materials in order to alter the taste of the product. Nevertheless, this change was not required by the Liquor Tax Law in order to make "Juhyo" qualify as shochu.

- According to a study, only 6 per cent of shochu consumers responded that they would drink "spirits" if shochu is not available.
- Contrary to the Community's allegation, the evidence submitted by the Community shows that shochu consumers are only as often (not more often) found in the "regular consumers" of premium brands of spirits and liqueurs as are found in all respondents.

and as to iv) classification in the HS:

- The 1996 version of the HS gives separate headings for rum (2208.40), gin (2208.50) and vodka (2208.60), as opposed to shochu (2208.90, "other"). Japan submitted that the HS is established for purposes other than internal taxation and does not offer appropriate criteria by which to judge "likeness" in terms of Article III, but even if "likeness" should be examined on the basis of identity of the HS heading . . . .

4.55 The **Community** responded that as far as shochu and "spirits" are concerned, Japan had been able to identify only two main differences in physical characteristics: the alcohol content and the packaging. According to the Community, the differences in alcohol content between shochu and "spirits" are not reflected in their respective legal definitions and, therefore, cannot provide a valid justification for applying different tax rates. . . .

4.56 **Japan** submitted that such commonality of sales outlets and advertising styles between "spirits" and shochu as pointed out by the Community are also observed among all alcoholic and non-alcoholic beverages and thus fails to demonstrate that products are "like". Though the Community points out similarity in the shochu-based pre-mixes and the pre-mixes made from other liquors, for Japan, such would not be evidence of "likeness" of shochu and "spirits", just as the similarity among tequila-based, wine-based and beer-based "margaritas" in the United States would not render tequila, wine and beer "like". For Japan, "Juhyo Vodka" and "Juhyo Shochu" are two distinct products with different raw materials and different production methods sold under the same established brand name, and are not "like products". . . .

(…)

b) The Second Step of the Test: Discriminatory Taxes

4.59 Concerning the second step of the test it suggested for the application of the first sentence of Article III:2, the assessment of discriminatory taxation, the **Community** submitted evidence according to which the tax rate per litre of shochu B is always lower than the rate on the category of "spirits". The tax rate per litre of shochu A is also lower than the rate per litre of "spirits" for beverages below 36 per cent - 37 per cent. Above that strength, the rate on shochu A is higher. Nevertheless, Article 3.5 of the Liquor Tax Law excludes from the

definition of shochu A beverages with an alcohol content of more than 36 per cent. Thus, in practice, the rate on shochu A is always lower than the rate on the category of "spirits". More specifically, the Community argued that the tax discrimination index between shochu B of the most common strength (25 per cent) and "spirits" of the most common strength (40 per cent) is 389 per cent. If the tax rates per litre of pure alcohol, instead of the rates per litre of each beverage, are compared, the tax rate applied to the category of "spirits" is still much higher and the tax discrimination index reached 243 per cent. The Community therefore concluded that the liquors falling within the category of "spirits" and the two sub-categories of shochu being "like products", the Liquor Tax Law violates Article III:2, first sentence, by applying a tax rate to the category of "spirits" which is in excess of the tax rates applied to each of the two sub-categories of shochu.

(…)

4.61 **Japan** called the legal test suggested by the Community a "two-step approach", and disagreed with it. It further argued that even if the "two-step approach" should be adopted, the examination of the second step (discriminatory or not) should be made by the comparison of tax/price ratio between imported "spirits" and domestic shochu. For Japan, the tax/price ratio is the superior yardstick for an examination of the tax burden since it indicates better the impact on consumer choice (and therefore discrimination) than the ratio of tax over volume product or alcohol content. A consumer usually does not buy a product exclusively on the basis of the size of the bottle or on the basis of the alcoholic strength. Consumers choose products by comparing the price and the overall value of a product, which rests upon the taste, flavour and other features and is not confined to the volume and strength.

This is why, Japan argued, the tax/price ratio is a better criterion to evaluate the effects of taxes on competitive conditions; and neutrality is achieved when the tax/price ratio is equalized, as is the case with the Japanese tax. Japan submitted that the weighted average of liquor-tax/price ratios for the 20 best-selling brands of domestic shochu A, shochu B, imported vodka, imported rum, and imported gin are 22 per cent, 13 per cent, 18 per cent, 12 per cent, and 18 per cent, respectively. Japan concluded that, even under the "two-step approach", taxes on "spirits" would not be found discriminatory against shochu when an appropriate yardstick is applied.

(…)

E.Article III:2, Second Sentence

(…)

2. Application to the Present Case of the Legal Analysis Suggested by the Community and Canada

a) The First Step of the Tests Suggested by the Community and Canada: Directly Competitive and Substitutable Goods

i) Physical characteristics, end-uses, tariff line and availability to the public

4.72 For the **Community**, the two categories of shochu and the liquors falling within the categories of "spirits", "whisky/brandy" and "liqueurs" are directly competitive and substitutable since they share the same essential physical characteristics, have similar end-uses, are similarly available to the public and are marketed in a similar way. Furthermore the prices of shochu and of the other distilled spirits and liqueurs are within a close range, once the liquor taxes are deducted. Moreover, there is evidence that, despite the distorting effects on competition of the Liquor Tax Law, the demand for shochu is largely influenced by the fluctuations in the prices of other types of distilled spirits and liqueurs.

(…)

4.74 The **Community** argued that the differences in physical characteristics and manufacturing methods between the two categories of shochu and the liquors falling within the category of "spirits" are minor. The differences between the physical properties of shochu and of "whisky/brandy" are somewhat more marked. Nonetheless, these two categories share the same essential characteristics: both shochu and "whisky/brandy" are spirits obtained by distillation and with a relatively high alcoholic content. The main differences between the two categories are thus restricted to the fact that neither malted grains nor grapes can be used in the production of shochu. For the Community, this difference is only relative, as most shochu is made, like whisky, from different types of grain, albeit not malted. Other differences are that shochu is, as a general rule, a white/clear spirit, while whisky and brandy are brown-coloured; whisky and brandy are matured/aged and, as a general rule, blended, while shochu is not. These last two differences are becoming irrelevant as an increasing number of shochu brands claim to be blended and aged in barrels and are brown coloured. For the Community, the absence of any fundamental differences between shochu and "whisky/brandy" is attested by the fact that the advertising of many shochu brands tends to emphasize their similarities with whisky and/or brandy in terms of raw materials, ingredients, manufacturing process and tradition.

In some cases, this policy has been pursued to the extreme of modifying the traditional manufacturing methods of shochu in a deliberate attempt to confer upon it whisky-like appearance and taste. . . .

(…)

4.79 **Japan** argued that "spirits" and "shochu" differ in physical characteristics, end-use, and in tariff lines as is described in paragraph 4.54 above. Japan also argued that whisky/brandy and shochu differ in materials (with malts versus without malts; Bourbon, Tennessee, and Canadian whiskies without malts are classified as "spirits" under the Liquor Tax Law), in the post-distillation processing (aged in wooden casks versus over 99 per cent not aged in wooden casks), in alcoholic strength (around 40 per cent versus 20 to 25 per cent), in colour (0.2 to 0.8 of optical density versus 0.08 of optical density) and in containers (0.7 litre glass

bottles versus bulky plastic, glass and paper bottles over 1.8 litres). For Japan, they also differ in end-uses: according to a study in Japan, 60 per cent of shochu consumers drink shochu during meals, while 72 per cent of whisky consumers drink whisky after meals; and according to a study submitted by the Community, only eight per cent of consumers of shochu drink the beverage "on the rocks" while 68 per cent of bourbon whisky consumers do. None of bourbon whisky consumers mix such whisky with hot water or juice, while 42 per cent and 37 per cent of shochu consumers do respectively. They also differ in tariff lines: whisky is classified as "2208.30 whisky" while shochu is classified as "2208.90 Other". Japan also argued that the commonality in availability to the public mentioned by the Community exists only to the extent applicable to all alcoholic and non-alcoholic beverages: the menus and promotion leaflets submitted by the Community list not only whisky(ies) and shochu but also sake, wine, beer, juice, coffee and tea side by side.

4.80 **Japan** also noted that the aptitude of the two products to serve the same uses raises the issue of the extent of the sameness. Since the use for quenching the thirst, for example, is common to all beverages, and since the use for enjoying alcohol is common to all alcoholic beverages, the concept of "sameness" should be understood in a narrower sense. According to Japan, the Community argues that sameness in drinking habits between shochu and other distilled liquors is sufficient to meet the criteria. However, Japan's evidence shows a good degree of divergence in drinking habits not only between shochu and spirits but between shochu and Bourbon whisky as well. The aptitude to serve the same uses does not seem to exist beyond what would apply to all alcoholic beverages.

(…)

ii) Cross-price elasticity

4.82 Continuing on the issue as to whether shochu and other imported liquors are directly competitive and substitutable, the **Community** argued that the retail prices of shochu and of the other distilled spirits and liqueurs are within a relatively short range once the liquor taxes and the *ad valorem* consumption taxes are deducted. This, in the Community's view, confirms that all of them are, at least potentially, competitive in terms of price. The retail prices net of taxes per litre of pure alcohol of most western-style liquors are much lower than the corresponding prices for shochu but both shochu and western-style liquors are frequently diluted with non-alcoholic beverages and drunk at roughly the same strength. Therefore, it may be concluded that, but for the discriminatory taxes imposed pursuant to the Liquor Tax Law, many western-style liquors would be less expensive than shochu in real terms. Price competition between shochu and the other spirits and liqueurs is therefore distorted by the lower taxes applied to shochu. Despite these distortions, there are clear indications that the demand for shochu is largely influenced by the fluctuations in the prices of the other distilled spirits and liqueurs.

4.83 In response to the Community's allegation of cross-price elasticity, supported by

Canada and the United States' claims, **Japan** submitted a rebuttal to the Community's arguments on the changes in consumption of whisky and shochu since 1989, the response of consumers to questions asked by Shakai-Chosa Kenkyujo (Institute for Social Studies), and the result of the econometric analysis of national household survey statistics.

(…)

b) The Second Step of the Test suggested by the Community for Article III:2, Second Sentence: " ... So as to Afford Protection"

4.94 As to the second step of the legal test it suggested for the second sentence of GATT Article III:2 in assessing whether a measure imposed on substitutable or directly competitive products is "so as to afford protection", the **Community** reiterated that the following criteria may be relevant in order to determine whether a difference in taxation is "so as to afford protection" to domestic production: 1) The level of the tax differential (but contrary to the first sentence of Article III:2, a tax difference does not lead automatically to a violation of the second sentence of Article III:2); 2) The degree of substitutability and competition between the two products; 3) Whether the less taxed product is produced in other countries. . .

4.95 For the **Community**, [the following facts] warrant the conclusion that the Liquor Tax Law affords protection to the Japanese domestic production of shochu:

(1) Despite the 1989 and the 1994 tax reforms, the tax rates on shochu A and shochu B are still much lower than the rates on "spirits", "whisky/brandy" and "liqueurs". The taxes on shochu are from 2.45 to 9.6 times lower in terms of rates per litre of beverage and from 2 to 6 times lower in terms of rates per litre of pure alcohol and these differences can thus hardly be considered as *de minimis*. . . .

(2) Shochu continues to be produced almost exclusively in Japan. In 1994 imports of shochu represented 1.7 per cent of the total sales of shochu and barely 1 per cent of the total sales of distilled spirits and "authentic liqueurs". In contrast, during the same year, imports from third countries accounted for 27 per cent of the total sales of whisky, 29 per cent of the total sales of brandy, 18 per cent of the total sales of "spirits" and 78 per cent of the total sales of "authentic liqueurs". Sales of domestically produced shochu account for almost 80 per cent of the total sales of domestically produced distilled spirits and "authentic liqueurs". Thus, by affording protection to shochu, Japan is in fact affording protection to the majority of its domestic production of spirits and liqueurs.

(3) Shochu and other imported liquors are mutually substitutable as evidenced by their cross-price elasticity, argued in paragraphs 4.82 and following above in the Community's discussion of the first step of the legal test it suggested for the second sentence of Article III:2.

4.96 **Japan** responded to the Community's arguments on the three criteria. First, concerning the potential protective effect, Japan submitted that the tax differential should be measured on the basis of the tax/price ratio, as it is a criterion to judge

whether or not a tax affords protection, and for Japan, there is no differential in the tax/price ratios. Secondly, for Japan, shochu and other distilled liquors do not show the aptitude of the two products to serve the same uses, and differ in the extent and the form in which the two products are available to the public, beyond what would apply to all alcoholic beverages. Cross-price elasticity of demand does not, therefore, exist. If a directly competitive or substitutable relationship were to be found in this case, it would have to be found between all alcoholic beverages, and, consequently, any liquor taxation currently in force would become inconsistent with Article III, unless all products show the same tax/price ratio. The degree of substitutability and competition between the products is minimal at best. Third, shochu is widely produced in Asian countries, and the third criterion is not met. Thus, Japan concluded that if the Community's interpretation is applied to the facts, one inevitably reaches a conclusion that Japan's liquor tax is consistent with Article III:2, second sentence.

4.97 **Japan** argued that the Community is criticizing Japan's tax distinction among distilled liquors while dividing wine into six categories in its liquor tax directive and legitimizing Germany's application of four completely different rates to categories of wines. For Japan, a position which holds that champagne and sherry may be distinguished from other wine while shochu and whisky should be treated alike, is equal to turning Article III into an instrument of harmonization of internal taxes with a system of a particular group of countries. Japan reiterated that the purpose of Article III is not to require Members to adopt a particular system of taxes or regulations, nor to harmonize taxation systems. Japan argued that only a small number of WTO Members apply a flat rate to all categories of distilled liquors and a larger number of Members apply more than one rate in one way or another. In Japan's view, the conclusion advocated by the Community in the present case would substantially affect other countries as well.

(…)

4.103 . . . Japan argued that in light of the emphasis Canada repeatedly attached to the price as a crucial element in determining the competitive relationship between shochu and whisky, the comparison ought to be made on the basis of the tax burden in relation to the price. By this standard, Japan argued that shochu and whisky are similarly taxed. Canada's . . . criterion "of affording protection" is, again, not met, in Japan's view, since tax/price ratios are roughly equal between imported whisky and domestic shochu: In restoring the balance in tax/price ratio between whisky and shochu in the 1994 reform, Japan chose to increase tax on shochu, not to reduce tax on whisky, for fiscal reasons, but both methods are equally effective in restoring the balance. Japan stressed that what is relevant to the purpose of neutrality and equity is relative relations of tax/price ratios among categories, not the absolute level of the ratios *per se*.

(…)

F. Application to the Present Case of the Legal Analysis Suggested by the

United States for the Interpretation of Article III:2

1. The Aim of the Legislation.

4.107 The **United States** argued that the protective aim of the Liquor Tax Law structure is apparent from (1) the stated policy objective and whether it was known at the time the legislation was enacted that it would draw a line between one group of products that would be foreign and another group that would be domestic (*ex-ante* knowledge), (2) the internal inconsistencies of the legislation and its structural incentives, (3) legislative statements and the preparatory work, as well as from (4) the arbitrary and irrational categories of the legislation under scrutiny. The United States continued by stating that:

(1) During the consultations, the Japanese Government asserted that the policy objective of the Liquor Tax Law system was to maximize tax revenue while ensuring that the tax is distributed among consumers in accordance with their "tax-bearing ability". However, this objective is nowhere stated in the law . . . . The official records of deliberations in the Finance Committee of the Diet in March 1994 show that Ministry of Finance Tax Bureau Director Ogawa testified that the reason for the difference in tax treatment was "out of consideration for the higher material costs etc" of shochu B. He also testified that particular attention had been made to coordinate the tax increases with the increased costs of raw materials associated with factors such as the poor rice harvest in the case of refined sake and shochu, especially shochu B. The legislation raising taxes included as well an extension of tax reductions for small-volume producers of shochu A and B, and provision for a subsidy fund for shochu producers. The package in context demonstrates that the operative consideration in passing the legislation was the economic well-being of domestic shochu producers, not a neutral tax policy.

(3) The lack of any policy rationale other than protection is apparent from the otherwise-arbitrary distinctions drawn in the product categories. The only difference between vodka and shochu A is that according to the definition in the Liquor Tax Law, shochu A cannot be filtered with white birch charcoal, although it can be filtered with any other material. Yet the tax rate on vodka is 2.55 times higher than the tax rate on shochu A. The Japanese government has never claimed that the ban on the use of white birch charcoal in filtering shochu was based on health reasons or any other policy. Thus the distinction cannot have any purpose other than excluding imported vodka from the tax benefits granted to the producers of shochu.

(…)

2. The Effect of the Legislation

4.113 The **United States** went on to argue that the distinction drawn by the Liquor Tax Law also has the effect of affording protection to domestic production. In this regard, data on sales and trade flows are relevant to show changes in the conditions of competition favouring domestic products. Other factors, including the creation of inherently domestic products and foreign products, and whether there is a large difference in rates between categories, also support the conclusion

of a protective effect. . . .

4.115 On the market shares of shochu and the price-cross elasticity of shochu, the **United States** . . . noted that there were clear indications that the demand for shochu is largely influenced by fluctuations in demand for other distilled spirits and liqueurs. This could be seen in the rearrangement of the market place for distilled spirits after the 1989 tax reform. The 1989 reform unified tax rates on whisky, abolished the classification of whisky into three classes, and consequently more than tripled the tax rate on second-class whisky while lowering the taxes on other whisky, authentic liquers and spirits. The 1989 law also raised the tax on shochu by a small amount. In particular the United States submitted that:

- Retail prices for second-class whisky almost doubled, and the market share for domestic whisky declined from 27 per cent in 1988 to 19.6 per cent in 1990. . . . Shochu makers were able to move into the place in the market formerly held by second-class whisky. Sales of Shochu have steadily increased and reached 74.2 per cent of distilled spirits in 1994. . . .

- Shochu continues to be made almost exclusively in Japan. In 1994, imports of shochu were 1.7 per cent of total sales and 1 per cent of total sales of distilled spirits and "authentic distilled spirits." . . .

4.137

Figure: Comparison of "Tax Discrimination Indices"

	Per Litre of Beverage		Per Litre of Pure Alcohol		Tax/Price Ratio	
	Liquor Tax	VAT	Liquor Tax	VAT	Liquor Tax	VAT
Shochu A	1.0	1.0	1.0	1.0	1.0	1.0
Imported Vodka	2.7	3.4	1.6	2.0	0.8	1.0
Imported Whisky	7.0	8.0	4.0	4.7	0.9	1.0

Note: Calculated on the basis of weighted average of 20 most selling brands.

4.138 **Japan** argued that this figure demonstrates that i) the liquor tax is similar to VAT in terms of "tax discrimination indices", and that ii) VAT would be regarded more

"trade-distortive" than the liquor tax as long as a comparison is made on the basis of the taxes by the tax amount per litre of beverage or of pure alcohol. Japan submitted that VAT is regarded as one of the most trade-neutral indirect taxes and its introduction is one of the conditions to join the European Union. On the other hand, a comparison made with the amount of tax per litre of beverage or of pure alcohol would find such VAT as trade-distortive. In fact it is the use of those two yardsticks as tools of comparing taxes which is problematic, rather than the tax itself.

(…)

4.140 **Japan** argued that the lack of plausible alternatives further testifies to the lack of protective intent. Conceivable alternatives to ensure neutrality and equity are: (i) to raise the *ad valorem* value-added tax to a level comparable to that of the European Union, which applies not only to liquor consumption but to almost all consumption or (ii) to alter the liquor tax into an *ad valorem* tax. However, for Japan, neither of these is practical. First, the decision to raise the *ad valorem* consumption tax from the present three per cent to five per cent beginning April 1997 was made in 1994 only after a prolonged, heated debate. It is not very likely that the rate would be raised to the Community level in the near future. Second, an *ad valorem* excise tax could easily invite tax evasion by way of transfer-pricing, particularly if applied at the shipping stage. Canada's Federal Manufacturers Sales Tax suffered from the same difficulty and was abolished in 1991. On the other hand, enforcement cost of an *ad valorem* tax would be very substantial if applied at the retail level.

(…)

VI. Findings

(…)

1.General Principles of Interpretation

(…)

6.7 The Panel understood the dispute among the parties over the appropriate legal analysis to be applied in this case required it to interpret the wording of Article III:2. The Panel recalled that Article 3:2 DSU states:

" ... The Members recognize that [the WTO dispute settlement system] serves to preserve the rights and obligations of Members under the covered agreements, and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law".

The Panel noted that the "customary rules of interpretation of public international law" are those incorporated in the Vienna Convention on the Law of Treaties (VCLT). GATT panels have previously interpreted the GATT in accordance with the VCLT.[3] The Panel

[3]See, for example, the panel report on "Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages", adopted on 10 November 1987, BISD 34S/83 (hereinafter "the 1987 Panel Report"); see also the panel report on "EC - Imposition of Anti-dumping Duties on Imports of Cotton Yarn From Brazil", ADP/137, adopted on 30 October 1995, paras. 540ff.; see also the Appellate Body report on "United States - Standards for Reformulated and

noted that Article 3:2 DSU in fact codifies this previously-established practice. The Panel also noted that there is no disagreement among the parties to proceed on this basis.

6.8 In the view of the Panel, Articles 31 and 32 VCLT provide the relevant criteria in the light of which Article III:2 should be interpreted. The Panel recalled that Articles 31 and 32 VCLT state:

"Article 31 General rule of interpretation
1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. (…)

3. There shall be taken into account together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
(c) any relevant rules of international law applicable in the relations between the parties.
(…)

6.10 (…), the Panel was of the view that panel reports adopted by the CONTRACTING PARTIES constitute subsequent practice in a specific case and as such have to be taken into account by subsequent panels dealing with the same or a similar issue. The Panel noted, however, that it does not necessarily have to follow their reasoning or results. The Panel further noted that unadopted panel reports have no legal status in the GATT or WTO system since they have not been endorsed through decisions by the CONTRACTING PARTIES to GATT or WTO Members. Thus, the Panel decided that it did not have to take them into account as they do not constitute subsequent practice. In the Panel's view, however, a panel could nevertheless find useful guidance in the reasoning of an unadopted panel report that it considered to be relevant. (…)

2.Artile III

6.12 (…) The Panel noted that while Article III:2, second sentence, contains a reference "to the principles set forth in paragraph 1", no such reference is contained in Article III:2, first sentence. The Panel recalled that according to Article III:1, WTO Members recognize that domestic legislation "should not be applied ... so as to afford protection to domestic production". In this context, the Panel felt that it was necessary to examine the relationship between Article III:2 and Article III:1. The Panel noted that the latter contains general principles concerning the imposition of internal taxes, internal charges, and laws, regulations and requirements affecting the treatment of imported and domestic products, while the former provides for specific obligations regarding internal taxes and

---

Conventional Gasoline", WT/DS2/AB/R, adopted on 20 May 1996.

internal charges. The words "recognize" and "should" in Article III:1, as well as the wording of Article III:2, second sentence, ("the principles"), make it clear that Article III:1 does not contain a legally binding obligation but rather states general principles. In contrast, the use of the word "shall" in Article III:2, both sentences, makes it clear that Article III:2 contains two legally binding obligations. Consequently, the starting point for an interpretation of Article III:2 is Article III:2 itself and not Article III:1. Recourse to Article III:1, which constitutes part of the context of Article III:2, will be made to the extent relevant and necessary. (…)

3.Article III:2, First Sentence

a)Overview

(…)

6.16 (…) The Panel noted, (…), that the proposed aim-and-effect test is not consistent with the wording of Article III:2, first sentence. The Panel recalled that the basis of the aim-and-effect test is found in the words "so as to afford protection" contained in Article III:1.4 The Panel further recalled that Article III:2, first sentence, contains no reference to those words. Moreover, the adoption of the aim-and-effect test would have important repercussions on the burden of proof imposed on the complainant. The Panel noted in this respect that the complainants, according to the aim-and-effect test, have the burden of showing not only the effect of a particular measure, which is in principle discernible, but also its aim, which sometimes can be indiscernible. (…)

6.17 The Panel further noted that the list of exceptions contained in Article XX of GATT 1994 could become redundant or useless because the aim-and-effect test does not contain a definitive list of grounds justifying departure from the obligations that are otherwise incorporated in Article III.5 (…) Moreover, proponents of the aim-and-effect test even shift the burden of proof, arguing that it would be up to the complainant to produce a prima facie case that a measure has both the aim and effect of affording protection to domestic production and, once the complainant has demonstrated that this is the case, only then would the defending party have to present evidence to rebut the claim.6 (…)

b)Like Products

(…)

[4]See paras. 4.16 - 4.19 and 4.24ff. of the Descriptive Part.

[5]In this context, the Panel noted that the Appellate Body in its report on "United States - Standards for Reformulated and Conventional Gasoline", noted that "one of the corollaries of the 'general rule of interpretation' in the Vienna Convention is that interpretation must give meaning and effect to all the terms of a treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility". WT/DS2/AB/R, at p.23.

[6]See para. 4.32 of the Descriptive Part.

6.21 The Panel noted that previous panel and working party reports had unanimously agreed that the term "like product" should be interpreted on a case-by-case basis.7 The Panel further noted that previous panels had not established a particular test that had to be strictly followed in order to define likeness. Previous panels had used different criteria in order to establish likeness, such as the product's properties, nature and quality, and its end-uses; consumers' tastes and habits, which change from country to country; and the product's classification in tariff nomenclatures.8 In the Panel's view, "like products" need not be identical in all respects. However, in the Panel's view, the term "like product" should be construed narrowly in the case of Article III:2, first sentence. (…)

6.22 The wording of Article III and of the Interpretative Note ad Article III make it clear that a distinction must be drawn between, on the one hand, like, and, on the other, directly competitive or substitutable products. (…) The wording ("like products" as opposed to "directly competitive or substitutable products") confirmed this point, in the sense that all like products are, by definition, directly competitive or substitutable products, whereas all directly competitive or substitutable products are not necessarily like products. (…) In the view of the Panel, to define a precise cut-off point that distinguishes between, on the one hand, like, and on the other, directly competitive or substitutable products requires an arbitrary decision. The Panel decided therefore, to consider criteria on a case-by-case basis in order to determine whether two products are like or directly competitive or substitutable. (…) In the Panel's view, the decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, inter alia, as shown by elasticity of substitution. The wording of the term "like products" however, suggests that commonality of end-uses is a necessary but not a sufficient criterion to define likeness. In the view of the Panel, the term "like products" suggests that for two products to fall under this category they must share, apart from commonality of end-uses, essentially the same physical characteristics. In the Panel's view its suggested approach has the merit of being functional, although the definition of likeness might appear somewhat "inflexible". Flexibility is required in order to conclude whether two products are directly competitive or substitutable. (…)

6.23 The Panel next turned to an examination of whether the products at issue in this case were like products, starting first with vodka and shochu. The Panel noted that vodka and shochu shared most physical characteristics. (…) In the Panel's view, only vodka could be considered as like product to shochu since, apart from commonality of end-uses, it shared with shochu most physical characteristics. Definitionally, the only difference is in the media used for filtration. Substantial noticeable differences in physical characteristics exist between the rest of the alcoholic beverages at dispute and shochu that would

---

[7]See, for example, the Working Party Report on "Border Tax Adjustments", L/3464, adopted on 2 December 1970, BISD 18S/97, p. 102, para. 18 (hereinafter "the 1970 Working Party report"); the panel report on "United States - Taxes on Petroleum and Certain Imported Substances", adopted on 17 June 1987, BISD 34S/136, pp.154-155, para. 5.1.1; the 1987 Panel Report, pp.113-115, para. 5.5-5.7; the 1992 Malt Beverages report, pp. 276-277, paras. 5.25 - 5.26.

[8]See the 1970 Working Party report on "Border Tax Adjustments", op. cit., at para. 18; the 1987 Panel Report at para. 5.6; the panel report on "United States - Taxes on Petroleum and Certain Imported Substances", op. cit., at para. 5.1.1; the panel report on "EEC - Measures on Animal Feed Proteins", adopted on 14 March 1978, BISD 25S/49, at para. 4.3.

disqualify them from being regarded as like products. More specifically, the use of additives would disqualify liqueurs, gin and genever; the use of ingredients would disqualify rum; lastly, appearance (arising from manufacturing processes) would disqualify whisky and brandy. The Panel therefore decided to examine whether the rest of alcoholic beverages, other than vodka, at dispute in the present case could qualify as directly competitive or substitutable products to shochu. (…)

c)Taxation in Excess of that Imposed on Like Domestic Products

6.24 (…), it noted that vodka was taxed at 377,230 Yen per kilolitre - for an alcoholic strength below 38° - that is 9,927 Yen per degree of alcohol, whereas shochu A was taxed at 155,700 Yen per kilolitre - for an alcoholic strength between 25° and 26° - that is 6,228 Yen per degree of alcohol.9 (…) The Japanese taxes on vodka and shochu are calculated on the basis of and vary according to the alcoholic content of the products and, on this basis, it is obvious that the taxes imposed on vodka are higher than those imposed on shochu. Accordingly, the Panel concluded that the tax imposed on vodka is in excess of the tax imposed on shochu.

6.25 The Panel then addressed the argument put forward by Japan that its legislation, by keeping the tax/price ratio "roughly constant", is trade neutral and consequently no protective aim and effect of the legislation can be detected. In this connection, the Panel recalled Japan's argument that its aim was to achieve neutrality and horizontal tax equity.10 The Panel noted that it had already decided that the existence or non-existence of a protective aim and effect is not relevant in an analysis under Article III:2, first sentence. To the extent that Japan's argument is that its Liquor Tax Law does not impose on foreign products (i.e., vodka) a tax in excess of the tax imposed on domestic like products (i.e., shochu), the Panel rejected the argument for the following reasons:

(i) The benchmark in Article III:2, first sentence, is that internal taxes on foreign products shall not be imposed in excess of those imposed on like domestic products. Consequently, in the context of Article III:2, first sentence, it is irrelevant whether "roughly" the same treatment through, for example, a "roughly constant" tax/price ratio is afforded to domestic and foreign like products or whether neutrality and horizontal tax equity is achieved.

(ii) Even if it were to be accepted that a comparison of tax/price ratios of products could offset the fact that vodka was taxed significantly more heavily than shochu on a volume and alcoholic content basis, there were significant problems with the methodology for calculating tax/price ratios submitted by Japan, such that arguments based on that methodology could only be viewed as inconclusive. More particularly, although Japan had argued that the comparison of tax/price ratios should be done on a category-by-category basis, its statistics on which the tax/price ratios were based excluded domestically produced spirits from the calculation of tax/price ratios for spirits and whisky/brandy. Since the prices of the domestic spirits and whisky/brandy are much lower than the prices of the imported goods, this exclusion has the impact of reducing

[9]See para. 2.3 of the Descriptive Part for a complete description of the Japanese liquor tax rates.

[10]See para. 4.132ff. of the Descriptive Part.

considerably the tax/price ratios cited by Japan for those products. In this connection, the Panel noted that one consequence of the Japanese tax system was to make it more difficult for cheaper imported brands of spirits and whisky/brandy to enter the Japanese market. Moreover, the Panel further noted that the Japanese statistics were based on suggested retail prices and there was evidence in the record11 that these products were often sold at a discount, at least in Tokyo. To the extent that the prices were unreliable, the resultant tax/price ratios would be unreliable as well.12

(iii) Nowhere in the contested legislation was it mentioned that its purpose was to maintain a "roughly constant" tax/price ratio. This was rather an ex post facto rationalization by Japan and at any rate, there are no guarantees in the legislation that the tax/price ratio will always be maintained "roughly constant". Prices change over time and unless an adjustment process is incorporated in the legislation, the tax/price ratio will be affected. Japan admitted that no adjustment process exists in the legislation and that only ex post facto adjustments can occur. The Panel lastly noted that since the modification in 1989 of Japan's Liquor Tax Law there has been only one instance of adjustment.

(…)

4.Article III:2, Second Sentence

a)Directly Competitive or Substitutable Products

6.29 (…) Turning to the evidence in this case, the Panel noted that the complainants had submitted a study (the ASI study) that concludes that there is a high degree of price-elasticity between shochu, on the one hand, and five brown spirits (Scotch whisky, Japanese whisky, Japanese brandy, cognac, North American whisky) and three white spirits (gin, vodka and rum), on the other.13 Japan questioned the relevance of this ASI study by noting that consumers were not allowed to choose other than the mentioned eight products (for example, they were not allowed to choose, beer, sake or wine) and also argued that if choices are too limited even such disparate products as hamburger and ice cream could be argued to be directly competitive or substitutable products. In the Panel's view, however, price-elasticity between the mentioned products is not altered by the fact that consumers were presented with a limited choice. (…)

6.30 (…) In the Panel's view, the fact that foreign produced whisky and shochu were competing for the same market is evidence that there was elasticity of substitution between them.

6.31 The Panel noted Japan's argument that there is no elasticity of substitution between shochu and the rest of the alcoholic drinks in dispute in this case. (…) Japan based its argument on a survey conducted among consumers that showed, according to Japan, that in case shochu were not available 6 per cent of the consumers would switch to

[11]See paras. 4.100, 4.142-4, 4.159, 4.160-1 of the Descriptive Part.

[12]See paras. 4.100, 4.159, 4.160 and 4.165 of the Descriptive Part.

[13]See paras. 4.171ff. of the Descriptive Part.

spirits whereas only 4 per cent to whisky; if whisky were not available, 32 per cent of the consumers would choose brandy and only 10 per cent would choose shochu. Japan submitted this survey to the Panel. The Panel did not accept Japan's argument on the grounds that Japan, in conducting this survey, failed to take into account price distortions caused by internal taxation. In other words, consumers' choices were sought within the existing price regime (which is the subject matter of the current dispute), and not independently of it. Moreover, in the Panel's view, the inadequacies of the survey notwithstanding, in case of non-availability of shochu, 10 per cent of the consumers would switch to spirits and whisky. This, in the Panel's view, was proof of significant elasticity of substitution between shochu, on the one hand, and whisky and spirits, on the other. (…)

b)"…So as to Afford Protection"

6.33 The Panel turned to the question whether Japan was violating its obligations under Article III:2, second sentence. In this respect, the Panel recalled the Interpretative Note ad Article III:2 that states:

"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".

(…) In this connection, the Panel noted that for it to conclude that dissimilar taxation afforded protection, it would be sufficient for it to find that the dissimilarity in taxation is not de minimis.14 (…) In the Panel's view, the following indicators, inter alia, are relevant in determining whether the products in dispute are similarly taxed in this case: tax per litre of product, tax per degree of alcohol, ad valorem taxation, and the tax/price ratio.

a) With respect to taxation per kilolitre of product the Panel noted that the amounts were:15

Shochu A (25°)	¥ 155,700	
Shochu B (25°)	¥ 102,100	
Whisky (40°)	¥ 982,300	
Brandy (40°)	¥ 982,300	
Spirits (38°)	¥ 377,230	(gin, rum, vodka)
Liqueurs (40°)	¥ 328,760	

The Panel concluded that the amounts of tax are not similar and that the differences are not de minimis.

[14]The Panel decided that it did not have to further define "*de minimis*", because in this case the differences in taxation were significant.

[15]See para. 2.3 of the Descriptive Part.

b) With respect to taxation per degree of alcohol the Panel noted that the amounts were:16

Shochu A (25°)	¥ 6,228	
Shochu B (25°)	¥ 4,084	
Whisky (40°)	¥ 24,558	
Brandy (40°)	¥ 24,558	
Spirits (38°)	¥ 9,927	(gin, rum, vodka)
Liqueurs (40°)	¥ 8,219	

The Panel concluded that the amounts of tax are not similar and that the differences are not de minimis. Since the Japanese taxes at issue were calculated on the basis of the alcohol content of the various products, the Panel considered this dissimilarity to be particularly dispositive for its analysis under Article III:2, second sentence.

c) The Panel noted that Japan's Liquor Tax Law does not provide for ad valorem taxation and this criterion is, consequently, irrelevant in this case.

d) With respect to the tax/price ratio, the Panel noted that the statistics submitted by Japan show that significant differences exist between shochu and the other directly competitive or substitutable products and also noted that there are significantly different tax/price ratios within the same product categories. (…)

6.35 The Panel took note, in this context, of the statement by Japan that the 1987 Panel Report erred when it concluded that shochu is essentially a Japanese product. The Panel accepted the evidence submitted by Japan according to which a shochu-like product is produced in various countries outside Japan, including the Republic of Korea, the People's Republic of China and Singapore. The Panel noted, however, that Japanese import duties on shochu are set at 17.9 per cent. At any rate what is at stake, in the Panel's view, is the market share of the domestic shochu market in Japan that was occupied by Japanese-made shochu. The high import duties on foreign-produced shochu resulted in a significant share of the Japanese shochu market held by Japanese shochu producers. Consequently, in the Panel's view, the combination of customs duties and internal taxation in Japan has the following impact: on the one hand, it makes it difficult for foreign-produced shochu to penetrate the Japanese market and, on the other, it does not guarantee equality of competitive conditions between shochu and the rest of “white” and “brown” spirits. Thus, through a combination of high import duties and differentiated internal taxes, Japan manages to “isolate” domestically produced shochu from foreign competition, be it foreign produced shochu or any other of the mentioned white and brown spirits. In the Panel's view, the table in Annex I illustrates this point.

VII.Conclusions

7.1 In light of the findings above, the Panel reached the following conclusions:

[16]Based on calculations upon information included in para. 2.3 of the Descriptive Part.

(i) Shochu and vodka are like products and Japan, by taxing the latter in excess of the former, is in violation of its obligation under Article III:2, first sentence, of the General Agreement on Tariffs and Trade 1994.

(ii) Shochu, whisky, brandy, rum, gin, genever, and liqueurs are "directly competitive or substitutable products" and Japan, by not taxing them similarly, is in violation of its obligation under Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994. (…)

Appeal by the U.S.

Japan - Taxes on Alcoholic Beverages (AB-1996-2)

SUBMISSION BY THE UNITED STATES (Appellant)
August 23, 1996

TABLE OF CONTENTS

(…)

4. The connection drawn by the Panel between national treatment obligations and tariff bindings is erroneous and should be eliminated

E. The Panel erred in its interpretation of the second sentence of Article III:2

1. The Panel's analysis of the reference to Article III:I in the second sentence of Article 111:2 is in error

2. The Panel's use of cross-price elasticity as the "decisive criterion" for whether products are "directly competitive or substitutable" was in error

IV. Conclusion

IV. Legal Discussion

A. Introduction

36. The Panel has found that "likeness" is to be determined purely on the basis of physical characteristics, consumer uses and the tariff classification of the products in question. This limited set of criteria removes from the analysis all other factors that may be relevant in the case before the panel. If two products are "like" according to these criteria, and if products produced domestically happen to fall in the lower-taxed category, then under the Panel's reasoning there is an automatic violation of Article III:2, first sentence, regardless of whether the purpose of the tax distinction is protectionist or even has anything to do with trade. For instance, if a Member chooses to tax automobiles sold for business use at a higher rate than automobiles sold for personal use, the Member applies the same tariff to all automobiles, a few business-use automobiles are imported and there is domestic production of cars sold for personal use, then according to the Panel report the Member in question is automatically in violation of its obligations under Article III:2, first sentence.

37. These findings do not just improperly limit the tax sovereignty of all Members. In doing so, they place the international trading rules in a needless conflict with domestic policy. They misinterpret the GATT as a matter of treaty law, and distort the system of national treatment guarantees under the GATT and the GATS.

(…)

B. The interpretation of "like product" by the Malt Beverages panel: "aim and effect of affording protection to domestic production"

43. The *Malt Beverages* panel examined the distinctions made in these two origin-neutral measures by taking into account not only the text of Articles III:2 and III:4, but also the context and the object and purpose of Article III as definitively stated by Article III:1. It examined these distinctions in the light of *all* relevant circumstances — not just physical characteristics, end-uses and tariff treatment but also other factors and circumstances relevant to these distinctions. In order to discern whether the distinctions were being drawn for protectionist purposes, the panel examined both the effect of these distinctions and their aim in accordance with Article III:1. In the case of the Mississippi tax law, it determined that both the aim and effect were protective in nature, and in the case of laws distinguishing low and high alcohol beer it determined that their aim and effect were not protective. Contrary to the picture presented in the present Panel decision, none of these determinations depended on an examination of the subjective motivations of the legislature; rather, the *Malt Beverages* panel's discussion of protective aim was based on the design of the measure in question and the incentive structure provided by it. Metaphorically speaking, the focus was on the direction in which the gun was pointing, rather than whether the person holding the gun even wanted to pull the trigger.

44. The 1987 Panel Report concerning Japan's liquor taxes took a similar approach. The 1987 Panel Report was the first GATT panel decision ever to apply the national treatment obligation of Article III to origin-neutral product distinctions, and in working through these difficult issues the panel attempted to square its findings with the mechanical and ad-hoc "like product" analysis in earlier panel decisions involving tariff discrimination. Nonetheless, the central findings of the 1987 Panel Report were fully consistent with the analysis in the *Malt Beverages* panel decision.

(…)

C. The Panel's reasons for rejecting the Malt Beverages interpretation were in error

1. *The Panel's refusal to interpret Article III:2 in the light of Article III:1 is contrary to accepted principles of treaty interpretation*

56. The manner in which the Panel has interpreted Article III:2, and in particular its failure to interpret Article III:2, first sentence in the light of Article III:I, is inconsistent with the general international principles of treaty interpretation, as reflected in the Vienna Convention and the Appellate Body's first report. The Panel should have taken into account all relevant elements: the text, the context, the object and purpose, and the indications of the intentions of the drafters in relevant drafting history. Instead: the Panel has refused to look beyond the text of Article III:2, first sentence at all; the Panel has disregarded Article III:I, which is part of the context for Article III:2 and Article III generally; and the Panel has disregarded the object and purpose of Article III as definitively stated in Article III:I. The misinterpretation of Article III:2 is thus inconsistent with the 'customary rules of interpretation of public international law' which the Panel should faithfully have applied under Article 3(2) of the DSU. It departs from the intentions of the parties and amounts to an alteration of the rights and obligations of Members contrary to the provisions of Article 3(2) of the DSU.

(…)

2. *Interpreting Article III:2 in the light of Article III:I does not require evaluation of the subjective motivations behind government measures*

60. Moreover, it is clear that a legal analysis that ignores the issue of purpose must either produce absurd decisions prohibiting harmless measures or, more likely, resort to non-transparent manipulation of which physical and end-use characteristics are dispositive in each particular case in order to avoid such absurd results. The *Malt Beverages* panel evaluated laws that distinguish between low alcohol beer and high alcohol beer. Such laws exist in many other countries, including the member States of the European Communities. If panels cannot consider all the relevant circumstances surrounding such measures, including the purpose of the measures, the only way to avoid a GATT prohibition under the "like product" standard of Article III:2, first sentence, would be to rule that the physical characteristics of low and high alcohol beer are not "like" — a conclusion that would be completely inconsistent with the conclusion in paragraph 6.23 of the present Panel report that the physical characteristics of vodka and shochu make them "like" regardless of difference in alcoholic strength. If panels resort to such manipulation of the "like product" concept to avoid absurd results, they will in fact be using the perceived purpose of measures as a criterion for their reaction, but they will be doing so covertly, in the guise of applying "product characteristics." It is this type of manipulation and covert reasoning, not the discerning of a measure's purpose, that create the risk of arbitrary decisions in this area.
(…)

D. The Panel erred by failing to interpret Article III:2 in light of Article III:1

1. *The Panel's failure to take Article III:I into account in interpreting national treatment obligations is also inconsistent with past panel reports and the intentions of the drafters of Article III*

71. For instance, in initial discussions of the provisions in Article 18 of the draft Charter on national treatment in regard to internal taxes, it was clarified that "... there was nothing in Article 18 to prevent taxes being imposed on privately owned motor-cars, but not on those used for public transportation." Similarly. it was clarified that it would not be permissible for the United States to impose a tax on imported natural rubber "in order to assist the production of synthetic rubber" (emphasis added). A working party then added the text of the present Article III:1 back into the text of Article 18, as a package with revisions made to the provisions corresponding to Article III:2. When the text of the revised article was adopted, one of the drafters stated that "The interpretative note narrowed the scope of paragraph 2 .... A Member could only allege a breach of the second sentence of paragraph 2, i.e., that the tax was designed to protect the domestic product, when the latter was directly competitive or substitutable" (emphasis added). In response, another of the drafters suggested that "a decision could not be made as to whether any two products were directly competitive or substitutable except in relation to a factual situation. It might be held that a tax on coal was in a particular case designed to protect the fuel oil industry, but that would have to be determined in relation to the particular case" (emphasis added).

(…)

2. *Failure to interpret Article III in the light of Article III:1 will lead to results that are unpredictable and unacceptable for the trading system*

74. Physical characteristics are only a small sub-set of the legitimate distinctions that exist. For instance, a WTO Member may tax different types of cups differently, and thereby draw a distinction between them. A cup may be taxed differently because it is a non-recyclable beverage container (subject to an environmental tax), a material producing toxic gas when incinerated (subject to regulation), or a household utensil (subject to reduction in VAT). If a panel compares the two objects as cups when they are not distinguished by the WTO Member as cups, this reflects an arbitrary distinction imposed by the panel.

3. *The Panel's failure to find that all distilled spirits were "like products" in this case was in error; the Panel's inconsistent application of its interpretation of the "like product" concept illustrates the impossibility of making meaningful product distinctions based on that interpretation*

(…)

83. Paragraph 6.23 of the Panel report states that "substantial differences in physical characteristics exist" between shochu and non-vodka distilled spirits. This determination only repeats and endorses the protectionist nature of the Japanese liquor tax classification scheme. For instance, the definition of "shochu" excludes spirits made with sugar such as rum, except for spirits made with certain sugars designated by government ordinance; evidence was presented during the panel proceeding that this exclusion to the exclusion was designed to permit Okinawan *awamori* shochu made with molasses to qualify for the low tax rates accorded to shochu. Yet the Panel has found that "the use of ingredients would disqualify rum". In fact, there is no difference between the use of sugar as an ingredient in rum and the use of sugar as an ingredient in *awamori* shochu. Similarly, some shochu has a brown appearance (resulting from manufacturing processes), yet the Panel has found that the appearance of whisky and brandy would disqualify it as a like product to shochu. (…)

4. *The connection drawn by the Panel between national treatment obligations and tariff bindings is erroneous and should be eliminated*

(…)

88. The Panel starts by making the conclusive judgment in paragraph 6.13 that "one of the main purposes of Article III is to guarantee that WTO Members will not undermine through internal measures their commitments under Article II." This statement is supported by two quotations taken out of context. Having assigned Article III this mistaken tariff-protecting purpose, the Panel report then draws the conclusion that "a parallelism should be drawn between the definition of products for the purposes of Article II and the term "like product" as it appears in Article III:2" (para. 6.21). This analogy is false. The scope of a tariff binding is completely within the discretion of a Member; concepts such as value-break tariffs or seasonal tariffs have been widely tolerated in GATT practice because there is no obligation under GATT to reduce tariff at all. (…)

E. <u>The Panel erred in its interpretation of the second sentence of Article III:2</u>

1. *The Panel's analysis of the reference to Article III:I in the second sentence of*

Article III:2 is in error

95. The Panel concluded that tax measures applicable to "directly competitive or substitutable" products could be found inconsistent with "the principles set forth in the first paragraph [of Article III]" whenever there was a dissimilarity in the taxation of such products that was not *de minimis*. Thus, if the tax difference between products in such a pair is greater than *de minimis*, and if products produced domestically happen to fall in the lower-taxed category, then under the Panel's reasoning there is an automatic violation of Article III:2, second sentence, regardless of whether the purpose of the tax distinction has anything to do with affording "protection to domestic production." The Panel's failure to consider the purpose of such tax distinctions would lead panels to prohibit tax distinctions that clearly have no protective purpose. (…)

2. *The Panel's use of cross-price elasticity as the "decisive criterion" for whether products are "directly competitive or substitutable" was in error*

101. Cross-elasticity is an important concept for understanding demand relationships in the abstract, but because of its inherent limitations and difficulties in implementing its use, use of cross-elasticity as "the decisive criterion" for determining rights and obligations under Article III:2 is completely inappropriate. The most basic objection is that making the legal rights and obligations of governments dependent on the level of cross-elasticity of demand between two products makes governments legally responsible (and vulnerable to trade retaliation) for matters that are beyond their control.

IV. Conclusion

117. The United States requests that the Appellate Body find that the distinctions between the various types of distilled spirits under Japan's Liquor Tax Law are not supported by any non-protectionist purpose, and that therefore these distilled spirits should all be deemed to be "like products" for the purpose of Article III:2, first sentence. It should therefore find that by taxing other distilled spirits in excess of shochu, Japan is in violation of Article III:2, first sentence. The Appellate Body should also modify the Panel's interpretation of Article III as indicated above.

* * *

WORLD TRADE ORGANIZATION

WT/DS8/AB/R
WT/DS10/AB/R
WT/DS11/AB/R
4 October 1996

(96-3951)

Appellate Body

Japan - Taxes on Alcoholic Beverages

AB-1996-2

Report of the Appellate Body

To download the original decision, visit http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm

WORLD TRADE ORGANIZATION
APPELLATE BODY

Japan - Taxes on Alcoholic Beverages	AB-1996-2
Japan, Appellant/Appellee United States, Appellant/Appellee	Present:
	Lacarte-Muró, Presiding Member
Canada, Appellee	Bacchus, Member
European Communities, Appellee	El-Naggar, Member

(…)

C. Issues Raised in the Appeal

The appellants, Japan and the United States, have raised the following issues in this appeal:

1. Japan

   (a) whether the Panel erred in failing to interpret Article III:2, first and second sentences, in the light of Article III:1;

   (b) whether the Panel erred in rejecting an "aim-and-effect" test in establishing whether the Liquor Tax Law is applied "so as to afford protection to domestic production";

   (c) whether the Panel erred in failing to examine the effect of affording protection to domestic production from the perspective of the linkage between the origin of products and their treatment under the Liquor Tax Law;

   (d) whether the Panel failed to give proper weight to tax/price ratios as a yardstick for comparing tax burdens under Article III:2, first and second sentences;

   (e) whether the Panel erred in interpreting and applying Article III:2, second sentence, by equating the language "not similarly taxed" in *Ad* Article III:2, second sentence, with "so as to afford protection" in Article III:1; and

   (f) whether the Panel erred in placing excessive emphasis on tariff classification as a criterion for determining "like products".

2. United States

(a) whether the Panel erred in failing to interpret Article III:2, first and second sentences, in the light of Article III:1;

(b) whether the Panel erred in failing to find that all distilled spirits are "like products";

(c) whether the Panel erred in drawing a connection between national treatment obligations and tariff bindings;

(d) whether the Panel erred in interpreting and applying Article III:2, second sentence, by equating the language "not similarly taxed" in *Ad* Article III:2, second sentence, with "so as to afford protection" in Article III:1;

(e) whether the Panel erred in its conclusions on "directly competitive or substitutable products" by examining cross-price elasticity as "the decisive criterion";

(f) whether the Panel erred in failing to maintain consistency between the conclusions in paragraph 7.1(ii) of the Panel Report on "directly competitive or substitutable products" and the conclusions in paragraphs 6.32-6.33 of the Panel Report, and whether the Panel erred in failing to address the full scope of products subject of this dispute;

(g) whether the Panel erred in finding that the coverage of Article III:2 and Article III:4 are not equivalent; and

(h) whether the Panel erred in its characterization of panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body as "subsequent practice in a specific case by virtue of the decision to adopt them".

D. Treaty Interpretation

Article 3.2 of the *DSU* directs the Appellate Body to clarify the provisions of GATT 1994 and the other "covered agreements" of the *WTO Agreement* "in accordance with customary rules of interpretation of public international law". Following this mandate, in *United States - Standards for Reformulated and Conventional Gasoline*,[17] we stressed the need to achieve such clarification by reference to the fundamental rule of treaty interpretation set out in Article 31(1) of the *Vienna Convention*. We stressed there that this general rule of interpretation "has attained the status of a rule of customary or general international law".[18] There can be no doubt that Article 32 of the *Vienna Convention*, dealing with the role of supplementary means of interpretation, has also attained the same status.[19] (…)

[17]Adopted 20 May 1996, WT/DS2/9.

[18]*Ibid.*, at p. 17.

[19]See *e.g.*: Jiménez de Aréchaga, "International Law in the Past Third of a Century" (1978-I) 159 Recueil des Cours p.1 at 42; *Territorial Dispute (Libyan Arab Jamahiriya/Chad), Judgment*, (1994), I.C.J. Reports, p. 6 at 20; *Maritime*

E. Status of Adopted Panel Reports

In this case, the Panel concluded that,

> ...panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body constitute subsequent practice in a specific case by virtue of the decision to adopt them. Article 1(b)(iv) of GATT 1994 provides institutional recognition that adopted panel reports constitute subsequent practice. Such reports are an integral part of GATT 1994, since they constitute "other decisions of the CONTRACTING PARTIES to GATT 1947".[20]

Article 31(3)(b) of the *Vienna Convention* states that "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation" is to be "taken into account together with the context" in interpreting the terms of the treaty. Generally, in international law, the essence of subsequent practice in interpreting a treaty has been recognized as a "concordant, common and consistent" sequence of acts or pronouncements which is sufficient to establish a discernable pattern implying the agreement of the parties regarding its interpretation.[21] An isolated act is generally not sufficient to establish subsequent practice;[22] it is a sequence of acts establishing the agreement of the parties that is relevant.[23]

Although GATT 1947[24] panel reports were adopted by decisions of the CONTRACTING PARTIES[25], a decision to adopt a panel report did not under GATT 1947 constitute agreement by the CONTRACTING PARTIES on the legal reasoning in that panel report. The generally-accepted view under GATT 1947 was that the conclusions and recommendations in an adopted panel report bound the parties to the dispute in that particular case, but subsequent panels did not feel legally bound by the details and reasoning of a previous panel report.[26]

Delimitation and Territorial Questions between Qatar and Bahrain, Jurisdiction and Admissibility, Judgment, (1995), I.C.J.Reports, p. 6 at 18; *Interpretation of the Convention of 1919 Concerning Employment of Women during the Night* (1932), P.C.I.J., Series A/B, No. 50, p. 365 at 380; cf. the *Serbian and Brazilian Loans Cases* (1929), P.C.I.J., Series A, Nos. 20-21, p. 5 at 30; *Constitution of the Maritime Safety Committee of the IMCO* (1960), I.C.J. Reports, p. 150 at 161; *Air Transport Services Agreement Arbitration* (*United States of America v. France*) (1963), International Law Reports, 38, p. 182 at 235-43.

[20]Panel Report, para. 6.10.

[21]Sinclair, *The Vienna Convention on the Law of Treaties* (2nd ed., 1984), p. 137; Yasseen, "L'interprétation des traités d'après la Convention de Vienne sur le Droit des Traités" (1976-III) 151 Recueil des Cours p. 1 at 48.

[22]Sinclair, *supra*., footnote 24, p. 137.

[23](1966) Yearbook of the International Law Commission, Vol. II, p. 222; Sinclair, *supra*., footnote 24, p. 138.

[24]By GATT 1947, we refer throughout to the General Agreement on Tariffs and Trade, dated 30 October 1947, annexed to the Final Act Adopted at the Conclusion of the Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment, as subsequently rectified, amended or modified.

[25]By CONTRACTING PARTIES, we refer throughout to the CONTRACTING PARTIES of GATT 1947.

[26]*European Economic Community - Restrictions on Imports of Dessert Apples*, BISD 36S/93, para. 12.1.

We do not believe that the CONTRACTING PARTIES, in deciding to adopt a panel report, intended that their decision would constitute a definitive interpretation of the relevant provisions of GATT 1947. Nor do we believe that this is contemplated under GATT 1994. There is specific cause for this conclusion in the *WTO Agreement*. Article IX:2 of the *WTO Agreement* provides: "The Ministerial Conference and the General Council shall have the exclusive authority to adopt interpretations of this Agreement and of the Multilateral Trade Agreements". (…)

Article XVI:1 of the *WTO Agreement* and paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement* bring the legal history and experience under the GATT 1947 into the new realm of the WTO in a way that ensures continuity and consistency in a smooth transition from the GATT 1947 system. This affirms the importance to the Members of the WTO of the experience acquired by the CONTRACTING PARTIES to the GATT 1947 -- and acknowledges the continuing relevance of that experience to the new trading system served by the WTO. Adopted panel reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute. However, they are not binding, except with respect to resolving the particular dispute between the parties to that dispute.[27] In short, their character and their legal status have not been changed by the coming into force of the *WTO Agreement*.

For these reasons, we do not agree with the Panel's conclusion in paragraph 6.10 of the Panel Report that "panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body constitute subsequent practice in a specific case" as the phrase "subsequent practice" is used in Article 31 of the *Vienna Convention*. Further, we do not agree with the Panel's conclusion in the same paragraph of the Panel Report that adopted panel reports in themselves constitute "other decisions of the CONTRACTING PARTIES to GATT 1947" for the purposes of paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement*.

However, we agree with the Panel's conclusion in that same paragraph of the Panel Report that *unadopted* panel reports "have no legal status in the GATT or WTO system since they have not been endorsed through decisions by the CONTRACTING PARTIES to GATT or WTO Members".[28] Likewise, we agree that "a panel could nevertheless find useful guidance in the reasoning of an unadopted panel report that it considered to be relevant".[29]

F. Interpretation of Article III

The *WTO Agreement* is a treaty -- the international equivalent of a contract. It is self-evident that in an exercise of their sovereignty, and in pursuit of their own respective national interests, the Members of the WTO have made a bargain. In exchange for the benefits they expect to derive as Members of the WTO, they have agreed to exercise their sovereignty according to the commitments they have made in the *WTO Agreement*. (…)

---

[27]It is worth noting that the Statute of the International Court of Justice has an explicit provision, Article 59, to the same effect. This has not inhibited the development by that Court (and its predecessor) of a body of case law in which considerable reliance on the value of previous decisions is readily discernible.

[28]Panel Report, para. 6.10.

[29]*Ibid.*

The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III "is to ensure that internal measures 'not be applied to imported or domestic products so as to afford protection to domestic production'".[30] Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products.[31] "[T]he intention of the drafters of the Agreement was clearly to treat the imported products in the same way as the like domestic products once they had been cleared through customs. Otherwise indirect protection could be given".[32] 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.[33] Members of the WTO are free to pursue their own domestic goals through internal taxation or regulation so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the *WTO Agreement.*

(…) The sheltering scope of Article III is not limited to products that are the subject of tariff concessions under Article II. The Article III national treatment obligation is a general prohibition on the use of internal taxes and other internal regulatory measures so as to afford protection to domestic production. This obligation clearly extends also to products not bound under Article II.[34] This is confirmed by the negotiating history of Article III.[35]

---

[30]*United States - Section 337 of the Tariff Act of 1930*, BISD 36S/345, para. 5.10.

[31]*United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9; *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.5(b).

[32]*Italian Discrimination Against Imported Agricultural Machinery*, BISD 7S/60, para. 11.

[33]*United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9.

[34]*Brazilian Internal Taxes*, BISD II/181, para. 4; *United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9; *EEC - Regulation on Imports of Parts and Components*, BISD 37S/132, para. 5.4.

[35]At the Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment, held in 1947, delegates in the Tariff Agreement Committee addressed the issue of whether to include the national treatment clause from the draft Charter for an International Trade Organization ("ITO Charter") in the GATT 1947. One delegate noted:

> This Article in the Charter had two purposes, as I understand it. The first purpose was to protect the items in the Schedule or any other Schedule concluded as a result of any subsequent negotiations and agreements - that is, to ensure that a country offering a tariff concession could not nullify that tariff concession by imposing an internal tax on the commodity, which had an equivalent effect. If that were the sole purpose and content of this Article, there could really be no objection to its inclusion in the General Agreement. But the Article in the Charter had an additional purpose. That purpose was to prevent the use of internal taxes as a system of protection. It was part of a series of Articles designed to concentrate national protective measures into the forms permitted under the Charter, i.e. subsidies and tariffs, and since we have taken over this Article from the Charter, we are, by including the Article, doing two things: so far as the countries become parties to the Agreement, we are, first of all, ensuring that the tariff concessions they grant one another cannot be nullified by the imposition of corresponding internal taxes; but we are also ensuring that those countries which become parties to the Agreement undertake not to use internal taxes as a system of protection.

G. Article III:1

(…) The proper interpretation of the Article is, first of all, a textual interpretation. Consequently, the Panel is correct in seeing a distinction between Article III:1, which "contains general principles", and Article III:2, which "provides for specific obligations regarding internal taxes and internal charges".[36] Article III:1 articulates a general principle that internal measures should not be applied so as to afford protection to domestic production. This general principle informs the rest of Article III. The purpose of Article III:1 is to establish this general principle as a guide to understanding and interpreting the specific obligations contained in Article III:2 and in the other paragraphs of Article III, while respecting, and not diminishing in any way, the meaning of the words actually used in the texts of those other paragraphs. In short, Article III:1 constitutes part of the context of Article III:2, in the same way that it constitutes part of the context of each of the other paragraphs in Article III. Any other reading of Article III would have the effect of rendering the words of Article III:1 meaningless, thereby violating the fundamental principle of effectiveness in treaty interpretation. Consistent with this principle of effectiveness, and with the textual differences in the two sentences, we believe that Article III:1 informs the first sentence and the second sentence of Article III:2 in different ways.

H. Article III:2

1. First Sentence

(…) There is no specific invocation in this first sentence of the general principle in Article III:1 that admonishes Members of the WTO not to apply measures "so as to afford protection". This omission must have some meaning. We believe the meaning is simply that the presence of a protective application need not be established separately from the specific requirements that are included in the first sentence in order to show that a tax measure is inconsistent with the general principle set out in the first sentence. However, this does not mean that the general principle of Article III:1 does not apply to this sentence. To the contrary, we believe the first sentence of Article III:2 is, in effect, an application of this general principle. The ordinary meaning of the words of Article III:2, first sentence leads inevitably to this conclusion. Read in their context and in the light of the overall object and purpose of the *WTO Agreement*, the words of the first sentence require an examination of the conformity of an internal tax measure with Article III by determining, 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. If the imported and domestic products are "like products", and if the taxes applied to the imported

---

This view is reinforced by the following statement of another delegate:

> ... [Article III] is necessary to protect not only scheduled items in the Agreement, but, indeed, all items for all our exports and the exports of any country. If that is not done, then every item which does not appear in the Schedule would have to be reconsidered and possibly tariff negotiations re-opened if Article III were changed to permit any action on these non-scheduled items.

See EPCT/TAC/PV.10, pp. 3 and 33.

[36]Panel Report, para. 6.12.

products are "in excess of" those applied to the like domestic products, then the measure is inconsistent with Article III:2, first sentence.[37] (…)

(a) *"Like Products"*

Because the second sentence of Article III:2 provides for a separate and distinctive consideration of the protective aspect of a measure in examining its application to a broader category of products that are not "like products" as contemplated by the first sentence, we agree with the Panel that the first sentence of Article III:2 must be construed narrowly so as not to condemn measures that its strict terms are not meant to condemn. Consequently, we agree with the Panel also that the definition of "like products" in Article III:2, first sentence, should be construed narrowly.[38]

How narrowly is a matter that should be determined separately for each tax measure in each case. We agree with the practice under the GATT 1947 of determining whether imported and domestic products are "like" on a case-by-case basis. The Report of the Working Party on *Border Tax Adjustments*, adopted by the CONTRACTING PARTIES in 1970, set out the basic approach for interpreting "like or similar products" generally in the various provisions of the GATT 1947:

> ... the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a "similar" product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is "similar": the product's end-uses in a given market; consumers' tastes and habits, which change from country to country; the product's properties, nature and quality.[39]

(…) In applying the criteria cited in *Border Tax Adjustments* to the facts of any particular case, and in considering other criteria that may also be relevant in certain cases, panels can only apply their best judgement in determining whether in fact products are "like". This will always involve an unavoidable element of individual, discretionary judgement. We do not agree with the Panel's observation in paragraph 6.22 of the Panel Report that distinguishing between "like products" and "directly competitive or substitutable products" under Article III:2 is "an arbitrary

---

[37]In accordance with Article 3.8 of the *DSU*, such a violation is *prima facie* presumed to nullify or impair benefits under Article XXIII of the GATT 1994. Article 3.8 reads as follows:

> In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an adverse impact on other Members parties to that covered agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge.

[38]We note the argument on appeal that the Panel suggested in paragraph 6.20 of the Panel Report that the product coverage of Article III:2 is not identical to the coverage of Article III:4. That is not what the Panel said. The Panel said the following:

> *If* the coverage of Article III:2 is identical to that of Article III:4, a different interpretation of the term "like product" would be called for in the two paragraphs. Otherwise, if the term "like product" were to be interpreted in an identical way in both instances, the scope of the two paragraphs would be different. (emphasis added)

This was merely a hypothetical statement.

[39]Report of the Working Party on *Border Tax Adjustments*, BISD 18S/97, para. 18.

decision". Rather, we think it is a discretionary decision that must be made in considering the various characteristics of products in individual cases.

(…) The concept of "likeness" is a relative one that evokes the image of an accordion. The accordion of "likeness" stretches and squeezes in different places as different provisions of the *WTO Agreement* are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term "like" is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply. We believe that, in Article III:2, first sentence of the GATT 1994, the accordion of "likeness" is meant to be narrowly squeezed.

The Panel determined in this case that shochu and vodka are "like products" for the purposes of Article III:2, first sentence. We note that the determination of whether vodka is a "like product" to shochu under Article III:2, first sentence, or a "directly competitive or substitutable product" to shochu under Article III:2, second sentence, does not materially affect the outcome of this case.

(…)

It is true that there are numerous tariff bindings which are in fact extremely precise with regard to product description and which, therefore, can provide significant guidance as to the identification of "like products". Clearly enough, these determinations need to be made on a case-by-case basis. However, tariff bindings that include a wide range of products are not a reliable criterion for determining or confirming product "likeness" under Article III:2.[40]

With these modifications to the legal reasoning in the Panel Report, we affirm the legal conclusions and the findings of the Panel with respect to "like products" in all other respects.

(b) *"In Excess Of"*

The only remaining issue under Article III:2, first sentence, is whether the taxes on imported products are "in excess of" those on like domestic products. If so, then the Member that has imposed the tax is not in compliance with Article III. Even the smallest amount of "excess" is too much. "The prohibition of discriminatory taxes in Article III:2, first sentence, is not conditional on a 'trade effects test' nor is it qualified by a *de minimis* standard."[41] We agree with the Panel's legal reasoning and with its conclusions on this aspect of the interpretation and application of Article III:2, first sentence.

---

[40]We believe, therefore, that statements relating to any relationship between tariff bindings and "likeness" must be made cautiously. For example, the Panel stated in paragraph 6.21 of the Panel Report that "... with respect to two products subject to the same tariff binding and therefore to the same maximum border tax, there is no justification, outside of those mentioned in GATT rules, to tax them in a differentiated way through internal taxation". This is incorrect.

[41]*United States - Measures Affecting Alcoholic and Malt Beverages*, BISD 39S/206, para 5.6; see also *Brazilian Internal Taxes*, BISD II/181, para. 16; *United States - Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, para. 5.1.9; *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.8.

2. Second Sentence

Article III:1 informs Article III:2, second sentence, through specific reference. Article III:2, second sentence, contains a general prohibition against "internal taxes or other internal charges" applied to "imported or domestic products in a manner contrary to the principles set forth in paragraph 1". As mentioned before, Article III:1 states that internal taxes and other internal charges "should not be applied to imported or domestic products so as to afford protection to domestic production". Again, *Ad* Article III:2 states as follows:

> 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.

(…)

Unlike that of Article III:2, first sentence, the language of Article III:2, second sentence, specifically invokes Article III:1. The significance of this distinction lies in the fact that whereas Article III:1 acts implicitly in addressing the two issues that must be considered in applying the first sentence, it acts explicitly as an entirely separate issue that must be addressed along with two other issues that are raised in applying the second sentence. Giving full meaning to the text and to its context, three separate issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:2, second sentence. These three issues are whether:

(1) the imported products and the domestic products *are "directly competitive or substitutable products" which are in competition with each other*;
(2) the directly competitive or substitutable imported and domestic products *are "not similarly taxed*"; and
(3) the dissimilar taxation of the directly competitive or substitutable imported domestic products *is "applied ... so as to afford protection to domestic production*".

Again, these are three separate issues. Each must be established separately by the complainant for a panel to find that a tax measure imposed by a Member of the WTO is inconsistent with Article III:2, second sentence.

(a) *"Directly Competitive or Substitutable Products*"

(…) How much broader that category of "directly competitive or substitutable products" may be in any given case is a matter for the panel to determine based on all the relevant facts in that case. As with "like products" under the first sentence, the determination of the appropriate range of "directly competitive or substitutable products" under the second sentence must be made on a case-by-case basis.

In this case, the Panel emphasized the need to look not only at such matters as physical characteristics, common end-uses, and tariff classifications, but also at the "market place".[42] This seems appropriate. The GATT 1994 is a commercial agreement, and the WTO is concerned, after

[42]Panel Report, para. 6.22.

all, with markets. It does not seem inappropriate to look at competition in the relevant markets as one among a number of means of identifying the broader category of products that might be described as "directly competitive or substitutable".

Nor does it seem inappropriate to examine elasticity of substitution as one means of examining those relevant markets. The Panel did not say that cross-price elasticity of demand is "*the* decisive criterion" [43] for determining whether products are "directly competitive or substitutable". The Panel stated the following:

> In the Panel's view, the decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, *inter alia*, as shown by elasticity of substitution.[44]

We agree. And, we find the Panel's legal analysis of whether the products are "directly competitive or substitutable products" in paragraphs 6.28-6.32 of the Panel Report to be correct.

We note that the Panel's conclusions on "like products" and on "directly competitive or substitutable products" contained in paragraphs 7.1(i) and (ii), respectively, of the Panel Report fail to address the full range of alcoholic beverages included in the Panel's Terms of Reference.[45] More specifically, the Panel's conclusions in paragraph 7.1(ii) on "directly competitive or substitutable products" relate only to "shochu, whisky, brandy, rum, gin, genever, and liqueurs," which is narrower than the range of products referred to the Dispute Settlement Body by one of the complainants, the United States, which included in its request for the establishment of a panel "all other distilled spirits and liqueurs falling within HS heading 2208". We consider this failure to incorporate into its conclusions all the products referred to in the Terms of Reference, consistent with the matters referred to the DSB in WT/DS8/5, WT/DS10/5 and WT/DS11/2, to be an error of law by the Panel.

(b) *"Not Similarly Taxed"*

To give due meaning to the distinctions in the wording of Article III:2, first sentence, and Article III:2, second sentence, the phrase "not similarly taxed" in the *Ad* Article to the second sentence must not be construed so as to mean the same thing as the phrase "in excess of" in the first sentence. On its face, the phrase "in excess of" in the first sentence means *any* amount of tax on imported products "in excess of" the tax on domestic "like products". The phrase "not similarly taxed" in the *Ad* Article to the second sentence must therefore mean something else. It requires a different standard, just as "directly competitive or substitutable products" requires a different standard as compared to "like products" for these same interpretive purposes.

---

[43]United States Appellant's Submission, dated 23 August 1996, para. 98, p.63. (emphasis added)

[44]Panel Report, para 6.22.

[45] The Panel's Terms of Reference cite the matters referred to the Dispute Settlement Body by the European Communities, Canada and the United States in WT/DS8/5, WT/DS10/5 and WT/DS11/2, respectively. In WT/DS8/5, the European Communities referred the Dispute Settlement Body to Japan's taxation of shochu, "spirits", "whisky/brandy" and "liqueurs". In WT/DS10/5, Canada referred the Dispute Settlement Body to Japan's taxation of shochu and products falling "within HS 2208.30 ('whiskies'), HS 2208.40 ('rum and tafia'), HS 2208.90 ('other' including fruit brandies, vodka, ouzo, korn, cream liqueurs and 'classic' liqueurs.)" In WT/DS11/2, the United States referred the Dispute Settlement Body to Japan's taxation of shochu and "all other distilled spirits and liqueurs falling within HS heading 2208".

Reinforcing this conclusion is the need to give due meaning to the distinction between "like products" in the first sentence and "directly competitive or substitutable products" in the *Ad* Article to the second sentence. If "in excess of" in the first sentence and "not similarly taxed" in the *Ad* Article to the second sentence were construed to mean one and the same thing, then "like products" in the first sentence and "directly competitive or substitutable products" in the *Ad* Article to the second sentence would also mean one and the same thing. (…)

(…) In other words, there may be an amount of excess taxation that may well be more of a burden on imported products than on domestic "directly competitive or substitutable products" but may nevertheless not be enough to justify a conclusion that such products are "not similarly taxed" for the purposes of Article III:2, second sentence. We agree with the Panel that this amount of differential taxation must be more than *de minimis* to be deemed "not similarly taxed" in any given case.[46] And, like the Panel, we believe that whether any particular differential amount of taxation is *de minimis* or is not *de minimis* must, here too, be determined on a case-by-case basis. 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.

In this case, the Panel applied the correct legal reasoning in determining whether "directly competitive or substitutable" imported and domestic products were "not similarly taxed". However, the Panel erred in blurring the distinction between that issue and the entirely separate issue of whether the tax measure in question was applied "so as to afford protection". Again, these are separate issues that must be addressed individually. If "directly competitive or substitutable products" are *not* "not similarly taxed", then there is neither need nor justification under Article III:2, second sentence, for inquiring further as to whether the tax has been applied "so as to afford protection". But if such products are "not similarly taxed", a further inquiry must necessarily be made.

(c) *"So As To Afford Protection"*

This third inquiry under Article III:2, second sentence, must determine whether "directly competitive or substitutable products" are "not similarly taxed" in a way that affords protection. This is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent. If the measure is applied to imported or domestic products so as to afford protection to domestic production, then it does not matter that there may not have been any desire to engage in protectionism in the minds of the legislators or the regulators who imposed the measure. It is irrelevant that protectionism was not an intended objective if the particular tax measure in question is nevertheless, to echo Article III:1, "*applied* to imported or domestic products so as to afford protection to domestic production".[47] This is an issue of how the measure in question is *applied*.

(…)

As in that case, we believe that an examination in any case of whether dissimilar taxation has been applied so as to afford protection requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported

[46]Panel Report, para. 6.33.

[47]Emphasis added.

products. We believe it is possible to examine objectively the underlying criteria used in a particular tax measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such a protective application, as the Panel rightly concluded in this case. Most often, there will be other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case.

(…)

We have reviewed the Panel's reasoning in this case as well as its conclusions on the issue of "so as to afford protection" in paragraphs 6.33 - 6.35 of the Panel Report. We find cause for thorough examination. The Panel began in paragraph 6.33 by describing its approach as follows:

> ... if directly competitive or substitutable products are not "similarly taxed", and if it were found that the tax favours domestic products, then protection would be afforded to such products, and Article III:2, second sentence, is violated.

This statement of the reasoning required under Article III:2, second sentence is correct. However, the Panel went on to note:

> ... for it to conclude that dissimilar taxation afforded protection, it would be sufficient for it to find that the dissimilarity in taxation is not *de minimis*. ... the Panel took the view that "similarly taxed" is the appropriate benchmark in order to determine whether a violation of Article III:2, second sentence, has occurred as opposed to "in excess of" that constitutes the appropriate benchmark to determine whether a violation of Article III:2, first sentence, has occurred.[48]

In paragraph 6.34, the Panel added:

> (i) The benchmark in Article III:2, second sentence, is whether internal taxes operate “so as to afford protection to domestic production”, a term which has been further interpreted in the Interpretative Note ad Article III:2, paragraph 2, to mean dissimilar taxation of domestic and foreign directly competitive or substitutable products.

And, furthermore, in its conclusions, in paragraph 7.1(ii), the Panel concluded that:

> (ii) Shochu, whisky, brandy, rum, gin, genever, and liqueurs are “directly competitive or substitutable products” and Japan, by not taxing them similarly, is in violation of its obligation under

[48]Panel Report, para 6.33.

> Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994.

Thus, having stated the correct legal approach to apply with respect to Article III:2, second sentence, the Panel then equated dissimilar taxation above a *de minimis* level with the separate and distinct requirement of demonstrating that the tax measure "affords protection to domestic production". As previously stated, a finding that "directly competitive or substitutable products" are "not similarly taxed" is necessary to find a violation of Article III:2, second sentence. Yet this is not enough. The dissimilar taxation must be more than *de minimis*. It may be so much more that it will be clear from that very differential that the dissimilar taxation was applied "so as to afford protection". In some cases, that may be enough to show a violation. In this case, the Panel concluded that it was enough. Yet in other cases, there may be other factors that will be just as relevant or more relevant to demonstrating that the dissimilar taxation at issue was applied "so as to afford protection". In any case, the three issues that must be addressed in determining whether there is such a violation must be addressed clearly and separately in each case and on a case-by-case basis. And, in every case, a careful, objective analysis, must be done of each and all relevant facts and all the relevant circumstances in order to determine "the existence of protective taxation".[49] Although the Panel blurred its legal reasoning in this respect, nevertheless we conclude that it reasoned correctly that in this case, the Liquor Tax Law is not in compliance with Article III:2. As the Panel did, we note that:

> ...the combination of customs duties and internal taxation in Japan has the following impact: on the one hand, it makes it difficult for foreign-produced shochu to penetrate the Japanese market and, on the other, it does not guarantee equality of competitive conditions between shochu and the rest of 'white' and 'brown' spirits. Thus, through a combination of high import duties and differentiated internal taxes, Japan manages to "isolate" domestically produced shochu from foreign competition, be it foreign produced shochu or any other of the mentioned white and brown spirits.[50]

Our interpretation of Article III is faithful to the "customary rules of interpretation of public international law".[51] WTO rules are reliable, comprehensible and enforceable. WTO rules are not so rigid or so inflexible as not to leave room for reasoned judgements in confronting the endless and ever-changing ebb and flow of real facts in real cases in the real world. They will serve the multilateral trading system best if they are interpreted with that in mind. In that way, we will achieve the "security and predictability" sought for the multilateral trading system by the Members of the WTO through the establishment of the dispute settlement system.[52]

I. Conclusions and Recommendations

For the reasons set out in the preceding sections of this report, the Appellate Body has reached the following conclusions:

---

[49] *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.11.

[50] Panel Report, para. 6.35.

[51] Article 3.2 of the *DSU*.

[52] *Ibid.*

(a) the Panel erred in law in its conclusion that "panel reports adopted by the GATT CONTRACTING PARTIES and the WTO Dispute Settlement Body constitute subsequent practice in a specific case by virtue of the decision to adopt them";

(b) the Panel erred in law in failing to take into account Article III:1 in interpreting Article III:2, first and second sentences;

(c) the Panel erred in law in limiting its conclusions in paragraph 7.1(ii) on "directly competitive or substitutable products" to "shochu, whisky, brandy, rum, gin, genever, and liqueurs", which is not consistent with the Panel's Terms of Reference; and

(d) the Panel erred in law in failing to examine "so as to afford protection" in Article III:1 as a separate inquiry from "not similarly taxed" in the *Ad* Article to Article III:2, second sentence.

With the modifications to the Panel's legal findings and conclusions set out in this report, the Appellate Body affirms the Panel's conclusions that shochu and vodka are like products and that Japan, by taxing imported products in excess of like domestic products, is in violation of its obligations under Article III:2, first sentence, of the General Agreement on Tariffs and Trade 1994. Moreover, the Appellate Body concludes that shochu and other distilled spirits and liqueurs listed in HS 2208, except for vodka, are "directly competitive or substitutable products", and that Japan, in the application of the Liquor Tax Law, does not similarly tax imported and directly competitive or substitutable domestic products and affords protection to domestic production in violation of Article III:2, second sentence, of the General Agreement on Tariffs and Trade 1994.
(…)

III. Chilean Pisco (2000)

WORLD TRADE ORGANIZATION

WT/DS87/R
WT/DS110/R
15 June 1999
(99-2313)

Original: English

CHILE – TAXES ON ALCOHOLIC BEVERAGES

Report of the Panel

To download the original report, consult
http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm

(…)
II. Factual Aspects

A. Measures in Issue

1. Transitional System

2.1 The measure at issue is the so-called "Additional Tax on Alcoholic Beverages" ("*Impuesto Adicional a las bebidas Alcohólicas*", hereafter "ILA"), contained in Law No. 19,534.[53]

2.2 The ILA is an excise tax levied on the sale and importation of alcoholic beverages. It is payable by the seller or, in the case of imports, by the importer. The ILA takes the form of an *ad valorem* tax. The tax basis is the same as for the assessment of the Value Added Tax.

2.3. Law No. 19,534 was signed by the President of the Republic of Chile on 13 November 1997, and promulgated on 18 November 1997, and entered into force as of 1 December 1997, replacing Decree-Law 825/1974, which provided a tax system until 30 November 1997 (hereafter, the "Old Chilean System"). Law No. 19,534 provides a new tax system which will become applicable as of 1 December 2000, and a transitional system which is applicable until 1 December 2000 (hereafter, the "Transitional System").

2.4. The Old Chilean System distinguished three types of distilled spirits ("pisco", "whisky" and "other spirits", a residual category comprising all distilled spirits other than pisco and whisky) and applied to each of them a different *ad valorem* tax rate.[54] The Transitional System also applies different rates of taxes depending on whether the product is considered "pisco", "whisky" or "other spirits," until 1 December 2000. Nevertheless, as a transitional measure, it provides for a progressive reduction of the rate on whisky in accordance with the schedule shown in Table 1 below, while applies the same rate to pisco as the Old Chilean System until the new tax system takes effect on 1 December 2000.[55.56]

---

[53] Law No. 19,534 of 13 November 1997, amending Article 42 of Decree Law 825/74 (hereafter, "Law 19,534/97") (EC Exhibit 3). The European Communities claims that the measure in issue is contained in Decree-Law No. 825, of 27 December 1974, on the Tax on Sales and Services (hereafter, "Decree-Law 825/74" (EC Exhibit 4), amended by Law No. 19,534. The text of this Decree-Law was replaced by Decree-Law No. 1606, of 30 November 1976 ("hereafter", Decree-Law 1606/76) (EC Exhibit 6). In contrast, Chile claims that Law No. 19,534 constitutes an entirely new law, repealing and replacing Decree-Law 825/74. The Panel considers that there is no substantive difference between the two positions.
[54] Article 42 of Decree 825/74, as lastly amended by Article 4.III of Law No. 18,413, of 8 May 1985 (hereafter, "Law 18,143/85") (EC Exhibit 11).
[55] Transitional Article of Law 19,534/97 (EC Exhibit 3).
[56] EC First Submission, Table 4.

Table 1
Applicable tax rates from 1 December 1997 to 1 December 2000

	Whisky	Pisco	Other Spirits
Until 30.11.1997*	70 %	25 %	30 %
From 1.12.1997	65 %	25 %	30 %
From 1.12.1998	59 %	25 %	30 %
From 1.12.1999/Until 1.12.2000	53 %	25 %	30 %

*Old Chilean System

2. New Chilean System

2.5. The new tax system introduced by Law 19,534 (hereafter referred to as the "New Chilean System") abolishes the distinction between pisco, whisky and "other spirits". Instead, all distilled spirits are taxed according to a scale based on their degree of alcohol content.[57]

2.6. Law 19,534 provides that, as shown in Table 2 below, all spirits with an alcohol content of 35° or less are taxed at the rate of 27 %. From that base, the rate escalates in increments of 4 percentage points per additional degree of alcohol, peaking at a rate of 47 % for all spirits bottled over 39°.

Table 2[58]
Tax rates applicable from 1 December 2000

Alcohol content	Tax rate *ad valorem*
Less or equal to 35°	27 %
Less or equal to 36°	31 %
Less or equal to 37°	35 %
Less or equal to 38°	39 %
Less or equal to 39°	43 %
Over 39°	47 %

B. Products in Issue

(…)

1.Pisco

2.8. Under Chilean law, the term "pisco" is a protected geographical indication, the use of which is reserved exclusively for wine distillates produced and bottled in certain regions of Chile from certain varieties of muscat grapes grown in those regions.[59]

(…)
2.15. By law, pisco must have an alcohol content of no less than 30°; the four types of pisco are

[57] Single Article of Law 19,534/97 (EC Exhibit 3).
[58] EC First Submission, Table 5.
[59] The European Communities points out that according to the explanations provided by Chile during the consultations, the protected geographical indication for pisco was "made official" in 1931 by means of Decree-Law 181. *See* Chile's answers to questions from the EC dated 22 July 1997 (EC Exhibit 1).

designated as[60]:

–	*Pisco corriente* or *tradicional*	between 30° and 35°;
–	*Pisco especial*	between 35° and 40°;
–	*Pisco reservado*	between 40° and 43°;
–	*Gran pisco*	43° or more.

2.16. According to the explanations provided by the Chile during the consultations, Chile's pisco industry is currently producing and selling pisco of the following alcohol contents[61]:

–	*Pisco corriente* or *tradicional*	30°, 32°, 33°
–	*Pisco especial*	35°[62]
–	*Pisco reservado*	40°
–	*Gran pisco*	43°, 46° and 50°

2.17. According to the regulations in force, the four different types of pisco are distinguished solely in terms of their alcohol strength.[63] As already indicated by its name, *pisco tradicional* or *corriente* used to be the largest selling type of pisco. Over the last few years, however, it has been overtaken by *pisco especial*, which is now the best selling pisco category. *Pisco reservado* and *gran pisco* account for about 9 % of the market.
(…)

2.20. Finally, the merger of the two largest producers of pisco, Control and Capel, was authorised by Chile's competition authority as of 30 October 1998. Their combined market share is 90%. In giving this authorisation, the competition authority indicated that pisco had a high degree of competition with other alcoholic beverages, such as wine, beer and whisky, given the practice of ingesting pisco mixed with a non-alcoholic beverages, and therefore, in the market for alcoholic beverages, and despite the fact that the merger of the applicant co-operative companies would result in a combined share of the pisco market of 98%, there are alternative products which consumers of alcoholic beverages could choose to drink.

2. The Other Spirits in Issue

(…)
2.22. Decree 78/1986 also prescribes the minimum alcohol content requirements for the use of the main type names of distilled spirits in dispute, as follows[64]:

[60] Decree 78/1986, Article 56.
[61] Chile's answers to questions from the EC dated 24 February 1998 (EC Exhibit 2).
[62] According to the European Communities, the brand "Control de Guarda" appears to be sold also at 36°. *See* EC Exhibit 51.
[63] Article 13 of Decree 78/1986 (EC Exhibit 13).
[64] Ibid., Article 12.

Table 5[65]

Legally required minimum alcohol strength in Chile

Whisky, rum, tequila, gin	40°
Brandy, cognac, armagnac	38°
Aguardiente, fruit aguardiente, grappa	30°
Fruit liqueurs	25-34°
Anisettes	25-40°
Bitters	25-30°
Cocktails	12-16°
Other liqueurs	25-28°

C. History of taxation of alcoholic beverages in Chile

(…)

2.29. The table below summarises the evolution of the applicable rates between 1974 and the entry into force of Law 19,534 on 1 December 1997.

Table 6[66]

Evolution of taxes rates between 1974 and 1997

	Pisco	Whisky	Other spirits
With effect from 12/74	40 %	40%*	40 %*
With effect from 12/77	25 %	30 %	30 %
With effect from 7/79	25 %	30 %	30 %
With effect from 12/83	25 %	50 %	50 %
With effect from 1/84	25 %	55 %	30 %
With effect from 5/85	25 %	70 %	30 %

* imported spirits subject to the 50 % *recargo* until 1977.

(…)

VII. Findings

A. Claims of The Parties

7.1. The claim of the European Communities is that both the Transitional System and the New Chilean System are inconsistent with Chile's obligations under GATT Article III:2, second sentence.

7.2. The European Communities claims that[67]:

[65] EC First Submission, Table 2, with corrections made by the Panel based upon Decree 78/1986, Article 18 (EC Exhibit 13)..

[66] EC First Submission, Table 7.

[67] The European Communities notes that in its panel request, it also invoked a violation of GATT Article III:2, first sentence. Even though certain spirits exported from the European Communities to Chile (including in particular certain types of brandy) may be considered as being "like" to pisco, the European Communities has decided not to pursue that claim, given that those spirits are in any event "directly competitive or substitutable" with pisco.

(i) the Transitional System, which is applicable through 30 November 2000, is contrary to GATT Article III:2, second sentence, because it provides for the imposition of lower internal taxes on pisco than on other directly competitive or substitutable imported spirits, which fall within the tax categories of "whisky" and "other spirits", so as to afford protection to Chile's domestic production;

(ii) the New Chilean System, which will become applicable as of 1 December 2000, is also contrary to Article III:2, second sentence, because it results in the imposition of lower taxes on pisco with an alcohol content of 35° or less than on other directly competitive or substitutable imported spirits which have a higher alcohol content, so as to afford protection to Chile's domestic production.[68]

7.3. In response, Chile claims that this Panel should reject the unwarranted and intrusive interpretation of the reach of Article III that the European Communities has put forward in this dispute, and that in keeping with the plain language and the history of Article III, the Panel should find that the New Chilean System is fully consistent with Article III:2, second sentence.

7.4. Chile also argues that to the extent that the Panel considers the Transitional System to be at issue notwithstanding the short time in which it will remain in effect, it would be appropriate for the Panel to find that pisco is not directly competitive or substitutable with other distilled spirits in Chile, and hence that the Transitional System also conforms with Article III:2, second sentence.
(…)

C. "directly competitive or substitutable"

1. General

7.12. The complainant in this case has not argued that any of the imported or domestic products are "like". We shall, therefore, proceed exclusively under Article III:2, second sentence, which is concerned with the question of direct competitiveness or substitutability.
(…)
7.14. The category of "directly competitive or substitutable" products is broader than the "like product" category covered under the first sentence. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* stated that how much broader this category should be "is a matter for the panel to determine based on all the relevant facts in that case".[69] It will be important to look at not only such matters as physical characteristics, common end-uses, and tariff-classifications, but also at the market. The Appellate Body also stated that it is appropriate to examine elasticity of substitution as a means of examining the relevant markets.

7.15. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* agreed with the reasoning of the panel with regard to the analysis of directly competitive or substitutable products. That panel made two important observations. First, the panel noted that the responsiveness of consumers to various products offered in the market may vary from country to country.[70] Second, the panel cautioned that differences in responsiveness of consumers to various products should not be

---

[68] The European Communities argues that the New Chilean System already constitutes mandatory legislation, and as such, it may be the subject of dispute settlement under the WTO Agreement, citing Panel Report on *United States – Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, paras 5.2.1-5.2.2.
[69] Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra*., p. 25.
[70] Panel Report on *Japan - Taxes on Alcoholic Beverages*, adopted on 1 November 1996, WT/DS8/R, WT/DS10/R, WT/DS11/R, para. 6.28, citing Working Party on Border Tax Adjustments, para. 18.

influenced or determined by internal taxation because "a tax system that discriminates against imports has the consequence of creating or even freezing preferences for domestic goods."[71] The Appellate Body stated that no single criterion is decisive in determining whether any two products are "directly competitive or substitutable".

7.16. The question for us to decide is whether, in Chile, the domestic and imported products at issue in this case are directly competitive or substitutable. This requires evidence of the relationship between the products, including, in this case, comparisons of their end-uses, physical characteristics, channels of distribution and prices.
(…)
2. Evidentiary matters

(a) Potential competition

7.20. The European Communities submitted that Article III:2, second sentence, is concerned not only with tax differentials between products that are actually competitive or substitutable in a given market, but also with tax differentials between products that are potentially competitive or substitutable. The European Communities further argued that the notion of potential competition must be deemed to include not only competition that would exist "but for" the tax measures at issue, but also competition that could reasonably be expected to develop in the near future.[72]

> 7.21. It is well established in GATT jurisprudence, that Article III does not protect export volumes but, instead, protects competitive opportunities. (…)

7.24. We agree that 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 or substitutable now or can reasonably be expected to become directly competitive or substitutable in the near future.

7.25. In the case before us, (…) , potential competition is relevant for several reasons. Until 30 November 1997, whisky faced very high rates of taxation (45 percentage points higher than pisco). We must take into consideration the possibility that the current level of actual competition between pisco and other spirits is less than the level that could have developed under equal tax conditions. It is possible that the tax system in question (in conjunction with other measures not at issue, such as previously higher duties) may have inhibited consumers from choosing imports.
(b) Product categories

(…)
7.28. In the case before us Chile did not argue that the various types of pisco constituted different products for either analytical purposes or for determining whether the imports and pisco were directly competitive or substitutable. The European Communities also argued that the appropriate category of imported products for consideration is all distilled alcoholic beverages identified in HS 2208 as described in the request for establishment of a panel. (…)

7.29. We take the parties' positions *in this case* as strong evidence that the appropriate category of imports *with respect to the Chilean market* is all distilled alcoholic beverages identified in HS 2208 and the relevant domestic products for purposes of the issue of directly competitive or substitutable

[71]Ibid., citing the Panel Report on *Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83 (hereafter, "*Japan – Taxes on Alcoholic Beverages I*").
[72] *See* EC First Submission at para. 102. We note that Chile did not address this issue.

is all pisco. The Panel shall proceed accordingly.

3. Product comparisons

(a) General

7.30. The next step is to consider the various attributes of the products at issue to determine whether these attributes support a conclusion that there is a directly competitive or substitutable relationship between the imported and domestic products. In this regard, we will examine the end-uses of the products, their physical characteristics, the channels of distribution, price relationships (including cross-price elasticities), and other relevant characteristics.[73]

(b) End-uses

(…)
7.34. The European Communities asserts that pisco and the imported distilled spirits are already used by Chilean consumers for similar end-uses. The European Communities refer to a market research done on the drinking habits of a representative sample of consumers.[74] The European Communities argues that on the basis of the 1997 SM Survey, pisco and the imported distilled spirits are consumed in the same way (straight, diluted with water, ice, soft drinks or fruit juice, and in cocktails). The European Communities thus argues that there is a substantial overlap of end-use between whisky and pisco, the two spirits which Chile emphasises as being the most different.

7.35. Chile raises questions on the probative value of the consumer surveys being relied on by the European Communities. With respect to the discussion of end-uses, Chile disagrees with the results of the 1997 SM survey. In Chile's view, questions that ask consumers what they would choose if their preferred spirit were unavailable can only lead to abnormal and unpredictable answers. Chile also points out that the data in the 1998 SM Survey[75] is a purported quantitative analysis, in which consumers were faced with a hypothetical change in the prices of whisky, pisco and other spirits, the results of which can only be misleading.

7.36. Chile argues that it is oversimplistic to conclude that all spirits whose basic constitution is water and alcohol, and which are drunk mixed in not too different a manner, have necessarily the same end-uses. In Chile's view, this argument is tantamount to saying that consumers' only consideration is simply to have alcohol, irrespective of the form in which it is contained. Chile argues that even wine and beer share these characteristics and end-uses despite being different forms of alcoholic beverages.

7.37. Chile further argues that assertions by the European Communities that the 1997 SM Survey shows that both pisco and imported distilled spirits are consumed by Chileans in roughly similar percentages at various occasions and in various places, e.g., discos, bars, at home after work, at friends' homes etc., has no probative value. According to Chile, the categories of end-uses offered by the European Communities are simply too broad. Chile argues that pisco is more of a popular

[73] These are the criteria we have examined in this case. There may be other criteria more or less relevant in other situations depending on the facts available.
[74] Comprehensive survey done by Search Marketing S.A., Santiago, December 1997 ("the 1997 SM Survey"), EC Exhibit 21. *See also* the 1998 SM Survey (EC Exhibit 22) discussed more fully below.
[75] *See* Table 23 in Descriptive Part of this Report.

spirit in Chile than the imported spirits, such as whisky, which tend to be more expensive and, consequently, are consumed by the wealthier segment of the population.
(…)
7.39. In our view, the 1997 SM Survey provides some useful evidence about overlapping end-uses. It tends to confirm the observation that distilled alcoholic beverages are used for relaxation and socialisation in appropriate social settings. (…)

7.40. We note that, while we find the 1997 SM Survey useful, we do not rely on this single piece of evidence for our analysis. Rather, in the process of weighing all the evidence presented, we take the 1997 SM Survey into consideration in determining whether the imported and domestic distilled alcoholic beverages are directly competitive or substitutable. (…)
(…)
7.43. Products do not have to be substitutable for all purpose at all times to be considered competitive. It is sufficient that there is a pattern that they may be substituted for some purposes at some times by some consumers. (…)
(…)

7.47. There is evidence that imported spirits and pisco are used similarly in various social settings – homes, bars, discos etc. The advertising of pisco indicates to consumers that it is suitable as an up-market distilled spirit which shows that the intention by the producers is to put it in the same competitive category with such up-market imports as whisky, cognac, brandy, etc. The various surveys reviewed also show that consumers have an increased willingness to shift between domestic and imported spirits for at least some purchases and some occasions. The current actual overlap in end-uses plus the evidence of potential overlap, is supportive of a conclusion that pisco and the imported distilled spirits are directly competitive or substitutable.[76]

(c) Physical characteristics

7.48. It is necessary to examine the physical characteristics of the products at issue. In our view, the closer the physical similarity the greater the likelihood of a directly competitive or substitutable relationship.

7.49. The European Communities argues that pisco and the imported distilled spirits share the same basic physical characteristics in that all have the essential feature of being beverages containing alcohol obtained using naturally fermented ingredients by similar distillation processes. The differences between pisco and whisky, according to the European Communities, are no greater than, for example, differences between brandy and whisky. This implies that the different substances from which brandy and whisky are distilled, that is grape wine and malted barley, are not fundamental physical characteristics in determining substitutability. Other differences arise from post-distillation processes such as ageing, colouring or flavouring that confer on each type of distilled spirit its own identity. In the EC's view, however, the differences are not so important as to render the various types of distilled spirits incapable of being directly substituted with each other by consumers.

7.50. Chile's response is that pisco and the imported distilled spirits share virtually no common physical characteristic other than containing alcohol and water. According to Chile, the ingredients of pisco and say, whisky, are markedly different. Chile points out these two spirits are made from

[76] We note that these conclusions with respect to end-uses support our conclusion that the identified imported products should be considered as a single category.

different ingredients, pisco from grapes and whisky from grain. Chile further argues that the basic similarities the European Communities refers to are mere characteristics of all distilled spirits and that the ultimate physical characteristics, which consumers use to distinguish between different types of spirits, are determined by the other processes involved in the production of spirits.

7.51. We are of the view that an examination of the physical characteristics of products is more critical in determining whether two products are "like" than in the determination of whether two products are directly competitive or substitutable. This does not mean, however, that products' physical similarities should not be examined when determining whether products are directly competitive or substitutable. (…)

7.52. Consequently, if two products are nearly physically identical, they are "like".[77] Because it necessarily follows that they are also then directly competitive or substitutable, physical similarity is a useful category of examination for our analysis in this case. This is relevant where such activities as marketing campaigns or government tax regimes, have created a distinction in consumer perceptions between very similar products. Such distinctions that result from consumer perception are relevant but not determinative of the *nature* of an actual or potential competitive relationship.
(…)

7.54. In our view, the post-distillation differences due to the filtration, colouring or aging processes of the beverages are not so important as to render the products non-substitutable.[78] We find these differences relatively minor. There are some differences imparted from such things as aging in wooden barrels. Some spirits have added flavourings such as juniper berries in gin. But we also note that pisco shares many identical physical characteristics with other spirits made from grapes such as grappa, cognac, brandy or "Peruvian pisco".[79] Overall, weighing the evidence presented, we find that the common physical features of the imported and domestic products are supportive of a finding that the imported and domestic products in question are directly competitive or substitutable.[80]
(…)

(e) Prices

(…)
7.68. The question arises, as to how a panel should deal with concepts such as cross-price elasticity in determining whether two classes of products are directly competitive or substitutable. In *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body affirmed the decision of the panel to look at the economic concept of "substitution" as one means of examining relevant markets. However, the Appellate Body emphasised that this should be considered together with all other legitimate

[77] Panel Report on *Japan – Taxes on Alcoholic Beverages II*, *supra*., para. 6.22.
[78] *See* Tables 7 and 8 of the Descriptive Part of this Report. Indeed the panel in *Korea – Taxes on Alcoholic Beverages* found that post-distillation differences between soju and imported spirits at issue in that case were relatively minor compared to the common feature of being potable distilled spirits. Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra*., para. 10.67.
[79] We note that the product labelled pisco by Peru is not allowed to use that appellation in Chile. Peru claims that it has a disagreement with Chile over who has rights to the appellation. That question is outside our terms of reference and we take no position on it and no implication should be drawn from our use of the term "Peruvian pisco."
[80] We note that these conclusions with respect to physical characteristics support our conclusion that the identified imported products should be considered as a single category.

considerations, in the aggregate, in determining direct competitiveness and substitutability, i.e., the use of cross-price elasticity of demand is not the decisive criterion, but merely one among other criteria, such as physical characteristics, common end-uses, etc.[81]
(…)

7.79. We find, (…), that the existence of cross-price elasticity between pisco and the imported distilled spirits, although at a low level in the studies, is further indication of a directly competitive and substitutable relationship between the two.

4. Conclusions with respect to "directly competitive or substitutable"

(…)
7.88. In summary, we are of the view that there is sufficient unrebutted evidence in this case to show both present and potential direct competition between the two categories of products. Accordingly, we find that the evidence concerning physical characteristics, end-uses, channels of distribution and pricing (including cross-price elasticity), [82] leads us to conclude that the imported and domestic products at issue in this case are directly competitive or substitutable.

D. "not similarly taxed"

1. General

(…)
7.90. In our view this means that panels should look at the particular market in question and the products themselves. That is, there is no set level of tax differential which can be considered *de minimis* in all cases. This follows from the Appellate Body's observation that with respect to "like products" the similarities between the products are so strong that it can be presumed that any differential in taxation will have an impact on the market. However, when products are somewhat different, but are still directly competitive or substitutable, then *de minimis* differences in taxation are permissible because it is not necessarily true that small differences in tax levels will have an effect in the market.
(…)

7.92. We must also note that this examination of whether products are similarly taxed or not involves no evaluation of the purpose or effect of the differences. Dissimilar taxation is not in itself inconsistent with Article III:2, second sentence. It is only inconsistent if such tax differentials are

[81] Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra*., p.25.
[82] The European Communities argued that tariff classification can be important in determining whether products are directly competitive or substitutable. In this case, the European Communities referred to the 4-digit Harmonized System category 2208 as such evidence. Chile responded that 4-digit classifications are too general to be of much analytical use and in some cases contained products which Chile maintained clearly were not substitutable. We note that the Appellate Body and previous panels have referred to the tariff classifications of products in making determinations. However, two issues must be taken into account. First, is the classification sufficiently narrow to be of much probative value? Chile has a valid point in urging caution in this regard. Second, is relying on tariff classifications merely duplicative of examinations made in greater detail for the specific market in question in regard to such factors as physical characteristics and similar end-uses? In our view, with respect to the Chilean market, there is not a great amount of probative value in referring to HS 2208 in light of other evidence available, but we note that the classification is consistent with our conclusions.

applied in a manner so as to afford protection.

2. Transitional System

7.93. The Transitional System took effect on 1 December 1997 and lasts until 1 December 2000. The Transitional System continues the pre-existing system of differentiation based on three categories of distilled beverages: pisco, whisky and "other spirits." Prior to the beginning of the implementation of the Transitional System, whisky was taxed at 70% *ad valorem*, while other spirits were taxed at 30% and pisco at 25%. The rates for pisco and other spirits remain the same throughout the period of the Transitional System. For the 12 months beginning on 1 December 1997 the rate on whisky dropped to 65%, falling to 59% for the 12 months beginning on 1 December 1998, to be reduced further to 53% for the final twelve month period the Transitional System is in effect.
(…)

7.96. It is obvious that the level of difference in taxation between the imported and domestic products is greater than *de minimis*. (…)

7.97. We are of the view that under the Transitional System imported and domestic distilled alcoholic beverages are not similarly taxed. The fact that some of the domestic production (e.g., products such as Chilean whisky) is similarly taxed is irrelevant to this step of the analysis. That is, it is sufficient to find that certain of the imports are taxed dissimilarly compared to certain of the domestic substitutable products. It is not necessary to show that all of the imports are taxed dissimilarly to all of the domestic products.[83]

3. New Chilean System

7.98. The New Chilean system becomes effective on 1 December 2000.[84] The distinction between types of distilled alcoholic beverages utilised in the Transitional System is eliminated. Instead, the New Chilean System assesses taxes on an *ad valorem* basis that varies according to alcohol content. All distilled alcoholic beverages of 35° of alcohol or less are taxed at the rate of 27% *ad valorem*. The rate increases by four percentage points *ad valorem* per degree of alcohol content through 39°, topping out at a rate of 47% *ad valorem* for alcoholic beverages of higher than 39°.

7.99. The European Communities argues that this system still taxes the domestic and imported products dissimilarly. They claim that 90% of pisco sales will be taxed at the lowest rate of 27% while imports such as whisky, vodka, rum, gin and tequila will be taxed at 47% while brandy will be taxed at no less than 39 %. The European Communities notes that under Chilean law, whisky, vodka, rum, gin and tequila *must* contain at least 40° of alcohol.

7.100. According to the European Communities, the New Chilean System cannot be considered as a tax on alcohol content, because it is applied on the value of the beverage as a whole and not on the

---

[83] *See* Appellate Body Report on *Canada – Periodicals*, *supra*., p. 29; Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra*., para. 10.100 (fn. 412).
[84] The new Chilean System has been enacted but not implemented. There appears to be no discretion allowed in its enforcement. The law is certain and definitive. We consider it appropriate to examine the law to determine its consistency with Article III:2, second sentence. Neither party has argued to the contrary.

value of the alcohol content. Moreover, the European Communities argues that the value of distilled spirits is not directly related to alcohol content. For those reasons the European Communities considers that, in order to determine whether pisco and the other spirtis are "similarly taxed", we should compare the rates per bottle of each spirit. Such *ad valorem* rates are manifestly different varying between 27% and 47% in steps of four percentage points and such differences are clearly not *de minimis*. (…)

7.101. Chile responds that the New Chilean System is based on objective and neutral factors. In Chile's view, the criterion of alcohol content was recognized by the panel in *Japan – Taxes on Alcoholic Beverages I* as a permissible objective means of taxation. Chile notes that that case involved non-taxable thresholds and taxes applied in a manner not directly proportional to alcohol content and that the panel did not object to either characteristic. In Chile's view, there is no requirement in GATT/WTO jurisprudence for the proposition that tax systems must be directly proportional.
(…)
7.103. In our view the question of dissimilar taxation is relatively straightforward. It does not involve judgements about the objectivity of the laws or regulations involved. It does not involve an assessment of who benefits from the tax system. It does not involve an examination of the design, structure or architecture of the law in question. Such inquiries are relevant only to the next step of our analysis; namely, whether any system of dissimilar taxation has been applied so as to afford protection to domestic production. All we are doing at this point is determining whether there is dissimilar taxation of directly competitive or substitutable imported and domestic products. Even if it were to turn out that the large majority of imported products benefited from a particular tax, that would be irrelevant to this stage of the analysis. Our only issue here is to identify whether there is dissimilar taxation.
(…)
7.107. To argue as Chile does that there is no rule requiring proportionality is rather beside the point. Even utilising the EC's system of expressing the difference of percentage points per degree of alcohol, an evaluation of the nature of the system still involves mixing together two types of criteria. It is not clear that, even if proportional with respect to *some* particular products, assessing an *ad valorem* tax qualified by the additional criterion of alcohol content would result in a *system* of taxation that would survive examination under this step of the analysis. In this case, a statement that the New Chilean System does not assess taxes in a proportional manner is merely another way of stating that it is not really an *ad valorem* system strictly speaking (and certainly is not a specific system).[85]
(…)

[85] Chile offered as an analogy the example of automobile taxation in Europe. According to Chile, such automobile taxes increase depending on the size or horsepower of the engines. Chile states that this could discriminate against high horsepower imports. Therefore, Chile concludes, the logic of the EC's argument implies that such a system would be inconsistent with the EC's WTO obligations if Chile's system is found to be so. Analogies can be useful analytical tools if they provide relatively simple illustrations of a problem. However, analogies lose their utility to the extent more and more facts need to be provided about the purportedly analogous situation to determine its relevance. With respect to engine power or size based systems of taxing automobiles, we would need to find out more about the competitive relationship of the products in question and structure of the tax system, as well as how it is applied. Again, we note, mere dissimilar taxation alone is not enough to render a tax system inconsistent with the obligations of Article III:2, second sentence. It is also necessary to determine if such a system of dissimilar taxation is applied in a manner so as to afford protection to domestic production. Even then, there may be questions regarding the potential applicability of exceptions pursuant to Article XX. Chile's analogy might or might not be correct, but it would require a whole new fact finding exercise to make such a determination and that clearly is beyond the scope of our terms of reference.

7.109. Chile has suggested that saying that the New Chilean System involves dissimilar taxation would be condemning luxury tax systems. However, in the context of the products involved in this case, a luxury tax system would be an *ad valorem* tax system that increased rates as the *value* of the products increased, not as some specific characteristic changed. Thus, for example, a system that assessed taxes at a rate of 20% for products valued between 1000 and 5000 pesos, 30% for products valued between 5,000 and 10,000 pesos, and 40% for products valued above 10,000 pesos and so on might arguably constitute a luxury tax. However, varying the *ad valorem* rate based on alcohol content does not necessarily tax high priced goods at a higher rate because the additional criterion of alcohol content is not necessarily related to value. Therefore, we need not reach the issue of whether luxury tax systems are consistent with the requirements of Article III:2, second sentence. [86]
(…)

7.113. As with our finding above with respect to the Transitional System, the fact that some imported and domestic distilled alcoholic beverages could in particular factual circumstances be assessed identical taxes, or different taxes at less than *de minimis* levels, does not change our conclusion.[87] It is sufficient for this step of the analysis to find that some of the imports are being taxed dissimilarly from some of the domestic production and the difference is more than *de minimis*.

E. "so as to afford protection to domestic production"

1. General

(…)

7.121. (…), the European Communities argues that the pisco industry agreed to sacrifice the high alcohol content versions of pisco in order to preserve the preferential tax treatment of the large majority of pisco production under 35° alcohol content. (…)

7.122. We do not think it fruitful or appropriate to try to evaluate the Chilean legislative process. As noted above, all sorts of agreements can be made in order to obtain support from a domestic constituent for changes in tax rates. Some may not even have anything to do with the legislation at hand. Furthermore, it is normal for one constituent to wish to push a tax burden onto another even if the products made by both constituents are not directly competitive. (…)

7.123. In our view, an important question is who receives the benefit of the dissimilar taxation. (…)For example, the magnitude of the differentials would not be particularly relevant if the products realizing the resulting benefits were imports. (…) This is only logical given the language of Article III itself.

7.124. We must consider in this regard that Article III is to protect competitive opportunities. If there have been significant governmental restrictions in the market-place (which can include completely WTO consistent measures such as tariffs) it may be that there are relatively few, if any,

---

[86] We also note, that a luxury tax system could be found to result in dissimilar taxation, but still not result in a violation of Article III:2, second sentence, as long as such a system was not applied so as to afford protection to domestic production.

[87] *See* Appellate Body Report on *Canada – Periodicals*, *supra*., p. 29. *See also* Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra*., para. 10.100, fn. 412; and Panel Report on *United States – Section 337 of the Tariff Act of 1930*, BISD 36S/345, para. 5.14.

imports and the distribution of the current benefits of the dissimilar taxation may be reflective of this fact. In such a situation, it would be necessary to consider if the large differentials could be having the effect of inhibiting potential imports.

2. Transitional System

7.125. The European Communities has argued that there are a number of factors that support a conclusion that the dissimilar taxation under the Transitional System is applied in a way so as to afford protection to domestic production. The European Communities refers to the following factors:

– the magnitude of the tax differentials;

(…)

– the fact that the beneficiary of the differentials (pisco) is by Chilean law a domestic product;

– the fact that the vast majority of Chilean production of distilled spirits is pisco;

– the fact that the majority of whisky (the highest taxed product) is imported; and,

(…)

7.126. Chile responds that the purpose of the Transitional System is to allow time for the domestic and foreign producers and distributors to prepare for the changes under the New Chilean System and also to begin phasing in immediate benefits for whisky producers. In effect, Chile argues that the Transitional System should not be condemned as being a measure applied so as to afford protection when the primary result is the lessening of taxes on importers.

7.127. We take note of this point made by Chile that the primary beneficiary of the changes under the Transitional System are some of the imported products, specifically whisky. However, it is not for the Panel to inquire into such issues as whether political deference should be accorded for these efforts. The fact that the Transitional System lessens the protective effect does not vitiate the conclusion that, even at its least discriminatory, it is a system that does and will afford protection to domestic production.

7.128. The Transitional System assesses tax rates by type of spirits. The lowest tax rate is on pisco which under Chilean law is exclusively a domestic product. There could be an import physically *identical* to pisco and it would be assessed a tax rate five percentage points higher. This illustrates the protective nature of the structure of the tax system.

7.129. The largest category of imports by far at the present time is whisky and that is presently taxed at a rate of 53% (at its least discriminatory level beginning 1 December 1999) compared to pisco's 25% and pisco accounts for almost 75% of domestic production of distilled spirits. It is clear that the beneficiary of this structure is the domestic industry.

7.130. In our view, the design, architecture and structure of the Transitional System is to apply dissimilar taxation in a manner so as to afford protection to domestic production. The fact that the level of protection is lessened during the period of applicability of the law does not obviate the fact that its objective is to maintain such protection during the period.

3. New Chilean System

(a) Arguments

7.131. The European Communities argues that under the New Chilean System taxes are assessed in a dissimilar manner so as to afford protection to domestic production based on the following arguments:

> (i) the European Communities argues that the magnitude of the tax differentials is large with a range from 27% for most pisco to 47% for most imports.
>
> (ii) the European Communities notes that these large differentials in the rates do not serve any legitimate policy purpose. It cannot be for health reasons, because there is no correlation between alcohol content and heath factors related to distilled beverages. It cannot be for income redistribution, because the taxes are not just ad valorem and there is no necessary correlation between alcohol strength and value.
>
> (iii) the European Communities claims that the large majority of Chile's distilled beverage production (between 70 and 80 percent, according to the European Communities) will enjoy the lowest rate of taxation, while over 95% of imports will be taxed at the highest rate. (…)

7.132. Chile responds that their system is based on completely objective factors and therefore cannot be considered to be applied in a manner so as to afford protection. According to Chile, any producer whether foreign or domestic can produce spirits at lower levels and benefit from the tax structure. Chile noted that there are a great deal of spirits produced in the European Communities at 35° of alcohol or less that could easily be exported to Chile and enjoy a lower level of taxation. Chile also noted that there is more absolute production of domestic spirits in Chile at the higher levels of taxation than there are imports.
(…)
7.135. Chile also argues that there is nothing in the GATT which requires a particular type of taxation or constrains the sovereign right of Member governments to structure their tax systems in a particular way. All that is required is that the tax system be based on objective factors and applied in a manner that allows any product, be it imported or domestic, to take advantage of the structure.

7.136. The European Community responds that under Chilean law, virtually all the categories of imported spirits (whisky, gin, rum, vodka and tequila) must have 40° or higher levels of alcohol. It would be impossible as a matter of law to sell whisky and these other beverages at anything other than the highest levels of taxation. Chile argued that they certainly could. Even if they had to change the product name somewhat, they could easily sell a diluted version. Adding water is the last step of the production process anyway and it would be a simple matter to add more water and sell, for example, "Johnnie Walker Light" or "Beef Eaters Lean". The European Community, as well as the third parties, objected that such a notion was absurd. Consumers wanted to buy whisky or vodka or gin. They didn't want to buy some diluted version that would taste different and be different.

7.137. Chile argues that if protection was what it wanted, it could raise the tariffs on spirits. Chile's binding is at 25% while the applied rate is 11%. This is evidence that the purpose of the tax

structure was not protective. The European Communities responded that since the 1970's Chile has applied a single flat rate to imports of all products. According to the European Communities, this is considered as one of the basic principles of Chile's trade policy and, if the Chilean authorities were to make now an exception to that principle, it would be difficult for them to resist similar requests from other industries.

(b) Discussion

(…)
7.141. (…) Chile then takes a further analytical step by asserting, therefore, that systems based on "objective" criteria are permissible.[88] This step is a non-sequitur. It is the case that Japan and Korea made distinctions based on types of beverages. However, the findings with respect to the second and third analytical steps under Article III:2, second sentence, were not dependent on that fact alone. As the panel stated in *Korea – Taxes on Alcoholic Beverages*:

> The structure of the Liquor Tax Law itself is discriminatory. It is based on a very broad generic definition which is defined as soju and then there are specific exceptions corresponding very closely to one or more characteristics of imported beverages that are used to identify products which receive higher tax rates. There is virtually no imported soju *so the beneficiaries of this structure are almost exclusively domestic producers.*[89]

7.142. Thus, the panel rested its conclusion in part on the factual finding that the primary beneficiaries of the particular structure in that case were the domestic producers. At no point did the panel in that case or the panels and Appellate Body in the cases of *Japan – Taxes on Alcoholic Beverages I and II* state or imply that any system based on so-called "objective" factors would necessarily survive scrutiny under Article III:2.

7.143. Chile also contends that there is not even *de facto* discrimination here because the imported product could easily be diluted to take advantage of the lower available tax rates. We do not find this persuasive. Exporters should not be required to alter important characteristics of their products and, indeed, change their generic name in order to compete equally with the domestic product.[90]
(…)
7.147. We agree with Chile that it is not for the Panel to question their policy objectives. Chile lists these objectives as: (1) maintaining revenue collection; (2) eliminating type distinctions as were found in Japan and Korea; (3) discouraging alcohol consumption; and, (4) minimizing the potentially regressive aspects of the reform of the tax system. We offer no comment on whether these are appropriate goals and objectives of tax policy. It is not for us to evaluate the measure in these terms, either to condemn it or condone it.

7.148. In our view, the failure of a measure to conform to its stated objectives may be indicative of certain aspects of its design structure and architecture. That is, while we will not examine the stated

---

[88] *See* Report, para. 4.399, Chile Second Submission, para. 28 and Chile's Statement at the Second Meeting, paras. 26-31.
[89] Panel Report on *Korea – Taxes on Alcoholic Bever*ages, *supra*., para. 10.102 (emphasis added).
[90] Chile argues that there is an inconsistency between arguing that products are directly competitive and substitutable and arguing that they should not be forced to change distinctive physical characteristics and names. We do not agree. Products which are directly competitive or substitutable have differences between them or they would be "like." Indeed, even like products do not need to be identical. It is perfectly logical for marketers to emphasize one product's distinctive qualities *in order to compete* effectively with other directly competitive products. We are not dealing with commodities here.

objective itself to determine its legitimacy, it is a relevant inquiry to examine the *relationship* between the stated objective and the measure in question. If a rational relationship between the stated objective and the measure is lacking, this may provide evidence of protective application, which we will take into consideration along with other factors.

7.149. With respect to the question of maintaining revenue neutrality, we note that there is no rational reason why such a structure as devised by Chile is necessary for this purpose. Chile has acknowledged that the same revenue result could be achieved with a single *ad valorem* rate at some point between 27% and 47%.

7.150. With respect to eliminating type distinctions, the New Chilean System does not achieve this. As discussed above, the favorable tax treatment accorded to products called "pisco" was removed. However, the system was replaced with one providing unfavourable tax treatment for any products called "whisky", "gin," "vodka" or "rum," which happen to be primarily imports.
(…)

7.155. To assist in evaluating the overall design, structure and architecture, we review the New Chilean System in the context of its predecessor systems. The prior systems through the Transitional System have imposed dissimilar taxation to all products not called "pisco." Pisco is a term limited to certain Chilean production according to Chilean law. As we have concluded above, this dissimilar taxation is greater than *de minimis* and was, and will continue to be, applied so as to afford protection to domestic production. The New Chilean System eliminated the *de jure* discrimination in these systems and moved to taxation on the basis of a combination of alcohol content and value. These levels were not arbitrarily chosen and applied. Between 70 and 80 percent of Chilean production consists of products with less than 35° alcohol content and, therefore, enjoy the lowest tax rate of 27%. Over 90% of pisco is in this category, pisco being the spirit enjoying *de jure* discrimination in its favor until 1 December 2000. However, under Chilean regulations, most of the imported beverages have generic names that require them to contain at least 40° of alcohol. Thus, almost 95% of current imports will be taxed at the highest rate of 47% or lose their ability to retain their name (their generic name, not their brand names) The beverages would also require a change of an important physical characteristic, namely their water/alcohol ratio. This is a clear case of a *de jure* discriminatory system being replaced by an at least equally *de facto* discriminatory system.[91]
(…)

7.158. It is important at this juncture to recall that Article III is meant to protect competitive opportunities. There is no question that the structure of the New Chilean System will distort competition between directly competitive domestic products and products which are now imported and ones that might reasonably be considered potential imports. First of all, it does not save a measure from running afoul of Article III:2, second sentence, merely because there are domestic products taxed at the same level as the imported products, as we noted in the previous section.[92] Second, as Chile itself has noted, there is considerable world-wide supply capacity of potential imports, the majority of which would be taxed at the highest level. The potential imports have the right to equal competitive opportunities to the Chilean market which they cannot receive under the New Chilean System. Were all distilled alcoholic beverages taxed at the same level, or at a level

[91] We note that, for most types of spirits, the New Chilean System will actually increase the discrimination against them compared to pisco.
[92] *See* Appellate Body Report on *Canada – Periodicals*, *supra*., p. 29. *See also* Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra*., para. 10.100, fn. 412; and Panel Report on *United States – Section 337*, *supra.*, para. 5.14.

reflecting no more than *de minimis* differences, then it is entirely possible that the percentages of domestic versus imports at 40° alcohol content or above would change dramatically. That is, lower value, high alcohol content imports could become more viable in the marketplace, particularly as consumers become more familiar with the products. In effect, Chile offers the result of its discrimination over a long period of time as a justification for perpetuating it. On balance, we find the most persuasive evidence to be that roughly 75% of domestic production will enjoy the lowest tax rate and that over 95% of current (and potential) imports will be taxed at the highest rate unless the imported products change their alcohol content and abandon their generic, familiar product names.

7.159. In sum, considering: (1) the structure of the New Chilean System (with its lowest rate at the level of alcohol content of the large majority of domestic production and its highest rate at the level of the overwhelming majority of imports); (2) the large magnitude of the differentials over a short range of physical difference (35° versus 39° of alcohol content); (3) the interaction of the New Chilean System with the Chilean regulation which requires most of the imports to remain at the highest tax level without losing their generic name and changing their physical characteristics; (4) the lack of any connection between the stated objectives and the results of such measures (recognizing that "good" objectives cannot rescue an otherwise inconsistent measure); and, (5) the way this new measure fits in a logical connection with existing and previous systems of *de jure* discrimination against imports, we find that the dissimilar taxation assessed on directly competitive or substitutable imports and domestic products is applied in a way that affords protection to domestic production.

VIII. Conclusions

8.1. In light of the findings above, we reach the conclusion that the domestic distilled alcoholic beverages produced in Chile, including pisco, and the imported products presently identified by HS classification 2208, are directly competitive or substitutable products. Chile's Transitional System and New Chilean System provide for dissimilar taxation of the imports in an amount that is greater than *de minimis* levels. Finally, the dissimilar taxation in both systems is applied in a manner so as to afford protection to Chile's domestic production. We therefore conclude that there is nullification or impairment of the benefits accruing to the complainant under GATT 1994 within the meaning of Article 3.8 of the Dispute Settlement Understanding.

8.2. We recommend that the Dispute Settlement Body request Chile to bring its taxes on distilled alcoholic beverages into conformity with its obligations under the GATT 1994.
(…)

WORLD TRADE ORGANIZATION

WT/DS/87/AB/R
WT/DS/110/AB/R
13 December 1999
(99-5414)

Original: English

CHILE – TAXES ON ALCOHOLIC BEVERAGES

AB-1999-6

Report of the Appellate Body

To download the original report, consult
http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm

(…)

III. Issues Raised in this Appeal

43.The following issues are raised in this appeal:

(a) whether the Panel erred in its interpretation and application of the term "not similarly taxed", which appears in the *Ad* Article to Article III:2, second sentence, of the GATT 1994;

(b) whether the Panel erred in its interpretation and application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, of the GATT 1994, by specific reference to the "principles set forth in paragraph 1" of Article III of that Agreement; (…)

IV. "Not Similarly Taxed"

(…)

46. Chile argues on appeal that, if the New Chilean System is examined from the "proper perspective"[93], it is clear that all of the beverages at issue, regardless of their origin, are taxed according to the same objective criteria: alcohol content and price. When evaluated from this "perspective", Chile maintains, the New Chilean System does not apply dissimilar taxation because all distilled alcoholic beverages, whether domestic or imported, with the same alcohol content are taxed at an identical *ad valorem* rate. Chile contends that, because there is no dissimilar taxation, there is no need or justification to proceed to the third issue under Article III:2, second sentence, of the GATT 1994 and examine whether the New Chilean System is applied "so as to afford protection to domestic production."

(…)

50. The New Chilean System applies a minimum tax rate of 27 per cent *ad valorem* to all distilled alcoholic beverages with an alcoholic content of 35° or less and a maximum rate of 47 per cent *ad valorem* to all such beverages with an alcohol content of more than 39°. The Panel found, as a factual matter, that "roughly 75% of domestic production will enjoy the lowest rate and … over 95% of all current (and potential) imports will be taxed at the highest rate …".[94]

51. Chile has argued that there is "similar taxation" of domestic and imported production under the New Chilean System because all beverages with a specific alcohol content are subject to identical *ad valorem* tax rates, irrespective of their origin. In making this argument, Chile invites us to focus exclusively on a comparison of the relative tax burden on domestic and imported products *within each fiscal category* and to disregard the differences of tax burden on distilled alcoholic beverages which have different alcohol

[93]Chile's appellant's submission, page 13, heading 4.

[94]*Ibid*., para. 7.158. Chile has not contested this factual finding.

contents and which are, therefore, in *different fiscal categories*. In other words, Chile asks us to disregard the comparison which the Panel undertook of the relative tax burden on domestic and imported products located in *different fiscal categories*.

52. (…) Chile's argument fails to recognize that the Panel has found, and Chile has not appealed, that imported beverages of a specific alcohol content are directly competitive or substitutable with other domestic distilled alcoholic beverages of a different alcohol content. To accept Chile's argument on appeal would, we believe, disregard the objective of Article III, which is to "provide equality of competitive conditions" for *all* directly competitive or substitutable imported products in relation to domestic products, and not simply for *some* of these imported products.[95] The examination under the second issue must, therefore, take into account the fact that the group of directly competitive or substitutable domestic and imported products at issue in this case is not limited solely to beverages of a specific alcohol content, falling within a *particular* fiscal category, but covers *all* the distilled alcoholic beverages in *each and every* fiscal category under the New Chilean System.

53. A comprehensive examination of this nature, which looks at *all* of the directly competitive or substitutable domestic and imported products, shows that the tax burden on imported products, most of which will be subject to a tax rate of 47 per cent, will be heavier than the tax burden on domestic products, most of which will be subject to a tax rate of 27 per cent. We agree with the Panel that the difference in the level of the tax burden is clearly more than *de minimis* and, in any event, Chile has not appealed the Panel's finding that the difference between these tax rates is more than *de minimis*.

54. In these circumstances, we uphold the Panel's finding, in paragraph 8.1 of the Panel Report, that directly competitive or substitutable imported and domestic products are "not similarly taxed", within the meaning of *Ad* Article III:2 of the GATT 1994.
(…)

V. "So As To Afford Protection"

56. (…) The Panel stated that the "real issue" is "how the measure in question is *applied*."[96] The Panel noted that this can often be discerned from an examination of the "design, architecture and revealing structure" of the measure, as well as from the magnitude of the dissimilar taxation.[97] The Panel also took the view that "an important question is who receives the benefit of the dissimilar taxation."[98]

57. The Panel expressed its conclusion on this issue in the following terms:

---

[95]Appellate Body Report, *Japan – Alcoholic Beverages*, *supra*, footnote 20, p. 16.

[96]*Ibid*., para. 7.115, citing the Appellate Body Report in *Japan – Alcoholic Beverages*, *supra*, footnote 20, p. 28.

[97]*Ibid*., para. 7.115, citing the Appellate Body Report in *Japan – Alcoholic Beverages*, *supra*, footnote 20, p. 29.

[98]*Ibid*., para. 7.123.

> In sum, considering: (1) the structure of the New Chilean System (with its lowest rate at the level of alcohol content of the large majority of domestic production and its highest rate at the level of the overwhelming majority of imports); (2) the large magnitude of the differentials over a short range of physical difference (35° versus 39° of alcohol content); (3) the interaction of the New Chilean System with the Chilean regulation which requires most of the imports to remain at the highest tax level without losing their generic name and changing their physical characteristics; (4) the lack of any connection between the stated objectives and the results of such measures (recognizing that "good" objectives cannot rescue an otherwise inconsistent measure); and, (5) the way this new measure fits in a logical connection with existing and previous systems of *de jure* discrimination against imports, we find that the dissimilar taxation assessed on directly competitive or substitutable imports and domestic products is applied in a way that affords protection to domestic production.[99]

58. Chile argues, first, that since its law is based on two widely accepted, non-arbitrary criteria – alcohol content and price – the structure of the system does not support a finding of protection.[100] In fact, imports are able to compete equally with domestic products in each and every fiscal category. Second, Chile submits that the New Chilean System is not applied "so as to afford protection" because a majority of the products in the highest tax brackets are domestic, not imported. Third, Chile contends that the Panel erred in taking into account the objectives of the New Chilean System. Finally, Chile rejects as non-relevant the Panel's assertion of a "logical relationship" between existing and previous systems of *de jure* discrimination against imports.
(…)

62. We emphasized (…) that, in examining the issue of "so as to afford protection", "it is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent."[101] The *subjective* intentions inhabiting the minds of individual legislators or regulators do not bear upon the inquiry, if only because they are not accessible to treaty interpreters. It does not follow, however, that the statutory purposes or objectives – that is, the purpose or objectives of a Member's legislature and government as a whole – to the extent that they are given *objective* expression in the statute itself, are not pertinent. To the contrary, as we also stated in *Japan – Alcoholic Beverages*:

---

[99]Panel Report, para. 7.159.

[100]Chile's appellant's submission, para. 39.

[101]*Ibid.*, p. 27.

> Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the *design*, the *architecture*, and the revealing *structure* of a measure.[102] (emphasis added)

63. We turn, therefore, to the design, the architecture and the structure of the New Chilean System itself. That system taxes *all* alcoholic beverages with an alcohol content of 35° or below on a linear basis, at a fixed rate of 27 per cent *ad valorem*. Thereafter, the rate of taxation increases steeply, by 4 percentage points for every additional degree of alcohol content, until a maximum rate of 47 per cent *ad valorem* is reached. This fixed tax rate of 47 per cent applies, once more on a linear basis, to *all* beverages with an alcohol content in excess of 39°, irrespective of how much in excess of 39° the alcohol content of the beverage is.

64. We note, furthermore, that, according to the Panel, approximately 75 per cent of all domestic production has an alcohol content of 35° or less and is, therefore, taxed at the lowest rate of 27 per cent *ad valorem*.[103] Moreover, according to figures supplied to the Panel by Chile, approximately *half* of all domestic production has an alcohol content of 35° and is, therefore, located on the line of the progression of the tax at the point *immediately before* the steep increase in tax rates from 27 per cent *ad valorem*.[104] The start of the highest tax bracket, with a rate of 47 per cent *ad valorem*, coincides with the point at which most imported beverages are found. Indeed, according to the Panel, that tax bracket contains approximately 95 per cent of all directly competitive or substitutable imports.[105]

65. Although the tax rates increase steeply for beverages with an alcohol content of more than 35° and up to 39°, there are, in fact, very few beverages on the Chilean market, either domestic or imported, with an alcohol content of between 35° and 39°.[106] (…)

66. In practice, therefore, the New Chilean System will operate largely as if there were only two tax brackets: the first applying a rate of 27 per cent *ad valorem* which ends at the point at which most domestic beverages, by volume, are found, and the second applying a rate of 47 per cent *ad valorem* which begins at the point at which most imports, by volume, are found. The magnitude of the difference between these two rates is also considerable. The absolute difference of 20 percentage points between the two rates represents a 74 per cent increase in the lowest rate of 27 per cent *ad valorem*. Accordingly, examination of the design, architecture and structure of the New Chilean System tends to reveal that the application of dissimilar taxation of directly competitive or substitutable products will "afford protection to domestic production."

---

[102] *Ibid*., p. 29.

[103] Panel Report, para. 7.158. See also Panel Report, para. 7.155.

[104] Chile's response to Question 1 of the Panel, 26 November 1998. At the oral hearing, Chile confirmed the accuracy of the figures contained in this response.

[105] Panel Report, para. 7.158.

[106] Chile's response to Question 1 of the Panel, 26 November 1998. These figures indicate that approximately 5 per cent of *all* distilled alcoholic beverages have an alcohol content in this range. At the oral hearing, Chile confirmed that very few beverages have an alcohol content of between 35° and 39°.

67. (…) The relative proportion of domestic versus imported products within a particular fiscal category is not, in and of itself, decisive of the appropriate characterization of the total impact of the New Chilean System under Article III:2, second sentence, of the GATT 1994. This provision, as noted earlier, provides for equality of competitive conditions of *all* directly competitive or substitutable imported products, in relation to domestic products, and not simply, as Chile argues, those imported products within a particular fiscal category.[107] (…)

68. The comparatively small volume of imports consumed on the Chilean market may, in part, be due to past protection.[108] We consider that it would defeat the objective of Article III:2, second sentence, of the GATT 1994 if a Member of the WTO were able to avoid a finding that a measure is applied "so as to afford protection" for reasons that could, in part, result from its past protection of domestic production.[109]

69. Before the Panel, Chile stated that the New Chilean System pursued four different objectives: "(1) maintaining revenue collection; (2) eliminating type distinctions [such] as [those which] were found in Japan and Korea; (3) discouraging alcohol consumption; and (4) minimizing the potentially regressive aspects of the reform of the tax system."[110] Chile also stated that the New Chilean System reflected compromises between the four objectives which became necessary in the process of legislative enactment. The Panel did not find any clear relationship between the stated objectives and the tax measure itself and considered the absence of a clear relationship as "evidence *confirming* the discriminatory design, structure and architecture of [the Chilean] measure."[111] (emphasis added)

70. On appeal, Chile argues that the Panel was "wrong to even consider the objectives" underlying the New Chilean System.[112] Chile declines to explain the relationship between the design, architecture and structure of the New Chilean System and the objectives it stated that System sought to realize. At the oral hearing, Chile confirmed that, in its view, the stated objectives of the New Chilean System were not "relevant" in assessing whether that measure would be applied "so as to afford protection".[113]

71. We recall once more that, in *Japan – Alcoholic Beverages*, we declined to adopt an approach to the issue of "so as to afford protection" that attempts to examine "the many

---

[107]*Supra*, para. 52.

[108]Chile acknowledged to the Panel that it reformed its taxation of distilled alcoholic beverages, in part, in order to eliminate the "type distinctions" between spirits condemned in *Japan – Alcoholic Beverages* and *Korea – Alcoholic Beverages* (see Panel Report, paras. 4.450 and 4.504). The "type distinctions" were formal distinctions between "pisco", "whisky" and "other spirits" (*ibid*., para. 2.4).

[109]See Appellate Body Report, *Korea – Alcoholic Beverages*, *supra*, footnote 21, para. 120.

[110]Panel Report, para. 7.147. See also Panel Report, paras. 4.449, 4.450 and 4.452.

[111]Panel Report, para. 7.154.

[112]Chile's appellant's submission, para. 100.

[113]Response by Chile to questioning at the oral hearing.

reasons legislators and regulators often have for what they do".[114] We called for examination of the design, architecture and structure of a tax measure precisely to permit identification of a measure's objectives or purposes as revealed or objectified in the measure itself. Thus, we consider that a measure's purposes, objectively manifested in the design, architecture and structure of the measure, *are* intensely pertinent to the task of evaluating whether or not that measure is applied so as to afford protection to domestic production. In the present appeal, Chile's explanations concerning the structure of the New Chilean System – including, in particular, the truncated nature of the line of progression of tax rates, which effectively consists of two levels (27 per cent *ad valorem* and 47 per cent *ad valorem*) separated by only 4 degrees of alcohol content – might have been helpful in understanding what *prima facie* appear to be anomalies in the progression of tax rates. The conclusion of protective application reached by the Panel becomes very difficult to resist, in the absence of countervailing explanations by Chile. The mere statement of the four objectives pursued by Chile does not constitute effective rebuttal on the part of Chile.

72. At the same time, we agree with Chile that it would be inappropriate, under Article III:2, second sentence, of the GATT 1994, to examine whether the tax measure is *necessary* for achieving its stated objectives or purposes. The Panel did use the word "necessary" in this part of its reasoning.[115] Nevertheless, we do not read the Panel Report as showing that the Panel did, in fact, conduct an examination of whether the measure is necessary to achieve its stated objectives. It appears to us that the Panel did no more than try to relate the observable structural features of the measure with its declared purposes, a task that is unavoidable in appraising the application of the measure as protective or not of domestic production.

73. In reaching its conclusion on the issue of "so as to afford protection", the Panel also relied on the fact that Chilean law imposes minimum alcohol content requirements on a range of distilled alcoholic beverages, including most of the beverages imported into Chile.[116] The Panel invoked the "interaction of the New Chilean System with the Chilean regulation which requires most of the imports to remain at the highest tax level without losing their generic name and changing their physical characteristics".[117] We believe this reliance by the Panel to be unjustified. Chilean law does not prohibit the importation of any distilled alcoholic beverages, whatever their alcohol content. Under Chilean law, a regulation imposes minimum quality standards, in respect of various kinds of distilled alcoholic beverages, relating to, *inter alia*, alcohol content, maximum sugar content and maximum volatile (e.g., aldehydes, furfural) impurities content.[118] This regulation appears to be broadly reflective of similar standards enforced in many markets. The "interaction" the Panel sees between the New Chilean System and the Chilean regulation

[114]*Supra*, footnote 20, p. 27.

[115]Panel Report, para. 7.149.

[116]Panel Report, para. 7.155.

[117]*Ibid.*, para. 7.159.

[118]Articles 9-13, Title II, Decree No. 78 of 31 July 1986, implementing Law No. 18,455 of 31 October 1985 (Exhibit No. 13 submitted by the European Communities to the Panel).

does not contribute to the cogency of the Panel's conclusion on the "so as to afford protection" issue and, in our view, should not have been taken into account by the Panel.

74. The final factor that the Panel relied upon in reaching the conclusion under the issue of "so as to afford protection" was "the way this new measure fits in a logical connection with existing and previous systems of *de jure* discrimination against imports".[119] In our view, the Panel has relied on the fact that previous Chilean measures, which are no longer applicable, involved some protection of domestic alcoholic beverages to show that the *new* tax system will also be applied "so as to afford protection". The Panel's reliance on this factor is wrong. Members of the WTO should not be assumed, in any way, to have *continued* previous protection or discrimination through the adoption of a new measure.[120] This would come close to a presumption of bad faith. Accordingly, we hold that the Panel committed legal error in taking this factor into account in examining the issue of "so as to afford protection".

75. However, in view of the other factors properly relied upon by the Panel, we believe that the Panel's conclusion that the dissimilar taxation is applied "so as to afford protection" is unaffected by the exclusion of these last two factors.

76. In light of the foregoing, we uphold the Panel's finding, in paragraph 8.1 of the Panel Report, that the dissimilar taxation under the New Chilean System is applied "so as to afford protection to domestic production", and, hence, is inconsistent with the requirements of Article III:2, second sentence, of the GATT 1994.
(…)

VIII. Findings and Conclusions

80. For the reasons set out in this Report, the Appellate Body:

(a) upholds the Panel's interpretation and application of the term "not similarly taxed", which appears in the *Ad* Article to Article III:2, second sentence, of the GATT 1994;

(b) upholds the Panel's interpretation and application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, of the GATT 1994, by specific reference to the "principles set forth in paragraph 1" of Article III of that Agreement, subject, however, to the exclusion of the third and fifth considerations relied upon by the Panel in reaching its conclusion in paragraph 7.159 of its Report; (…)

[119]Panel Report, para. 7.159.

[120]As we have said, past protection of domestic production may, however, be a relevant factor in assessing current consumer preferences and the current structure of a market, since these may have been influenced, in part, by that past protection (see *supra*, para. 68, and Appellate Body Report, *Korea – Alcoholic Beverages*, *supra*, footnote 21, para. 120).

Optional Reading

Argentinean Leather (2000)

WORLD TRADE ORGANIZATION

WT/DS155/R
19 December 2000

(00-5282)

Original: English

ARGENTINA – MEASURES AFFECTING THE EXPORT OF BOVINE HIDES AND THE IMPORT OF FINISHED LEATHER

Report of the Panel

To download the original report, visit http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm

(…)

XI. Findings

(…)

C. claims under Article III:2, first sentence, of the gatt 1994

(a) Value-added tax (IVA)

(i) The IVA

11.104 The IVA (*Impuesto al Valor Agregado*) is a general value-added tax. Its principal legal basis is the Law on the IVA[121].

11.105 The types of transactions subject to the IVA include, *inter alia*, the sale of goods inside Argentina's territory and the definitive importation of goods into its territory. With respect to imports, the IVA is collected together with any applicable import duties. With respect to internal sales, sellers must charge the IVA to the purchasers and then pay the amounts so collected to the tax administration on a monthly basis, after deducting therefrom any IVA paid on their own purchases and imports during the same period.

11.106 The IVA is applied to both imports and internal sales at a general rate of 21 percent *ad valorem*.[122]

11.107 Taxable persons whose annual sales do not exceed a certain amount may choose not to register themselves with the tax authorities.[123] Non-registered taxable persons are not directly liable to pay the IVA in respect of their internal sales. Thus, no IVA is charged on sales by non-registered taxable persons to other non-registered taxable persons. However, where registered taxable persons make sales to non-registered ones, the former are directly liable for the tax payable by the latter on their subsequent re-sales. Accordingly, registered taxable persons must collect not only the IVA due on their sales to non-registered taxable persons, but also an additional amount which is assumed to represent the IVA due on the subsequent re-sales by non-registered taxable persons. That additional amount is calculated by applying the relevant IVA rate to 50 percent of the net sales price of the goods in question.[124] Where the applicable IVA rate is 21 percent, the additional amount is therefore equivalent to 10.5 percent of the net sales price.

(i) Pre-payment of the IVA

(…)

Pre-payment of the IVA on imports

11.109 RG 3431 provides that when goods are definitively imported into Argentinean territory, the Directorate-General of Customs (*Dirección General de Aduanas*) must collect from importers not only the IVA due on the import transaction itself, but also an additional amount. Where the importer is a registered taxable person, that additional

[121] Law No. 23349/97 (Exhibit EC II.1), as last amended by Law No. 25239/99 (Exhibit EC II.3) (hereafter the "IVA Law").

[122] Lower rates apply to transactions involving certain specified products, including live bovine animals, offal of bovines as well as fresh fruit and vegetables.

[123] See Article 29 of the IVA Law.

[124] See Articles 4, 30 and 38 of the IVA Law.

amount collected represents a pre-payment of part of the IVA liability which arises once the imported goods are re-sold in Argentina. The pre-payment made can be credited at the time of settlement of the definitive IVA liability.[125] Where the importer is a non-registered taxable person, the additional amount to be paid is assumed to represent a pre-payment of the full IVA which is payable on the re-sale of the imported goods. That pre-payment cannot be credited because, as already mentioned, non-registered taxable persons are not directly liable to pay the IVA in respect of their internal sales.

11.110 The pre-payments on imports are collected at the following general *ad valorem* rates[126]:

- imports by registered taxable persons: 10 percent
- imports by non-registered taxable persons: 12.7 percent

(…)

Pre-payment of the IVA on internal sales

11.112 RG 3337 provides that when certain categories of persons sell goods in Argentina to a registered taxable person, they must collect from their purchasers the IVA due on the particular sales transactions as well as an additional amount.[127] That additional amount collected on internal sales represents a pre-payment of part of the IVA liability which arises once the goods are re-sold in Argentina.[128] The pre-payment made can be credited at the time of settlement of the definitive IVA liability.[129]

11.113 The persons required to collect the pre-payment on internal sales, the so-called collection agents (*agentes de percepción*), are appointed by the tax administration on the basis of its fiscal interests. Those persons include, e.g., large companies of the private sector.

11.114 The pre-payments on internal sales are collected at the following *ad valorem* rate:

- sales to registered taxable persons[130]: 5 percent

(…)

2. Overview of the parties' arguments and analytical approach followed[131]

(…)

---

[125] See Article 4 of RG 3431.

[126] See Article 3 of RG 3431. Lower rates apply to import transactions involving certain specified products, including live bovine animals, offal of bovines as well as fresh fruit and vegetables. The European Communities does not challenge those rates.

[127] See Article 1 of RG 3337.

[128] See Article 9 of RG 3337.

[129] *Ibid*.

[130] See Article 2 of RG 3337.

[131] It should be noted that notwithstanding the fact that the present case is entitled *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather*, the European Communities' claims under Article III:2, first sentence, are not limited to finished leather, but rather extend to imported products in general. See the European Communities' request for the establishment of a panel (WT/DS155/2).

11.129 (…) According to the European Communities, the pre-payments on imports required by RG 3431 (…) exceed the pre-payments to be made on internal sales of goods, with the consequence that importers bear a heavier financial cost than buyers of like domestic goods. (…)
11.130 Argentina rejects the European Communities' claims. Argentina recalls that the IVA Law (…) treat imported and domestic products alike. The measures challenged by the European Communities do not, according to Argentina, create additional taxes, but rather provide for the pre-payment of the IVA and IG. Argentina submits that RG 3431 (…) are tax administration and collection measures and that, as such, they fall outside the scope of Article III:2. Argentina notes, moreover, that the pre-payments made pursuant to RG 3431 (…) can be credited at the time of settlement of the definitive tax liability arising from the IVA Law (…). Argentina considers that imported products are thus in any event not subject to internal taxes in excess of those applied to like domestic products.
(…)

4. Likeness of imported and domestic products

(…)
11.167 It is well to recall at the outset that the Appellate Body, in its report on *Canada – Periodicals*, stated that "… Article III:2, first sentence, normally requires a comparison between imported products and like domestic products …"[132] The Appellate Body, in the same report, further noted that a determination of likeness for purposes of Article III:2, first sentence, must be made by reference to relevant factors including the products' end-uses in a given market, consumers' tastes and habits and the products' properties, nature and quality
11.168 In the case before us, the European Communities has neither compared specific products nor addressed the criteria relevant to determining likeness. The European Communities considers that it is not incumbent upon it to do so. We agree. In circumstances such as those confronting us in this case no comparison of specific products is required.[133] Logically, no examination of the various criteria relevant to determining likeness is then called for either.
11.169 We consider that in the specific context of a claim under Article III:2, first sentence, the quantum and nature of the evidence required for a complaining party to discharge its burden of establishing a violation is dependent, above all, on the structure and design of the measure in issue.[134] The structure and design of RG 3431 (…) and their domestic counterparts RG 3337 (…) are such that the level of tax pre-payment is not determined by the physical characteristics or end-uses of the products subject to these resolutions, but instead is determined by factors which are not relevant to the definition of likeness, such as whether a particular product is definitively imported into Argentina or sold

---

[132] Appellate Body Report on *Canada - Periodicals*, *supra*, at p. 20.
[133] This should not be construed to mean that we disagree with the appropriateness, in different factual circumstances, of the approach outlined by the Appellate Body in *Canada – Periodicals*.
[134] As the Appellate Body has stated in *United States – Shirts and Blouses*, *supra*, at p. 14:

> In the context of the GATT 1994 and the *WTO Agreement*, precisely how much and precisely what kind of evidence will be required to establish such a presumption will necessarily vary from measure to measure, provision to provision, and case to case.

domestically as well as the characteristics of the seller or purchaser of the product.[135] It is therefore inevitable, in our view, that like products will be subject to RG 3431 and its domestic counterpart, RG 3337. (…)

5. Comparison of tax burdens imposed

(…)
(a) Tax burdens imposed

11.176 The European Communities submits that, even if the pre-payments of the IVA (…) may be credited against the definitive tax liability under the IVA Law (…), taxable persons are still required to "advance" money to the Argentinean tax authorities. (…) The European Communities asserts that, if taxable persons were not required to pre-pay part of the tax, they would have the opportunity to earn interest on the amount pre-paid until the end of the relevant tax period. According to the European Communities, the loss of that revenue represents an additional financial cost for taxable persons. The European Communities considers that that additional cost is higher for importers than for buyers of domestic goods since the collection mechanisms applicable to imports provide for higher collection rates.
(…)
11.182 (…), it is necessary to recall the purpose of Article III:2, first sentence, which is to ensure "equality of competitive conditions between imported and like domestic products"[136]. Accordingly, Article III:2, first sentence, is not concerned with taxes or charges as such or the policy purposes Members pursue with them, but with their economic impact on the competitive opportunities of imported and like domestic products. It follows, in our view, that what must be compared are the tax burdens imposed on the taxed products.
(…)
11.185 With this in mind, we now turn to examine the actual tax burdens which RG 3431 and RG 3543 impose on imported products. We recall that under RG 3431 imports are subject, upon importation, to pre-payment of the IVA at a rate of 10 percent or 12.7 percent *ad valorem*. (…)
11.187 The actual tax burden which arises from RG 3431 (…) may take one of two forms, depending on the factual circumstances of each case. First, in situations where taxable persons have disposable working capital to finance the pre-payment of the IVA (…), they are forced, on account of the pre-payment requirement, to forego interest on that working capital in the interval between the tax pre-payment and its crediting. Alternatively, in situations where taxable persons do not have disposable working capital to finance the pre-payment of the IVA (…), they need to raise the necessary capital and pay interest on it in the interval between the tax pre-payment and its crediting.
11.188 It is clear to us that both of these situations give rise to a financial burden, an

[135] In our view, the mere fact that a product is of non-Argentinean origin or that it is being definitively imported into Argentina does not, *per se*, distinguish it - in terms of its physical characteristics and end-uses - from a product of Argentinean origin or a product which is being sold inside Argentina. Nor does likeness turn on whether the sellers or purchasers of the products under comparison qualify as registered or non-registered taxable persons or as *agentes de percepción* under Argentinean tax law.
[136] Appellate Body Report on *Canada – Periodicals*, *supra*, at p. 18.

opportunity "cost" in one case and a debt financing "cost" in the other.[137] Likewise, it is readily apparent that that financial burden is incidental to and directly caused by RG 3431 (…).[138] For these reasons, it is properly regarded as an integral part of the actual tax burden imposed by RG 3431(…).[139] As such, it falls squarely within the scope of Article III:2, first sentence.

(…)

11.190 (…), it is necessary once again to draw attention to the direct causal link between the tax pre-payments specifically envisaged in RG 3431 (…), on the one hand, and the incidental financial burden in the form of interest foregone or paid, on the other hand. Thus, to the extent that, pursuant to RG 3431 (…), higher nominal pre-payment *rates* apply to imported products than to like domestic products, this necessarily implies that a heavier actual tax *burden* is imposed on imported products.

11.191 In view of the fact that Argentina does not compensate importers subject to RG 3431 (…) for all or part of the interest lost or paid,[140] it is sufficient, for purposes of establishing violations of Article III:2, first sentence, for the European Communities to demonstrate that imported products are subject to higher nominal pre-payment rates than like domestic products or are subject to pre-payment when like domestic products are not.

---

[137] We recall that no *a priori* statements are possible as to who bears that financial burden. Depending on the market situation, the taxable person may have to bear that burden and suffer lower profit margins. Alternatively, where the market situation allows a taxable person to sell a product at a higher price, the burden may be borne by the purchaser of the product. Regardless of who bears the burden, it has an immediate impact on the competitive opportunities of the products affected.

[138] We note that if RG 3431 and RG 3543 were to cease to exist, so would those tax burdens. It should be noted in this context that we do not agree with Argentina that the extra financial burden in the form of interest lost or paid is a "cost" necessarily associated with all import transactions in the same way as certain inherently import-related costs, such as customs clearance-related costs or certain freight and insurance costs. It is important to recall in this regard that the pre-payment mechanisms established by RG 3337 and RG 2784, i.e. those governing internal sales transactions, impose the same type of financial burden on the purchasers or sellers involved in these transactions.

[139] We note the European Communities' view that the interest lost or paid by importers constitutes, in itself, an "internal tax or other internal charge of any kind" within the meaning of Article III:2, first sentence. In favour of its argument, the European Communities refers to the report of the GATT 1947 panel in *EEC - Fruits and Vegetables*. It is true that in that case, which dealt with Article II:1(b) of the GATT 1947, the panel found that lost interest and other related costs were "other duties or charges of any kind imposed on or in connection with importation" within the meaning of Article II:1(b). See *EEC – Fruits and Vegetables*, *supra*, at para. 4.15. Even considering the fact that the aforementioned panel did not deal with Article III:2, first sentence, we consider that our approach is not inconsistent with that panel's finding. The interest charges and costs at issue in *EEC – Fruits and Vegetables* were connected to the lodging of a security, which in turn was required to guarantee a minimum import price established for tomato concentrates. In our view, those were factual circumstances which are quite unlike those prevailing in the present case. In the present case, the loss or payment of interest is incidental to the pre-payment of the IVA and IG envisaged in RG 3431 and RG 3543. In *EEC – Fruits and Vegetables*, the loss of interest was not incidental to the payment of the applicable customs duty – which would have been a situation under Article II:1 analogous to that in the present case. Instead, the loss of interest arose as a consequence of the measure establishing the minimum import price, which, in legal terms, was distinct from the customs duty. In light of the foregoing, we see no need to make findings on the merits of the European Communities' argument.

[140] Argentina's reply to Panel Question 81(a). Argentina's argument that compensating importers for the interest lost or paid would be too costly is addressed in Section XI.C.6 below, where we consider Argentina's defence under Article XX(d) of the GATT 1994.

(b) Pre-payment of the IVA

(i) Claims by the European Communities

(…)

Lower pre-payment rates applicable to internal sales to registered taxable persons

11.193 The European Communities notes that RG 3431 establishes a generally applicable pre-payment rate for imports by registered taxable persons of 10 percent.[141] The European Communities points out that, on the other hand, pursuant to RG 3337, internal sales of goods to registered taxable persons are subject to pre-payment at a lesser rate of 5 percent.[142]

11.194 Argentina points out that internal sales transactions may be subject to either collection at source in accordance with RG 3337 or withholding pursuant to General Resolution (AFIP) No. 18/97[143]. RG 18 establishes a withholding rate of 10.5 percent.[144] Argentina further points out that, previously, no pre-payment of the IVA had to be made on imports. Argentina notes that RG 3431 was enacted to ensure equal treatment of imports and internal sales.

11.195 We note that imports governed by RG 3431 are subject to pre-payment of the IVA at a rate of 10 percent, whereas, in accordance with RG 3337, internal sales of like products by *agentes de percepción* to registered taxable persons are subject to pre-payment of the IVA at a lower rate of 5 percent.

11.196 Even recognizing that a heavier tax burden is imposed on internal sales transactions which are governed by RG 18 (which provides for a withholding rate of 10.5 percent) than on import transactions falling under RG 3431 (which provides for a collection rate of 10 percent) and involving like products, this would not be inimical to the European Communities' claim. The provisions of Article III:2, first sentence, are applicable to each and every import transaction. It is well established that the fact that some imported products receive more favourable tax treatment than like domestic products cannot successfully be invoked as justification for less favourable tax treatment of other imported products.[145]

11.197 In light of the foregoing, we conclude that RG 3431, by providing for higher pre-payment rates for imports by registered taxable persons than for internal sales subject to RG 3337, is inconsistent with Article III:2, first sentence.

(…)

---

[141] See Article 3 a) of RG 3431.

[142] See Article 2 of RG 3337.

[143] Exhibit ARG-XVIII (hereafter "RG 18").

[144] See Article 8 (a) of RG 18. Import transactions are not subject to withholding.

[145] See the Panel Report on *United States – Measures Affecting the Importation, Internal Sale and Use of Tobacco* (hereafter "*United States – Tobacco*"), adopted on 4 October 1994, DS44/R, at para. 98. For reports with respect to Article III:4 of the GATT 1994, see the Panel Reports on *United States – Section 337*, *supra*, at para. 5.14; *United States – Gasoline*, adopted on 20 May 1996, WT/DS2/R, at para. 6.14.

6. Defence under Article XX(d) of the GATT 1994

(…)

(b) Provisional justification under paragraph (d) of Article XX

(…)

(iii) Necessity of the measures taken to secure compliance

11.299 Argentina contends that Members invoking Article XX(d) are entitled to a certain degree of discretion in determining whether a measure is "necessary". Argentina considers that the Member taking a measure is best placed to assess whether that measure is necessary. Argentina also argues that paragraph (d) of Article XX does not say that a Member must evaluate a number of alternative measures which would ensure the observance of its laws and then choose the least trade-restrictive among them.
11.300 The European Communities argues that it is our task to examine whether Argentina's measures are "necessary" to achieve Argentina's desired level of enforcement of the IVA Law (…) The European Communities notes that that panel held that a Member cannot justify a measure as necessary in terms of Article XX(d) "if an alternative measure which [that Member] could reasonably be expected to employ and which is not inconsistent with other GATT provisions is available to it".[146]
(…)
11.303 It must be stated, as a preliminary matter, that the question which we must examine here is whether the contested *measures* are "necessary" to secure compliance with the IVA Law (…)[147] At this point in our analysis, we look at the relationship of Argentina's claimed policy objective of securing compliance with the IVA Law and the IG Law and the *general* design and structure of RG 3431 (…)[148]
(…)
11.305 We are satisfied that Argentina has adduced argument and evidence sufficient to

---

[146] Panel Report on *United States – Section 337*, *supra*, at para. 5.26.
[147] The Appellate Body stated in *United States – Gasoline* that "[t]he chapeau of Article XX makes it clear that it is the "measures" which are to be examined under Article XX(g), and not the legal finding of [violation]". See the Appellate Body Report on *United States – Gasoline*, *supra*, at p. 16. While this statement refers to Article XX(g), the Appellate Body's reasoning relies on the chapeau, which applies equally to Article XX(g) and Article XX(d). The Appellate Body's reasoning must therefore also extend to Article XX(d). Accordingly, we do not consider it appropriate to examine under Article XX(d) whether the less favourable tax treatment accorded to imported products as a result of the application of RG 3431 and RG 3543 is "necessary". It should be noted that the GATT 1947 panel in *United States – Section 337* considered that "what [had] to be justified as "necessary" under Article XX(d) [was] each of the inconsistencies with another GATT Article found to exist". See the Panel Report on *United States – Section 337*, *supra*, at para. 5.27. While the approach adopted by the panel in *United States – Section 337* could be seen to be based on the view that the "necessity" test set forth in Article XX(d) gives rise to a somewhat different Article XX analysis than, for instance, the "relating to" test contained in Article XX(g), we see no need to dwell upon this point, since the Appellate Body has outlined, in the more recent *United States – Gasoline* case, what, in its view, is the correct and general approach to interpreting and applying Article XX.
[148] See the Appellate Body Report on *United States – Import Prohibition of Certain Shrimp and Shrimp Products* (hereafter "*United States – Shrimp*"), adopted on 6 November 1998, WT/DS58/AB/R, at para. 149.

raise a presumption that the contested measures, in their general design and structure, are "necessary" even on the European Communities' reading of that term. Argentina stresses the fact that tax evasion is common in its territory and that, against this background of low levels of tax compliance, tax authorities cannot expect to improve tax collection primarily through the pursuit of repressive enforcement strategies (e.g. aggressive criminal prosecution of tax offenders). In those circumstances, Argentina maintains, tax authorities must direct their efforts towards preventing tax evasion from occurring in the first place. According to Argentina, this is precisely what RG 3431 (…) are designed to accomplish.[149]
11.306 The European Communities does not dispute that, in the circumstances of the present case, collection and withholding mechanisms are necessary to combat tax evasion.[150] Nor has the European Communities submitted other arguments or evidence which would rebut the presumption raised by Argentina in respect of the "necessity" of RG 3431 (…).[151]
11.307 In light of the foregoing, we conclude that, in view of their general design and structure, RG 3431 and RG 3543 are "necessary" measures within the meaning of Article XX(d).
(…)
(c) Consistency with the requirements of the chapeau of Article XX

(i) Interpretation and application of the chapeau

(…)
11.313 The chapeau sets forth three standards which a particular measure must meet.[152] Those standards are cumulative in nature. As a result, if the measure for which justification is claimed fails to meet one of them, the measure *ipso facto* fails to satisfy the requirements of the chapeau. The order in which the standards are examined is therefore immaterial. In the present case, we consider it appropriate to analyse first whether the application of RG 3431 (…) constitutes a means of "unjustifiable discrimination between countries where the same conditions prevail".
(…)
11.315 Since we have already found that RG 3431 (…) give rise to discrimination between

[149] In our view, the presumption raised by Argentina of the existence of a relationship of necessity between Argentina's declared objective of securing compliance with the IVA Law and IG Law and the general design of RG 3431 and RG 3543 is not affected by the inconsistency of these measures with Article III:2, first sentence.
[150] See para. 8.258 of this report.
[151] It is true that the European Communities disputes that the higher rates applied to imported products pursuant to RG 3431 and RG 3543 are "necessary" in order to secure compliance with the IVA Law and IG Law. See e.g. EC First Oral Statement, at paras. 79, 82 and 84. We consider that this contention goes to the question of whether Argentina makes improper use of the exception set out in Article XX(d) and not to the question of whether RG 3431 and RG 3543, in light of their general design and structure, fall within the terms of Article XX(d). We therefore address the justifiability of applying higher rates to imported products when we appraise RG 3431 and RG 3543 under the chapeau of Article XX. This approach is in accordance with that followed by the Appellate Body in *United States – Gasoline*. See the Appellate Body Report on *United States – Gasoline*, *supra*, at pp. 19 and 25-29.
[152] The chapeau provides that the measure in question must not be applied in such a manner as to constitute (i) a means of "arbitrary … discrimination between countries where the same conditions prevail", (ii) a means of "unjustifiable discrimination between countries where the same conditions prevail" or (iii) a "disguised restriction on international trade".

imported products and like domestic products, the only remaining issue is whether the discrimination resulting from the application of RG 3431 (…) is "unjustifiable".[153] It is important to bear in mind that the standard of "unjustifiable" discrimination is different in nature and quality from the standard of discrimination contained in Article III:2, first sentence.[154] As Argentina correctly points out, the prohibition on unjustifiable discrimination in the application of a measure by necessary implication leaves room for justifiable discrimination. On the other hand, this does not imply that some discrimination is always justifiable. Whether or not any discrimination is justifiable, in a given instance, and if so, to what extent, must be ascertained by way of analysis of the specific circumstances of each case.

(…)

(ii) Justifiability of discrimination

11.316 Argentina submits that the rates applicable to import transactions pursuant to RG 3431 (…) are warranted because Customs represents a point where there is a high concentration of formal transactions. Argentina notes that in cases where there is a comparable concentration of formal transactions in the internal market, Argentina applies rates equal to or higher than those applied at Customs. Argentina refers to the examples of RG 18, pursuant to which the IVA is to be withheld at a rate of 10.5 percent, and of General Resolution No. 3316/91, which envisages a 14 percent withholding on payments of certain professional fees.

(…)

11.319 The European Communities argues that from the fact that the collection of pre-payments is easier for imports it does not follow that it is necessary to collect those pre-payments at rates which are higher than those applicable to internal sales. The European Communities further submits that it is not clear why the collection of pre-payments of the IVA on imports at a rate of less than 10 percent would constitute a "disincentive" to declare subsequent transactions. The European Communities notes in this regard that it is difficult to understand why importers could be interested in not charging the IVA on their re-sales, since that would seem to be the easiest way for them to credit the IVA paid on their import transactions. (…) On this point, the European Communities maintains that Argentina has not provided evidence demonstrating that the payment of the IVA is more frequently evaded when imported goods are re-sold by importers than when domestic goods are re-sold by "domestic" sellers.

(…)

11.325 We note in this regard that one alternative course of action available to Argentina

---

[153] Argentina has not been able to convince us that, in the present case and for purposes of applying the chapeau, "the same conditions [do not] prevail" between Argentina and the European Communities. In particular, the fact that Argentina is a developing country Member which has to contend with low levels of compliance with its tax laws, does not, in our view, provide a justification for discriminating against imported products under the facts of the present case. It should be recalled, moreover, that the Appellate Body in *United States – Gasoline* - a case which also involved discrimination between imported and like domestic products - did not specifically examine and make a finding on whether the "same conditions prevail[ed]" between Brazil and Venezuela, on the one hand, and the United States, on the other hand. See the Appellate Body Report on *United States – Gasoline*, *supra*, at pp. 25-29. We therefore do not see a need to further examine this element.

[154] See the Appellate Body Report on *United States – Shrimp*, *supra*, at para. 150; *United States – Gasoline*, *supra*, at p. 23.

would be to reimburse importers for the additional interest foregone or paid. Similarly, Argentina could provide for the additional interest lost or paid to be creditable against the tax liability arising from the IVA Law (…). Whichever way compensation of importers is achieved, it would not, in our view, call into question the usefulness of RG 3431 (…) as measures for securing compliance with the IVA Law (…). We do not therefore consider that the extra tax burden imposed on importers in the form of interest lost or paid is unavoidable.

11.326 Argentina argues that compensating importers would not be an option because it would be virtually impossible to quantify an importer's additional loss or payment of interest. We do not find this argument convincing. It is true that relevant market rates for determining the interest lost or paid are subject to change over time and that the level of those rates tends to vary depending on the length of the term for which capital is invested or borrowed. It does not follow, however, that compensation is therefore impossible. Even if it were administratively too difficult to use actual market rates as a basis for calculating the additional loss or payment of interest (which has not been demonstrated to the Panel), it would still be possible, in our view, to use other appropriate rates[155], such as average market rates[156].[157] (…)

11.327 Argentina submits, in addition, that compensation of importers for the extra tax burden in the form of interest lost or paid would result in an excessive administrative cost for the government, which would cause the failure of RG 3431 (…) In any event, Argentina could, in our view, alleviate the administrative burden, for instance by requiring importers to supply supporting documentation for purposes of claiming compensation.[158] (…)

11.331 We therefore conclude that RG 3431 and RG 3543 do not meet the requirements of the chapeau of Article XX. For that reason, and even though RG 3431 (…) fall within the terms of Article XX(d), we do not accept Argentina's claim of justification under Article XX as a whole.

(…)

---

[155] It is worth noting that the same "appropriate interest" standard is also used, in similar context, in footnote 59 to item (e) of Annex I to the Agreement on Subsidies and Countervailing Measures. According to that footnote, "… Members recognize that deferral [specifically related to exports of direct taxes paid or payable by industrial or commercial enterprises] need not amount to an export subsidy where, for example, appropriate interest charges are collected".

[156] Such average rates could be calculated for various terms of investment or borrowing. It should be pointed out in this connection that the Working Party on Border Tax Adjustment found that, for purposes of border tax adjustment and in cases where the calculation of the exact amount of adjustment was difficult, it could in principle be administratively sensible and sufficiently accurate to calculate the average taxation of categories of products rather than the actual tax levied on a particular product. See the Working Party Report on Border Tax Adjustment, *supra*, at para. 16. We believe that the same reasoning applies to the calculation of the appropriate interest rate in the present case.

[157] We consider that Resolution 1253 confirms that compensation along these lines is possible. Resolution 1253 lays down a particular rate - 0.5 percent per month - for the interest payable by the Argentinean government, as of the filing date of a refund request, in cases where the pre-payments of the IG made result in overpayment of the IG. See Argentina's reply to Panel Question 45(e). In referring to the example of Resolution 1253, we do not, however, pronounce on the appropriateness of the interest rate laid down in Resolution 1253.

[158] In particular, as already mentioned, importers claiming compensation could be required to provide evidence regarding the date of the various pre-payments made pursuant to RG 3431 and RG 3543.

Case Note (Shochu II)

http://www.ejil.org/journal/Vol9/No1/sr1b.html;

Recapturing a Lost Opportunity: Article III:2 GATT 1994 Japan-Taxes on Alchoholic Beverages 1996

Serena B. Wille

Original Text of the Appellate Body Report **(WordPerfect Format): http://www.wto.org/wto/dispute/alcohpr.wp5"**

I. Introduction

In the 1996 World Trade Organization dispute, Japan-Taxes on Alcoholic Beverages, neither the Panel nor the Appellate Body appreciated the significance of its decision. The Panel and the Appellate Body focused solely on resolving the complaint by the United States, the European Community (EC), and Canada that the Japanese Liquor Tax Law[159] discriminated against imported liquors. In the fall of 1995, the US, the EC and Canada requested that the Dispute Settlement Body form a panel to assess whether the Japanese system of internal taxation for liquors protected shochu, a predominantly domestic product, and discriminated against other, almost exclusively imported, liquors.[160] The complainants argued that the higher tax levied on liquors other than shochu decreased the competitive opportunities of these products in violation of Japan's obligations under Article III:2, National Treatment on Internal Taxation and Regulation, of the General Agreement on Tariffs and Trade 1994 incorporated into the Agreement Establishing the World Trade Organization.[161] By October 1996, both the Panel and the Appellate Body had recommended that Japan bring the Liquor Tax Law into conformity with its obligations under Article III:2.

The most important question in the dispute was not, however, whether the Japanese Liquor Tax Law discriminated against imported liquors under Article III:2. Rather, the most important question, and the one whose implications were overlooked, was how to design a test for Article III:2 that does not encroach upon the fiscal

[159] Shuzeiho (Japanese Liquor Tax Law), Law No. 6 of 1953 as amended. This law laid down a system of internal taxation applicable to all liquors, defined as domestically produced or imported beverages with greater than or equal to one degree of alcohol which are intended for consumption in Japan.
[160] See Panel Report, Japan-Taxes on Alcoholic Beverages ,WT/DS8/R, WT/DS10/R, WT/DS11/R, 11 July 1996 (96-2651), paras. 3.1-3.4, 4.1-4.181, for the parties' claims and arguments [hereinafter referred to as the Panel Report].
[161] General Agreement on Tariffs and Trade 1994, reprinted in **Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts** (GATT Secretariat ed., 1994)[hereinafter referred to as the GATT or the Agreement].

sovereignty of the Contracting Parties to the Agreement. As the Panel in Malt Beverages stated, "[it is] imperative that...determinations [made] in the context of Article III...not unnecessarily infringe upon the regulatory authority and domestic policy options of contracting parties."[162] The Panel and the Appellate Body, however, employed a test that restricts the fiscal sovereignty of the Contracting Parties both prior to and during a dispute.[163]

The United States and Japan presented a viable alternative to the Panel's test that provides the Contracting Parties with greater flexibility and power to pursue the non-trade fiscal polices within their sovereignty. Their option, the aim-and-effect test, asks whether the purpose of the measure was to protect domestic production and whether the measure has a distorting effect on the competitive opportunities of the products. A panel must answer both questions affirmatively before finding a violation of Article III:2. As a result, governments are able to pursue non-trade policies that have no protective purpose but create unintentional protective trade effects. Not only did the Panel and the Appellate Body reject this alternative, but they also failed to discuss the serious issues underlying the tests.

This paper is an effort to recapture a lost opportunity. It addresses the issues Panel and the Appellate Body did not examine in this dispute and advocates a test for Article III:2 that preserves the fiscal sovereignty of the Contracting Parties. First, I summarize the arguments of the parties to the dispute and outline the Panel's test and the aim-and-effect test. Second, I elaborate the aim-and-effect test, discussing the rationales for the test and its viability. The section on rationales examines fiscal sovereignty generally, the ability of the aim-and-effect test to protect the fiscal sovereignty of the Contracting Parties, and the inapplicability of Article XX to this type of dispute. In the section on the mechanics of the test, I focus on the textual basis for the test, the specific inquiries into the aim and the effect of the measure, and the methodology for measuring the tax differential. Finally, in the Conclusion, I respond to potential criticisms of the aim-and-effect test.

II. Background

In Japan-Taxes on Alcoholic Beverages, the Panel and the Appellate Body agreed with the US, the EC, and Canada that the Japanese Liquor Tax Law violated Japan's obligations under Article III:2 GATT 1994 by taxing shochu at a lower rate than other liquors. Article III:2 prohibits imported products from being subject to internal taxes in excess of taxes levied on "like" domestic products.[164] Imported products that are "directly competitive" with domestic products cannot be taxed dissimilarly, as stated in the interpretive note to Article III:2, Ad Article III:2.[165] The US, the EC, and Canada

[162] Panel Report, United States-Measures affecting Alcoholic and Malt Beverages, DS23/R, adopted 19 June 1992, BISD 39S/209, para. 5.21 [hereinafter referred to as Malt Beverages].
[163] This test will be referred to as the Panel's test even though, as used in this paper, it includes the Appellate Body's modifications.
[164] For the full text of Article III:2, see infra p. 16.
[165] For the full text of Ad Article III:2, see infra p. 16.

requested that the Panel find that the other liquors are either "like" shochu or, alternatively, "directly competitive" with shochu. The tax rates would then have to be the same or at least similar for shochu and the other liquors. The Panel and the Appellate Body found that shochu and the other liquors are either "like" or "directly competitive," and therefore the different rates of taxation in the Japanese Liquor Tax Law violated Article III:2. However, the reasoning used to arrive at this outcome was acceptable only to the EC and Canada, and not to the US or Japan.[166]

The test the Panel and the Appellate Body used to find the violation of Article III:2 relied exclusively on descriptive criteria to classify the alcoholic beverages as "like" or "directly competitive."[167] Whether the products are "like" or "directly competitive" is assessed on a case-by-case basis using a panel's "best judgment."[168] For potentially "like" products, a panel looks to the physical characteristics, end-uses, and tariff classifications of the products. After determining that products are "like," a panel decides if the tax on imports is "in excess" of the tax on domestic goods. If the tax is "in excess," then the measure is presumed to be protective and violates Article III:2. Products are considered "directly competitive" if they have similar consumer end-uses, as illustrated, for example, by the cross-price elasticity of demand. Once the products are found to be "directly competitive," then a panel determines if the products are similarly taxed, and, finally, if the fiscal measure has a protective effect. Essentially, if there is a greater than de minimus tax difference between the products, then the measure is presumed to be discriminatory.

Even though the United States agreed with the outcome of the dispute, it appealed the Panel's test for determining a violation under Article III:2 and again offered the aim-and-effect test as an alternative.[169] The US based its argument on the language of Article III:2 and Article III:1. Article III:1 lays out the general obligation of the Contracting Parties not to apply internal measures to imported or domestic products "so as to afford protection to domestic production."[170] The US argued that the specific obligations of Article III:2 must be read in light of Article III:1, which forms part of the context of Article III:2. A panel should determine the likeness and competitiveness of products by evaluating whether the defendant government categorized the products "so as to afford protection" to the local product. "Applied...so as to afford protection" should be interpreted to mean that the measure was both intended to and has the effect of protecting domestic production. If a measure does not have both the aim and the effect of protection, then the products are not "like" or "directly competitive" for the purposes of

---

[166] See Panel Report, paras. 6.6 - 6.35, for the Panel's Findings; See Appellate Body Report, Japan-Taxes on Alcoholic Beverages, AB-1996-2, 4 Oct. 1996 (96-0000), sec. I, for the Appellate Body's findings [hereinafter referred to as the Appellate Report].

[167] Panel Report, para. 6.21; Appellate Report, sec. H.1.a.

[168] Id.

[169] Submission of the United States (Appellant), WTO Appellate Body, Japan-Taxes on Alcoholic Beverages, AB-1996-2, 23 Aug.1996, paras. 39-48 [hereinafter referred to as the Appellate Submission]; Japan also appealed the Panel's reasoning advocating the aim-and-effect test, although with a different outcome.

[170] For the full text of Article III:1, see infra p. 17.

Article III:2. The Appellate Body, like the Panel, rejected the aim-and-effect test to the long-term detriment of the fiscal sovereignty of the Contracting Parties.

III. The Aim-and-Effect Test

A. Rationales for the Aim-and-Effect Test

1. Fiscal Sovereignty Generally

In international trade agreements, fiscal powers remain within the realm of government sovereignty as long as the measures are not used to alter the competitive opportunities of products. Different governments make different social choices, many of which are manifested in the fiscal policies of the state. Whether it is to support a certain region, increase or decrease the use of a raw material or a means of production, or encourage small enterprises, governments frequently distinguish between products for non-trade policy reasons. However, an infinite number of non-trade fiscal policies can distort the market and affect trade. Should they all be struck down as discriminatory? The Contracting Parties cannot have intended such a restraint on their sovereignty. As the Panel in Malt Beverages stated, "the purpose of Article III is not to prevent contracting parties from differentiating between different product categories for policy purposes unrelated to the protection of domestic production."[171] To preserve their fiscal sovereignty, the Contracting Parties must have the opportunity to distinguish valid exercises of fiscal sovereignty from policies intended to undermine the goals of the GATT. Without the chance to show that measures fall within the permissible realm of non-trade policies, governments will be wary of enacting non-trade policies for fear that these policies may have unintended effects on trade and may result in dispute proceedings. It is precisely these concerns that the Panel and the Appellate Body did not adequate weigh in choosing the test to determine a violation of Article III:2.

2. Product Differentiation

Given that governments distinguish between products for both valid non-trade policy and discriminatory trade policy reasons, a panel's assessment of the product differentiations is crucial for the fiscal sovereignty of the Contracting Parties. The Panel in US-Auto Taxes concluded that notions of likeness and direct competition cannot be separated from the objectives of the regulatory scheme that draw a line between two otherwise similar products.[172] The aim-and-effect test therefore integrates the purpose of the fiscal measure into the determination of a violation of Article III:2. The Panel's test, by contrast, excludes the purpose of the measure from its assessment of the government's product differentiations. As a result, the purely descriptive test fails to create an objective

[171]Malt Beverages, para. 5.25.
[172]Panel Report, United States-Auto Taxes, DS31/R, dated 11 Oct. 1994 (unadopted)(92-0658) noted in Second Submission of the United States, WTO Panel, Japan-Taxes on Alcoholic Beverages, 26 Feb. 1996, para. 41 [hereinafter referred to as Second Submission]..

means for distinguishing between products and limits the sovereignty of the Contracting Parties.

If a panel uses descriptive criteria to determine whether two products are "like" or "directly competitive" for the purposes of Article III:2, the panel can only make arbitrary distinctions between products based upon its "best judgment" and a case-by-case analysis. There is no guidance as to what constitutes "like" or "directly competitive" products. Under the Panel's test, the definition of "like" consists of physical characteristics, end-uses, and tariff classifications. But why does one physical characteristic determine likeness and another does not? Is the color of the alcohol most important or the distillation process? Does the type of sugar used in the process determine likeness or it is more pertinent to know if the alcohol is usually diluted before consumption? Under the Panel's test, products are considered "directly competitive" if they have similar consumer end-uses as shown through the marketplace. But how similar do the end-uses have to be? Which group of consumers determines the end-uses if different age groups, for instance, use a product differently? Depending upon how a product is characterized or how the consumer group is defined, an infinite number of products can be considered "like" or "directly competitive." Where should the line be drawn? Distinctions made by reference to the Panel's criteria are arbitrary because the criteria is only descriptive.[173] Panels are therefore singling out characteristics at random. They have no objective way to determine <u>which</u> characteristics or market analyses are most illustrative of likeness or direct competition.

Whether products are "like" or "directly competitive" under Article III:2 depends upon <u>why</u>
the product differentiation is being made. The supposedly objective criteria of physical characteristics and end-uses are not objective because they have been singled out by policy-makers for a reason. From the government's point of view, if two products do not serve the same policy purpose, then they cannot be "like" or "directly competitive" or they would undermine the government's policy. It is only this policy that can guide a panel as to <u>which</u> criteria it should single out to determine if products are "like" or "directly competitive" for the purposes of Article III:2. For instance, are bicycles and motor scooters "like"? Yes, if one compares them to cars in price and fuel efficiency. No, if one compares them to each other in price, consumers, manufacturing processes, and environmental impact. Governments might classify bicycles and scooters together and tax them less than cars to discourage the use of cars or gasoline. Governments might place them in different categories and tax bicycles less than scooters to enable the poor to purchase a means of transportation or to limit noise pollution. Only by determining the

[173] The Panel tried to compensate for the arbitrariness of its test by advocating a flexible line between "like" and "directly competitive" products. Panel Report, para. 6.22. Flexibility emerges during the case-by-case analysis of product distinctions. Such flexibility, however, does not answer the original objection that a panel's inquiry is arbitrary unless it examines the aim of the measure. It only acknowledges that the Panel's delineation between the definitions is problematic for those products that could fall in either category. Moreover, flexibility itself is an arbitrary concept because there is no indication of how much flexibility is permissible. Finally, flexibility could engulf the definitions so that there is no difference between the categories.

policy reasons behind a measure can a panel objectively decide if a measure violates Article III:2.

The natural effect of this more objective legal reasoning process is the protection of the fiscal sovereignty of the Contracting Parties. In determining the government's rationale for differentiating between products, a panel is also assessing whether that rationale is a valid exercise of fiscal sovereignty. A panel must consider the aim of a measure to determine which differences between products are permitted to form the basis for tax distinctions. The permissible differences between products are those that stem from valid non-trade policies. It is these non-trade policies that lie within the fiscal sovereignty of the Contracting Parties. A test that does not assess the purpose of the measure cannot protect fiscal sovereignty because it fails to ask the crucial question. The aim-and-effect test, by contrast, inherently protects fiscal sovereignty because it has integrated the inquiry into the validity of the measure into its determination of a violation of Article III:2.

Although a panel must examine the aim of a measure before it can objectively determine a violation of Article III:2, a panel encroaches on the fiscal sovereignty of the Contracting Parties when it engages in an unrecognized or unspoken motive analysis. This type of analysis occurs when panels use their "best judgment" without any objective guidance to supplement the descriptive criteria.[174] Implicit motive analysis occurs because the categories of "like" or "directly competitive" and the distinctions between products reflect government policy decisions. When a panel begins its inquiry with the government's categories, it is immediately involved with and implicitly assessing the policy choices of the government. A panel may also knowingly weigh the government's claimed policy aim against the alternative reasons offered by the complainants but may refuse to admit this process for fear of calling the defendant government a liar. When a panel accepts the government's categories, it is, therefore, implicitly or explicitly, approving the government's reasons for distinguishing between products. The panel is stressing the same characteristics and end-uses as the government did. As the government singled out these elements to achieve its policy goals, the panel must find these policy goals compelling or else it would reject the government's categories and single out other characteristics.

Given the inevitable motive analysis in the Panel's test, a panel could find itself in an awkward situation. It might agree with the government's policy motives but the application of the descriptive criteria would place products in categories that would undermine the government's policy. To divide the products as the government did, the panel would be forced to distort either the categories or the product characteristics. For instance, if a government wants to support small breweries by taxing them less than large breweries, and there are equal numbers of both sized breweries in the country, a panel

[174] Although the Panel claimed to rely only the descriptive criteria, it stated, "Nowhere in the contested legislation was it mentioned that its purpose was to maintain a roughly constant tax/price ratio" (emphasis added). Panel Report, para. 6.25(iii). The Panel's legal reasoning illustrates that the descriptive criteria only gain significance when examined in conjunction with the aim of the measure. It is clear that the Panel could not avoid an analysis of the aim of the measure.

would have to decide that beer from small and large breweries are neither "like" nor "directly competitive." It could be quite difficult to argue that the beers have different characteristics, different end uses, and different consumers. By relying on the descriptive criteria, the panel undermines its credibility by engaging in a convoluted reasoning process.

This unacknowledged or unspoken motive analysis interferes with the sovereignty of the Contracting Parties both during the dispute and before the dispute, in legislative and administrative processes. During the dispute, the defendant government has no opportunity to rebut the claims against its policies. Rather, the panel decides for itself, based upon limited information and its own intuition, whether to accept or reject the government's categories and policies. Similarly, it gives policymakers no guidance as to acceptable non-trade policies and distinctions between products. Governments will hesitate to enact any non-trade measures that may have an unintended impact on trade because they will have no opportunity to show their valid motives. Both the lack of notice about a panel's reasons for a judgment and the inability of a defendant government to respond to a motive analysis encroach on the sovereignty of the Contracting Parties.

The weaknesses of the Panel's test, namely arbitrary line-drawing and an elusive and convoluted legal reasoning process, illustrate the need for panels to openly determine the purpose of the measure. By inquiring into the aim of the government's policy, the aim-and-effect test creates an objective and transparent method to assess the differences between products and determine a violation of Article III:2. Even more importantly, in making this crucial assessment about product differentiations, the aim-and-effect test protects the fiscal sovereignty of the Contracting Parties.

3. Article III:2 and Article III:4

When a panel considers the aim of a measure before determining if a government has validly differentiated between two products under Article III:2, it also expands the tools a government can use to implement its policy. By equalizing the incentives for governments to pursue taxation or regulation, the aim-and-effect test protects the sovereignty of the Contracting Parties. Discriminatory regulation is prohibited in paragraph 4 of Article III and the accepted test for Article III:4 includes an evaluation of the aim of the regulation.[175] As both Article III:4 and Article III:2 seek to prevent governments from undermining the GATT through internal measures, the two paragraphs should produce the same outcomes. This equality would enable governments to choose freely between taxation and regulation. Such a result occurs when the aim-and-effect test is used, but not when a panel relies exclusively on descriptive criteria.

If a panel only uses descriptive criteria for Article III:2, it undermines its own credibility and skews the choice of policy tools of the Contracting Parties. By relying on

[175] The relevant portion of Article III:4 states:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

descriptive criteria for Article III:2, a panel is using a narrower test than the accepted test for Article III:4.[176] The discrepancy between the tests for Article III:2 and Article III:4 may force a panel to manipulate the categories and product differences for Article III:2. Consider the case where imported wine is taxed more heavily than domestic beers and advertisements for wines are more restricted than those for beer and the aim of both measures is clearly discriminatory. A panel would find the difference in advertising regulations violates Article III:4 because wine and beer would be "like" products under the broader Article III:4 test. However, it would be difficult for a panel to determine that wine and beer are "like" for the purposes of Article III:2 because these products have different physical characteristics, potentially different end-uses, and possibly different tariff classifications.[177] In order to find both measures discriminatory, a panel would either have to consider the aim of both measures or would be forced to manipulate categories and product characteristics to find a violation of Article III:2.

From a government's perspective, a discrepancy in the tests for Article III:2 and Article III:4 limits its fiscal sovereignty on two levels: during the dispute and during legislative and administrative decisions. During a dispute, a government can comply more easily with Article III:4 than with Article III:2. A government can argue that a regulation is valid because it was enacted for non-trade reasons but it does not have the same defenses for its tax measures. Moreover, the convoluted legal reasoning process of panels gives a government no notice ex ante as to how the two definitions of "like" will be interpreted or how far the coverage of the two paragraphs will extend. If a panel refuses to consider the aim of a measure in its test for a violation of Article III:2, it skews a government's choice of method for implementing a policy towards regulation and away from taxation.

When the aim-and-effect test is used for Article III:2, there are no discrepancies in the definitions of "like" in Article III:2 and Article III:4 or in the coverage of the paragraphs. Both definitions of "like" are interpreted broadly and include an evaluation of the purpose of the measure. The coverage of the paragraphs is the same because both paragraphs are focused on the protective application of the measure. The equality means that a government can defend the aim of both its tax and regulatory measures and is on notice about the important criteria for a panel in both situations. There is no longer an incentive to implement a policy through regulation. As a result, the aim-and-effect test enables governments to choose freely between the two methods and protects the sovereignty of the Contracting Parties on this level, as well as during the assessment of the government's product differentiation.

4. The Article XX Issue

---

[176] See First Submission of the United States, WTO Panel, Japan-Taxes on Alcoholic Beverages, 1 Dec. 1995, paras. 25-26, 30-31 [hereinafter referred to as First Submission]; Appellate Submission, paras. 107-108.

[177] Admittedly, wine and beer could be considered "directly competitive" for the purposes of Article III:2 and the tax measure would be an Article III violation. However, the ECJ, with similar facts and a similarly mechanical test, has held that only cheap wine and beer are "directly competitive." There would still be problems with finding all wines and beer to be "directly competitive."

Admittedly, after finding a violation of Article III:2, the Panel's test permits the defendant government to defend its tax measure based on the list of exceptions in Article XX.[178] However, because the list provides only seven possible defenses, it restrains the Contracting Parties rather than liberates them from the Panel's narrow Article III:2 test. For instance, if a government wants to impose a luxury tax, it has no recourse under Article XX because there is no exception for redistributive policies. The government would have to rely on a panel to determine that a Mercedes Benz is not "like" or "directly competitive" with a Honda and the government can tax the vehicles differently. The Panel's test forces a panel to either reject valid exercises of fiscal sovereignty or, in the Article III:2 inquiry, to develop arbitrary distinctions and similarities between products and engage in a motive analysis.

Even though Article XX does not mitigate the violations of the sovereignty of the Contracting Parties in the Panel's test, the Panel and Appellate Body used Article XX to reject the aim-and-effect test. They claimed the aim-and-effect test would render Article XX redundant. A panel should not examine the aim of a measure during the Article III:2 inquiry because Article XX provides the only permissible policy rationales. Article XX plays a different role than the Panel and Appellate Body envisioned, however, and does not require the rejection of the aim-and-effect test.

Article XX only applies when there is a facial violation of the GATT obligations, as when a measure is origin-specific. Although Article XX does not refer to origin-specific measures, limiting Article XX to such violations can be inferred from the fact that Article III:2 can only apply to origin-neutral measures. The Article III:2 inquiry into whether products are "like" or "directly competitive" is only relevant if a panel is unsure if the measure is "applied...so as to afford protection to domestic production." Uncertainty about the protective aim and effect of a measure does not arise with origin-specific measures. These measures target imports and are, by definition, applied to protect domestic production. Uncertainty about the aim and effect of a measure only arises when the measure is origin-neutral. It is in these situations where the aim-and-effect test is necessary to determine if products are "like" or "directly competitive." If Article III:2 applied to origin-specific measures, the ensuing Article III:2 inquiry would be redundant because the protection is evident. As Article III:2 cannot apply to origin-specific measures, a panel must look elsewhere for the violation and the exceptions. That facially discriminatory measures are per se violations of the GATT is found throughout the Agreement, such as in Article I:1 or Article III:1. Article XX, in turn, enables a government to argue that its origin-specific measure is necessary to achieve a non-trade

[178] To summarize, the Article XX General Exceptions to GATT 1994 include policies designed to protect public morals and human, animal, and plant life or health; policies relating to the importation and exportation of gold or silver; policies necessary to comply with laws or regulations not inconsistent with the GATT, such as customs, anti-trust, and intellectual property laws; policies relating to the products of prison labor; policies to protect national treasures; policies relating to conservation of exhaustible natural resources, as long as they also apply to domestic goods; policies taken in pursuance to intergovernmental commodities agreements that meet the criteria of the contracting parties; policies restricting the exports of materials, implemented as part of government stabilization program; and policies essential to the acquisition or distribution of products in short supply. The pursuance of these policies, however, cannot be a disguised restriction to trade or an arbitrary or unjustifiable discrimination between countries where the same conditions prevail.

policy. As such violations are egregious, the list of exceptions must be narrow and well-defined.

Another approach to the role of Article XX is found in the language of the Appellate Body in United States-Standards for Reformulated and Conventional Gasoline. The purpose of Article XX is to "enumerate the various categories of governmental acts, laws or regulations which WTO Members may carry out or promulgate in pursuit of differing legitimate state policies or interests outside the realm of trade liberalization" (emphasis added).[179] Article XX secures areas of government policy that are not subject to the GATT. The language of Article XX supports this analysis. It states, "Nothing in this agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures necessary to...." Article XX outlines what the Agreement cannot do, rather than what governments can do. It defines the parameters of the Agreement, not what is permissive within the bounds of the Agreement. Questions of permissive behavior within the bounds of the Agreement are analyzed under the main provisions of the Agreement such as Article III:2. Article III:2 recognizes the interests within the realm of trade liberalization, i.e., that taxes cannot be applied with the aim and effect of protecting domestic products. The Contracting Parties have already agreed that, while most taxes are exercises of the fiscal sovereignty of the parties, some taxes are not permissible. They are giving up a measure of fiscal sovereignty in return for trade benefits. Article XX, by contrast, protects the areas of government policy that will not be subject to an accord or restricted for the purpose of trade liberalization.

Finally, Article XX cannot be an exclusive list of the exceptions to the GATT because the Contracting Parties have included additional exceptions based on the larger principles of the GATT in related contexts. For instance, the Agreement on Technical Barriers to Trade (TBT), incorporated into the GATT and considered an elaboration on Article III, permits governments to enact technical regulations that fulfill "legitimate objectives." The TBT Agreement sets out legitimate policies that permit governments to distinguish between products that are otherwise "like" or "directly competitive." The list of policies in the TBT Agreement includes measures not contained in Article XX. As the TBT is consistent with the principles of the GATT, then there are policies in addition to those listed in Article XX which are still compatible with these larger principles. Article XX is only a subset of this larger group of acceptable policies. Article III:2, like the TBT Agreement, is consistent with the larger principles of the GATT because it is concerned with protective measures. As Article III:2 embodies these principles, then acceptable non-trade policies under Article III:2 are similarly a sub-set of the group of policies compatible with the GATT, just like the policy exceptions in the TBT Agreement and in Article XX.

If the Panel and the Appellate Body had understood the significance of their decisions, they would have been more sensitive to the restrictions on the fiscal sovereignty of the Contracting Parties that result from their reading of Article XX. Under accepted rules of interpretation in international law, the preferred interpretation of

[179] Panel Report, United States-Standards for Reformulated and Conventional Gasoline, WT/DS2/AB/R, at 17, cited in Appellate Submission, para. 65.

an agreement is the one that best preserves the sovereignty of the contracting parties. All other things being equal, it is assumed that parties have given up as little power as necessary to achieve the goals of the agreement. Article XX should be interpreted not to apply to cases of origin-neutral measures falling within the realm of trade liberalization. Otherwise, the fiscal sovereignty of the Contracting Parties would be limited to seven permissible policies. Once the argument about the redundancy of Article XX is eliminated, there remains little basis for rejecting the aim-and-effect test in favor of the Panel's test.

B. The Mechanics of the Aim-and-Effect Test

1. Textual Basis

The aim-and-effect test would not be a viable option, even with its sensitivity to the fiscal sovereignty of the Contracting Parties, if it did not stem from a solid textual and contextual basis. In considering Article III:2, a panel should look to both the text and the context of the paragraph. The context is important for two reasons. First, the texts of Article III:2 and its interpretive note, setting out the requirements for "like" products and "directly competitive" products, respectively, are ambiguous. Article III:2 states:

> 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. Moreover, no 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.

The interpretive note, Ad Article III, paragraph 2, adds:

> 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.

The interpretive questions are numerous. For instance, does "moreover" indicate another category of products or another set of criteria for "like" products? "Moreover" means "besides," is a synonym for "also" and "likewise," and stresses the importance of what is to come. Does Ad Article III:2 mean that the first and second sentences of Article III:2 set out different standards for different categories of products? Or, does it close a loophole by stating that other product differentiations, not just those between "like" products, also violate Article III:2?

The second reason it is necessary to look beyond the text is that the Vienna Convention on the Law of Treaties requires examining the context of the terms in question. Specifically, Article 31(1) provides:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.[180]

As shown, the meanings of the words of Article III:2 are not "ordinary" and, therefore, the context and the object and purpose of the Article become even more important.

GATT 1994 Article III:1 forms the crucial context of Article III:2. Article III:1 sets out the general obligations of the Contracting Parties on which the subsequent paragraphs elaborate:

> The contracting parties recognize that internal taxes and other internal charges and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

The key language, "internal taxes...should not be applied...so as to afford protection to domestic production," indicates that both the aim and the effect of the measure are important for a panel to evaluate. "So as to" means "in order to" and indicates a conscious decision to apply the measure in a certain way to achieve the chosen goal. Although this phrase could be ambiguous as to whether it includes both aim and effect, the active decisional quality of this phrase is unmistakable. If only the effects of the measures are examined, an infinite number of tax measures could be "applied...so as to protect domestic production," thereby limiting the sovereignty of the Contracting Parties. However, it is neither the object nor the purpose of the Agreement to restrict the sovereignty of the Contracting Parties by encroaching on valid non-trade policies. Rather, the Agreement seeks to prevent overt discriminatory trade policies and disguised restrictions to trade. Any interpretation that limits a government's internal non-trade polices would be more than the Contracting Parties intended and should be rejected .

As Article III:1 outlines the goals and meaning of the whole Article, its emphasis on protective measures should permeate all the tests designed for the Article.[181] The most important element of any test is to determine if the measures and product designations are "applied...so as to afford protection to domestic production." To further underscore this concern, Article III:2 actually refers to the principles of Article III:1 as the standard. Both measures designating products as "like" or "directly competitive" must overcome the hurdle in the second sentence of Article III:2. The conjunction, "moreover," links the two sentences of Article III:2 so that potentially "like" products are included in the same test as potentially "directly competitive" products. As a result,

---

[180] Vienna Convention on the Law of Treaties, May 23,1969, art. 31(1), 155 U.N.T.S. 331, 8 I.L.M. 679.

[181] The Appellate Body argued that Article III:1 applies to the first and second sentences of Article III:2 differently because Article III:2(1) does not refer to Article III:1. Appellate Report, sec. H.1. However, the context, object and purpose of the Article do not change from one sentence to another. The fact that only the second sentence of Article III:2 refers to Article III:1 does not mean Article III:1 informs the sentences differently. Most of the other paragraphs in Article III do not mention Article III:1 and, yet, Article III:1 still informs their interpretations.

whether products are "like" or "directly competitive" can only be determined by referring to the language of Article III:1, in other words, to the aim and the effect of the measure. This textual basis supports the legal reasoning and sovereignty arguments in favor of the aim-and-effect test.

2. The Operation of the Test

The aim-and-effect test is not only viable on theoretical and textual levels, but also in implementation. The inquiry into the aim of the measure does not require investigating the subjective understandings or intents of individual legislators or the legislature. Rather, it examine the purpose of the measure as embodied in the measure itself. As stated in the US Appellate Submission, "the focus [is] on the direction in which the gun [i]s pointing rather than whether the person holding the gun even want[s] to pull the trigger."[182] Purpose is shown by examining the nexus between the means and ends of the legislation. For instance, what is the structure of the measure, does it draw a line between imports and domestic products, what incentives does it create, what is the wording of the legislation as a whole, and how "exceptional" are the categories it articulates? Is the measure proportional to its stated goals and does it create the least degree of inconsistency with the GATT provisions generally? It is also important to examine if the defendant government has presented a plausible alternative to the complainants' claims of protective intent.

To clarify, an "exceptional" category means the government has drawn an distinction between products that is not normally part of a general scheme of taxation. For instance, it would require drastic changes in the nature of the product for another product to fit into the protected category. The category may include detailed requirements or may be defined by the exclusion of other potentially similar products.[183] It could be argued that if a product is forced to change its nature to qualify for the "exceptional" category, then it is a different product. However, because a government can single out any characteristic to include in a category, it is arbitrary rather than illustrative to say that a product cannot fit into a government's category without changes. A government cannot be absolved from drawing an "exceptional" category by stating that the products are "directly competitive." A narrowly drawn category indicates that the government may have been pursuing a protective purpose mind when designing the measure. Nor is it acceptable for a government to claim the categories follow "socially established boundaries."[184] Such a claim illustrates why "exceptional" categories may be problematic: they can reinforce the historical biases of consumers which may have been determined, in part, by the protection of the products in these categories.

The aim prong of the aim-and-effect test may also use the descriptive criteria as evidence of the protective intent of the measure. As a result, the inquiries for

[182] Appellate Submission, para. 43.
[183] Shochu had its own category that was very detailed, including requirements about the types of still and sugar. Japanese Liquor Tax Law, Article 3.
[184] Japan argued that socially established boundaries were one of three criteria for its tax categories. Panel Report, para. 4.120.

determining the likeness of or direct competition between products are slightly different. For arguably competitive products, a panel might evaluate the incentive structure of a measure by comparing it to current or potential end uses of the products and determining how the incentives might alter product usage. For arguably "like" products, whether a product can fit into an "exceptional" category will depend upon its raw materials and manufacturing processes. The descriptive criteria are not free-standing factors or arbitrarily applied but, rather, they are grounded in and given significance by the inquiry into protective intent.[185]

As the inquiry into the aim of the measure is only concerned with the purpose of the measure as revealed by the measure itself, the burdens on the complainant and a panel to show a discriminatory aim are not onerous.[186] Moreover, the WTO dispute resolution process is designed so that both parties have the roles of claim and rebuttal. The claim of a legitimate non-trade policy does not automatically override obligations under the Agreement. There are also other options for designating the burden of proof. For instance, after the complainant presents a credible case that the measure protects domestic production, the government would have to rebut the claim by demonstrating a legitimate purpose. The burden of persuasion thus falls on the defendant government and the burden of going forward with the evidence lies with the complainant. Alternatively, after the complainant shows a protective effect, the defendant would have to rebut a presumption of protective intent. The burden of persuasion is thus split between the complainant and the defendant.

Concurrent with the inquiry into the purpose of the measure, a panel examines the effects of the measure on the equality of the competitive opportunities of the products. Thus, like the aim prong of the test, the effects inquiry is integrated into the determination of whether products are "like" or "directly competitive" and whether there is a violation of Article III:2. The effects inquiry is not concerned with trade volumes but if the tax rates afford greater competitive opportunities to the domestic product than to the imported product. As such, the complainant only needs to show that circumstances can lead to a protective effect rather than proving a protective effect. The effects of the measure are evident in changes in consumer behavior and in the market share of the products, as shown by data on sales and trade flows. Signs of unequal competitive opportunities include definitions that draw a clear line between domestic and imported products and an increase in the development of domestic production facilities. In some instances, the inquiries into the aim and the effect of a measure will overlap. For instance, examining the incentive structure of the measure for a discriminatory purpose may involve examining the effects of that incentive structure on consumer behavior. Evidence of the protective effects of a measure are often presented in the complaint, so a panel may be less involved in ascertaining the effects of a measure than the aim of the

[185] Even this Panel found this to be the case. See supra note 16.

[186] Indeed, the Panel examined the purpose of the Japanese Liquor Tax Law. See supra note 16. In addition, the Appellate Body outlined the very type of analysis required for the aim-and-effect test when it stated, "[a] protective application can most often be discerned from the design, the architecture, and the revealing structure of the measures." Appellate Report, sec. H.2.c.

measure. The effects prong of the inquiry may not even be necessary if a panel decides the measure does not have a protective aim.

One piece of evidence used in the inquiry of the effects of the measure is the tax differential.[187] Depending whether the panel's inquiry is into the likeness or competitiveness of products, the use of the levels of taxation might be slightly different. If products are claimed to be "like," the relevant text of Article III:2 states, "the products imported...shall not be subject...to...charges of any kind in excess of those applied...to like domestic products." Any difference in the level of taxation seems protective, although it is not conclusive evidence of protective effect. The main concern is still whether the measure has altered the competitive opportunities of the products.[188] If the products are claimed to be "directly competitive," the language of Ad Article III:2 indicates the taxes must be similar. "Directly competitive" products can be taxed dissimilarly to reflect the dissimilarities of the products, as long as there is no protection. Although the aim-and-effect test cannot determine the tax differential at which protection begins, finding the exact point where the competitive relationship changes is not crucial because the the tax differential is not dispositive.[189]

As a piece of evidence for both potentially "like" and "directly competitive" products, the tax differential can be used to show a protective effect in a variety of ways. For instance, if more domestic products fall into the lower tax category and more imported products fall into the higher tax category, then the structure of the measure raises suspicions of protection. If this division occurs as a by-product of a non-trade policy, the purpose inquiry will protect the government's measure. If a tax is progressive, the tax differential can show whether the rise is consistent or climbs steeply as imports become more prevalent. The magnitude of the difference in taxes levied on the categories could also indicate a protective effect. The tax differential is used in conjunction with other pieces of evidence such as the existence of exceptional categories or changes in consumer behavior in response to the incentive structure and, therefore, is not dispositive.

---

[187] The Panel's test treats the tax differential as a second step in its inquiry after it has determined whether products are "like" or "directly competitive."

[188] The Panel's test, by contrast, presumes a measure has a protective effect once a tax differential is shown between "like" products. This presumption is inappropriate because is assumes products can be found "like" without considering the effects of the taxation. Moreover, the existence of a tax differential between products becomes dispositive rather than an actual or potential change in the competitive relationship.

[189] The Panel's test, by contrast, permits a de minimus difference in the tax rates of "directly competitive" products. This standard obstructs the more important question whether any change in the competitive opportunities of the products has occurred. A de minimus standard assumes that no protection of domestic products occurs before a certain tax differential but protection does occur after that differential. As the level of competition is determined by more factors than the tax differential, its is arbitrary to single out the rate of taxation as the main indicator of protective effect. In addition, once a panel accepts that a government can tax the dissimilarities between products dissimilarly, the dissimilarities may be significant enough to warrant a larger than de minimus difference in taxes. A de minimus standard is also arbitrary because it offers no guidance as to the amount of change permitted in the competitive relationship before a violation of Article III:2 occurs.

When a panel uses the descriptive criteria only as pieces of evidence of protection in the aim or the effect prong of the test, it is freed from relying on potentially erroneous factors to determine a violation of Article III:2. For instance, tariff classifications, one of the descriptive criteria, should not be a conclusive indication of the likeness of two products. First, a panel is accepting the government classifications as a starting point for the analysis. It is such government classifications that are often at issue, however. Second, tariff classifications result from compromises among signatories to an agreement and reflect the parties' concessions rather than the likeness or competitiveness of products. Third, governments would be bound to these classifications for more purposes than they originally intended. The reliance on tariff classifications limits the excise taxes a government can charge for non-trade policy reasons. Tax policy would be subordinate to tariff policy and, once again, the fiscal sovereignty of the Contracting Parties would diminish. Given that the aim-and-effect test refers to many pieces of evidence, a panel would not even have to consider tariff classifications or, if it did, it could limit the evidentiary value of the classifications.

Another piece of evidence that the aim-and-effect test incorporates but prevents from becoming dispositive is the cross-price elasticity of demand. As a methodology, cross-price elasticity is too problematic to be indicative of the direct competition between products. For example, it is hard to use and easy to manipulate. The absence of cross-price elasticity does not mean there is no competition between the products. The longer a consumer has to respond to a change in price, the more likely that cross-price elasticity will exist. Cross-price elasticity also varies from one price point to another, with the least elasticity of demand occurring at higher prices. There are also the inevitable effects of income on purchasing behavior. As an interpretive tool, cross-price elasticity of demand is arbitrary. There is no objective way to specify which level of cross-price elasticity determines direct competition for the purposes of Article III:2. On a policy level, cross-price elasticity is difficult for governments to anticipate or prevent. It can occur for reasons outside the control of the government, like technological advances. It also forces policy-makers to change taxes whenever the existence of cross-price elasticity can be shown, such as when the market changes or when a new study is issued. The aim-and-effect test does not need to rely on this evidence to find a violation under Article III:2. In the aim-and-effect test, cross price elasticity of demand serves as one factor to determine if a measure has a protective intent and effect.

Finally, by considering diverse pieces of evidence in determining a violation of Article III:2, the aim-and-effect test weighs many of the same factors that consumers consider in their purchasing decisions. Given that Article III:2 is concerned with the equality of the competitive opportunities of the products, it is counterintuitive for a test under Article III:2 to rely on factors unimportant to the consumer. For consumers, the most important factor in a purchase is generally price, not, for instance, raw materials or manufacturing processes. Even consumers who are concerned with the environmental and health impacts of the raw materials or the manufacturing processes will only purchase environmentally-friendly or healthy products within his or her price range. The second concern of most consumers is likely to be quality, which is often reflected in the price of the product. In the aim-and-effect test, the aim inquiry looks to the incentive

structure of the measure which would impact the price and thus consumer behavior. Similarly, the effects inquiry examines the tax differential, which would also alter prices, as evidence. By including factors important to the consumer in determining a violation of Article III:2, the aim-and-effect test can assess the competitive opportunities of products as perceived by the consumers and as evidenced in their behavior.[190]

The discussion of the mechanics of the aim-and-effect test is not complete without a word about the options of the defendant government after a panel recommendation. Under the aim-and-effect test, if a measure does not have a protective purpose or protective effect, then the products are not "like" or "directly competitive." A government can tax the products as it wishes in keeping with its fiscal sovereignty. Once a protective purpose and a protective effect are shown, then the defendant government must bring its measure into compliance. If the products are "directly competitive," there may be a point at which a tax no longer evidences protective effect. Governments could conceivably adjust the tax rates so that the taxes are similar. However, the tax differential is not the only evidence of a protective aim and effect. If a government lowered a tax on a "directly competitive" product but did not eradicate it, there would still be other pieces of evidence pointing to the protective aim and effect of the measure. The government would have to change the incentive structure and the definitions of the categories, for instance, in order to argue that the measure no longer violated Article III:2.

C. Measuring the Tax Differential

In order to fully operationalize the aim-and-effect test, it is necessary that the methodology for measuring the tax differential best reflects the competitive relationship between products. The choice of methodology is the last major piece in establishing the viability of the aim-and-effect test and in protecting the fiscal sovereignty of the Contracting Parties. The tax differential is initially important because without one, it is unlikely that the competitive opportunities have been distorted and the complainants would not have a cause of action. As discussed, a tax differential also serves as evidence of the protective aim and effect of the measure. This evidence is then used to determine if the measure violates Article III:2. Although the tax/price ratio is not the prevailing methodology, it is the most appropriate method for the aim-and-effect test because it measure the competitive relationship between products on a number of levels.[191]

---

[190] Even if the descriptive definitions of "like" or "directly competitive" were expanded to include price or focus more on end-uses, price and end-uses reflect consumer preferences which are often the result of historical biases. In addition, this change would neither address the arbitrariness of drawing distinctions between products nor the hidden or implicit motive analyses that result when panels do not consider the purpose of the measure.

[191] The prevailing methodologies in GATT and ECJ alcohol tax cases compare the taxes levied on products by the tax/alcohol content or tax/volume ratios. E.g., Panel Report, paras. 6.24, 6.33; Case 170/78, Commission v. United Kingdom of Great Britain and Northern Ireland (Wine and Beer Case), 1983 E.C.R. 2265.

The test based on alcohol content is generally considered the most objective possibility although it is not as objective as it appears. Within each category of alcohol, there are varying strengths of alcohol and an average must be chosen. The average strength the defendant government or the complainants propose is manipulable and arbitrary. For instance, a government could compare mid-strength imported

The crucial feature of the tax/price ratio for the aim-and-effect test is that it incorporates the most important factor to consumers. If consumers base their decisions more on price than on other factors, then price should be the basis by which the competitive opportunities of products are measured. To a large extent, consumers determine whether products are competitive. Factors such as prices or taxes that change the perceptions of consumers and their purchasing behavior influence the level of competition between products. Therefore, all other things being equal, the competitive relationship between products and distortion of that relationship are reflected in a comparison of the prices of the products. The tax/price ratio is the only methodology that measures the characteristic of a product which most affects consumer behavior and alters the competitive relationship of products.

If the aim-and-effect test does not use the tax/price ratio to measure the tax differential, then the inquiries into the aim and effect of a measure will be distorted and could threaten the fiscal sovereignty of the Contracting Parties. Because the tax differential serves as evidence that the measure has altered the competitive relationship between the products, it is crucial that the differential measure the change in the competitive opportunities as the consumer perceives the change. Otherwise, the tax differential may reflect alcohol content or volume, arguably of less importance to the consumer. This same tax differential is then used to show that a tax measure may change consumer behavior and may have a protective aim and effect. The result of this incongruity is that the different steps of the analysis into an Article III:2 violation measure different relationships between products.

To illustrate the danger of using the aim-and-effect test with a methodology other than the tax/price ratio, consider the following scenario. The tax/price ratio shows no tax differential between potentially "like" products and only a minimal differential between potentially "directly competitive" products. By contrast, a ratio based, for

---

beers with mid-strength domestic wines. However, these beers may be taxed less than other beers or they may not be competitive with wines of mid-strength. The average strength beer may also not be the most consumed variety of beer. In addition, the differences in strengths of beer may vary more than differences in other factors like price. As alcohol content has less impact on consumer behavior than other factors, it is arbitrary to use the tax/alcohol content ratio as evidence of a change in the competitive relationship in the aim-and-effect test. Alcohol content as a yardstick also loses objectivity when a progressive system of taxation is introduced. Suppose a government chooses to tax stronger alcoholic beverages more than weaker alcoholic beverages. A ratio of 1/3/5/10 could become 1/9/25/100 but the tax/alcohol content methodology would not be concerned with the size of the differentials between the categories which raises questions about its objectivity.

A tax differential determined by volume is thought to be the most consistent methodology because governments frequently establish their tax classifications by volume. However, the logistical ease of placing a tax on volume does not indicate that the tax/volume ratio is a good measure of the rate of taxation. Similarly, the government's choice to assess the tax by volume does not mean that a panel cannot evaluate the effects of a tax by a different ratio. The volume of the container is even less likely to affect consumer choice than alcohol content. Again, a tax differential measuring a characteristic of little importance to the consumer is not the most objective or accurate method to show a change in consumer behavior for the aim-and-effect test. Governments and panels would also need to incorporate a corrective factor when comparing the ratios. Otherwise, it might be difficult, for instance, to compare alcohol that is usually diluted to thirst-quenching alcohol that is usually drunk in large quantities. A methodology based on volume turns out to be less consistent than originally thought.

instance, on alcohol content shows a differential. If a panel uses the latter methodology to decide the measure has the purpose of protecting the domestic product, this conclusion is not necessarily correct. There is no distortion of the competitive relationship if the taxes are the same percentage of the price. The consumer only sees that the higher priced product has a larger final price, i.e., tax plus price, as it should. Consumer behavior is thus unlikely to change, raising questions about whether the measure is protective. The panel, however, by relying on a different yardstick than the tax/price ratio believes that it has found evidence showing protection for the aim-and-effect test. In the end, a panel may not find a violation of Article III:2 depending on the other pieces of evidence. However, it is likely that a panel would decide a case erroneously if it does not use the tax/price ratio in conjunction with the aim-and-effect test. The panel would be encroaching on the fiscal sovereignty of the Contacting Parties by invalidating a legitimate non-trade measure which does not even have a protective effect.

The tax/price ratio is also appropriate for the aim-and-effect test because it reflects multiple elements of the competitive relationship between products. On one level, as discussed, price impacts consumer behavior more than other product characteristics. On another level, price incorporates the alcohol content of the product, volume discounts, economies of scale, the differing costs of production and transportation, the quality of the product, and the costs of complying with government regulations. Price thus reflects both the competitive relationship between products and ensures that all other things, such as the cost of inputs, are equal in that relationship. The tax/price ratio is an objective piece of evidence when a panel is determining if a measure has a protective effect.

There are, however, potential objections to using this methodology. First, if most tax systems are structured around volume or alcohol content, it could be inappropriate for a panel to use a different method. It might encourage governments to engage in ex-post facto reasoning. Governments might claim their measure does not create a tax differential when the tax/price ratio is examined, even though the measure was designed to protect domestic production. If a panel suspects that a government is using the tax/price ratio to rationalize its tax scheme, then the panel could use both the tax/price ratio and the method designated in the measure to verify the government's claims.[192] Governments are also prevented from rationalizing their tax schemes by the tax/price ratio because the fiscal measure would need a mechanism to change the taxes as prices change.[193] Even if a government has implemented such a mechanism, the reevaluation of the taxes has to be frequent enough to keep the ratio constant in a given period.

A second problem with the methodology could arise if the sales markets of the products have divergent structures. For instance, wines vary greatly in price while beers

[192] The Panel here examined the tax differential by both tax/volume and tax/alcohol content. It considered the comparison by alcohol content to be most significant because Japan had chosen that method to apply the tax. Panel Report, para. 6.33.

[193] The Japanese government had no mechanism for maintaining a consistent tax/price ratio. The Panel interpreted this omission as one sign that the government was engaging in ex-post facto reasoning. Panel Report, para. 6.34(iii).

vary less in price. In order to compare the tax/price ratio of these two products, it is necessary and feasible to choose wines that are representative in availability, market share, and quality. Only representative products can reflect a distortion of the competitive relationship between products with different market structures. Another objection is that this methodology says nothing about the appropriate ratios or differentials. However, it is the government's decision to set the ratio in pursuit of its chosen policy. The role of a panel is to ensure that the government maintains the stated ratio and is not protecting the domestic market.

Finally, because this methodology is a ratio, any distortion in the absolute price resulting from consumer biases or from the historical or current cost of taxes does not appear in the tax differential. The canceling out of consumer preferences occurs when the tax changes to reflect consumer bias by the same percentage that the price changes to reflect consumer bias. If the tax does not change, the government is evidently favoring preferred products. Similarly, the portion of the price that reflects the cost of the tax cancels out of the equation. A panel can then objectively determine if the government has levied a higher tax on a product and if the competitive opportunities of the products differ.

In sum, the aim-and-effect test is not fully operable unless the tax/price ratio is used to determine the tax differential. This methodology complements the inquiries into the aim and the effect of a measure because it also assesses the competitive opportunities between products. The sensitivity of the tax/price ratio to the relationship between products is important because a panel uses the tax differential as evidence of protection for Article III:2. If the tax differential does not reflect the competitive relationship of the products, the panel might invalidate a measure that falls within the fiscal sovereignty of the defendant government.

IV. Conclusion

The aim-and-effect test is not only more sensitive to the fiscal sovereignty of the Contracting Parties but it is also a viable alternative to the Panel's test. The aim-and-effect test protects fiscal sovereignty because the purpose of the government's measure is integral to whether products are "like" or "directly competitive." The result is a transparent and objective test to determine a violation of Article III:2. Moreover, the aim-and-effect test does not force defendant governments to rely on the limited exceptions to the GATT listed in Article XX, which, after further inquiry, do not apply to origin-neutral violations such as violations of Article III:2. The Contracting Parties can then defend their valid non-trade measures that have an unintended effect on trade during a dispute. In legislation, Contracting Parties will not limit their use of valid fiscal measures out of fear of negative trade effects or as a result of skewed incentives. From the perspective of a panel, the aim-and-effect test is complex but entirely feasible. Although Panels use numerous pieces of evidence for both the aim and the effect inquiries of the test, neither prong creates an excessive burden for either the panel or the complainants. Given all the benefits of the aim-and-effect test, it is surprising and

disappointing that the Panel and the Appellate Body dismissed the test without considering its viability or addressing the important issues underlying the test.

Although the aim-and-effect test is more sensitive than the Panel's test to protecting the fiscal sovereignty of the Contracting Parties, opponents of the aim-and-effect test can make two powerful criticisms. First, panels do not see themselves performing a teleological role and should not perform this role. They are not courts interpreting the law, but rather bodies settling disputes among parties. If a panel is perceived as expanding its role or the Agreement between the Contracting Parties, its report may not be accepted by the parties to the dispute. As a panel report is not binding on future panels or even on the parties, a panel may not see the value in raising or responding to unnecessary or tangential concerns and issues. As a result, panels may choose a more mechanical approach as the safer and more appropriate route.

By following such a route, however, panels are abdicating a necessary role. They cannot remain mechanical given the ambiguity of the text of the Agreement. It is also frequently unclear what the Contracting Parties intended and therefore some interpretation is inevitable and desirable. Parties to the dispute might even reject the more mechanical approach if they feel panels are unable or unwilling to assess the parties' interests. The Vienna Convention also dictates a certain amount of teleology by requiring an examination of the context, purposes, and object of an article. Finally, panels already engage in this type of analysis, as the Panel evidenced, and the aim-and-effect test would enables panels to acknowledge this role.

The second criticism involves the potential long-term consequences of the aim-and-effect test. Does the aim-and-effect test make it too easy for governments to claim their policies are not trade-related? Should all non-trade policies be equally valid regardless of their effects on the competitive opportunities of imported products? Will the aim-and-effect test undermine the goals of the GATT? Is the potentially permissive aim-and-effect test a better option than restricting the sovereignty of the Contracting Parties?

Some of the arguably non-trade policies might indeed be cleverly disguised restrictions to trade. When the governments become more subtle in its disguises, the panels must become more attentive and more critical to discern the true purpose of the measures. In addition to the strategies already discussed to assess the purpose of a measure, panels should ask increasingly stringent questions. For instance, a higher tax on goods manufactured by workers with wages below a certain level has no ostensible trade purpose but could fall mostly on imported goods. If the government has a minimum wage and the policy begins the tax at or near that wage, then domestic goods will never be affected and the measure is a restriction on trade.

If there is no national minimum wage, in this example, then a panel must be more critical. This stringency will, in turn, force governments to ensure that their non-trade policies truly and clearly serve a domestic purpose. There must be a consistent objective in other government policies, such as education and health, to protect low wage workers.

Similarly, it could be important evidence of a disguised restriction to trade if the government does not object to prison or child labor. A even more stringent analysis would require that the purpose of the measure was in the general interest on two levels: many, if not most, citizens of the country benefit from the policy and a significant public consensus on the issue exists. The measure would have to be the least trade restrictive means to achieve its goal and impose the government's social choices as little as possible on other Contracting Parties. By asking these questions, a panel can decide whether an arguably non-trade policy having significant trade effects is a disguised restriction to trade.

If a panel is convinced the measure is not a disguised restriction to trade, then the measure should stand regardless of its impact on trade. The question is how often will this occur? Under the aim-and-effect test, a panel could not decide that the trade effects are too great and the valid non-trade policy must be changed. The aim-and-effect test is not a balancing test because this type of test would restrict the fiscal sovereignty of the Contracting Parties. Panels, however, may not find themselves in such a situation. Governments may be deterred from pursuing a policy that significantly affects trade by the fear that other Contracting Parties will retaliate against them. If a government enacts a higher tax on goods made by low-wage workers and there is no protective purpose, then a second government hit by the first government's policy may decide to place a higher tax on other goods. A panel will ultimately find that the purpose of this second measure was to retaliate and negatively affect imports. Prior to a panel's determination, however, the damage to the first government could outweigh the benefit it received from its low-wage tax. Game theory dictates that governments should think twice before enacting a non-trade fiscal measure that has significant trade effects.

Admittedly, the consequences of the aim-and-effect test remain to be seen. Although the aim-and-effect test is potentially too permissive of policies that negatively affect trade, it does not seem to open the gates very wide. The protection of the fiscal sovereignty of the Contracting Parties counterbalances the unlikely, although existent, possibility that the objectives of the GATT would be undermined. The other option would be to restrict the sovereignty of the Contracting Parties so that all non-trade policies with trade effects would be invalid. The Contracting Parties, however, did not intend to restrict their sovereignty to such an extent. Given its other benefits and its greater sensitivity to the fiscal sovereignty of the Contracting Parties, the aim-and-effect test remains a more desirable choice than the Panel's test and one which future Panels should use to determine a violation of Article III:2.

(b)

Case Note (Chilean Pisco)

http://www.ejil.org/journal/curdevs/sr9.html)

WTO Appellate Body Report: ***Chile—Taxes on Alcoholic Beverages,*** AB-1999-6, WT/DS87/AB/R, WT/DS110/AB/R, (99-5414), adopted by Dispute Settlement Body, 12 January, 2000. Chile, Appellant; European Communities, Appellee; Third Participants: Mexico and United States. Division: Feliciano, Ehlermann and Lacarte-Muró. **Major topics addressed by Appellate Body: De Facto Discrimination under Article III(2) of GATT 1994**.

1. Abstract

This case concerned Chile's Special Sales Tax on Spirits, as modified by the Additional Tax on Alcoholic Beverages. The panel found that approximately 75% of domestic spirits would be taxed at 27% under this regime, while over 95% of imported spirits would be taxed at 47%. The Appellate Body upheld the panel's decision that the Chilean regime violated Article III(2) of GATT 1994. The Appellate Body's decision provides a further articulation of the jurisprudence developed in Japan—Alcoholic Beverages and Korea—Alcoholic Beverages. It is notable for its extension of the critiques of domestic regulatory categories structured around types of beverages in the previous decisions to regulatory categories structured around alcohol content. It is also notable for its clarification of the role of legislative intent in decision-making under Article III. It is permissible to consider aim and effects, but only as evidenced by the actual structure of the measure.

2. Facts

This case concerned Chile's Special Sales Tax on Spirits, as modified by the Additional Tax on Alcoholic Beverages. The new Chilean system, scheduled to be implemented from 1 December 2000, provides for taxation of spirits at varying *ad valorem* rates based on their alcohol content as follows: for alcohol content of 35 degrees or less, the rate is 27%, and the rate increases by 4 percentage points per additional degree of alcohol, up to a maximum of 47% for spirits over 39 degrees. The panel found that approximately 75% of domestic spirits would be taxed at 27% under this regime, while over 95% of imported spirits would be taxed at 47%.[194] The European Communities (EC) argued that the Chilean system violates Article III:2, second sentence, of GATT, because it provides preferential treatment to a domestic alcoholic beverage, pisco. The panel found that the imported distilled beverages were 'directly competitive or substitutable' with domestic products.

3. Analysis of the Appellate Body Report

[194] Panel Report, *Chile—Taxes on Alcoholic Beverages*, WT/DS87/R; WT/DS110/R, 15 June 1999, para. 7.158. The panelists were Wilhelm Meier, Mohan Kumar and Colin McCarthy.

Chile argued that the panel erred by virtue of its failure to evaluate the new Chilean system as a 'hybrid' system, combining features of an *ad valorem* and a specific tariff and referring to *both* alcohol content *and* price. Chile argued that if looked at as an *ad valorem* tax at a fixed rate *dependent* on the alcoholic content, the new system is not discriminatory. The question Chile raises is whether WTO law accepts the alcohol content-based categories that its new system establishes. Chile argued that the panel had improperly evaluated the 'efficiency' of its regulatory structure.[195] Chile argued that, unlike the systems criticized in *Japan—Taxes on Alcoholic Beverages* and *Korea—Taxes on Alchoholic Beverages*, the Chilean system does not use product names as categories. Chile argued that the panel erred in its interpretation of Article III(2), second sentence, as it considered discriminatory effect. Chile argued that the panel should have ended its inquiry once it found facially neutral categories.

The European Communities argued that Article III(2), second sentence, requires a comparison of the relative tax burdens on imported and domestic products.[196] The products subject to comparison are those that are directly competitive or substitutable. Facial neutrality is not sufficient to withstand scrutiny under this provision. The fact that some imports are in the lowest tax category, and some domestic spirits are in the highest, does not insulate a measure from scrutiny.[197]

The United States suggested application of an 'aim and effects test' under the 'so as to afford protection' language of Article III(2), second sentence. The United States argued that there was evidence revealing a 'protective structure'.

The Appellate Body, following *Japan—Alcoholic Beverages*, first examined whether the domestic and imported products are 'directly competitive or substitutable products' in competition with each other. As Chile did not appeal the panel's finding that the relevant beverages were 'directly competitive or substitutable products', the Appellate Body was required to base its reasoning on this finding.[198]

Following *Japan—Alcoholic Beverages*, the Appellate Body turned to the question of whether these products were 'not similarly taxed'. It rejected Chile's request that it respect Chile's fiscal categories, refusing to confine its comparison to imported and domestic products within a single fiscal category. Rather, the Appellate Body applied the clear language of Article III(2), second sentence, finding that its comparison must be among all 'directly competitive or substitutable products', regardless of the domestic fiscal categories.[199] The Appellate Body considered '*all* the distilled alcoholic beverages in *each and every* fiscal category'.[200] The Appellate Body upheld the panel's finding that

---

[195] Appellate Body Report, para. 14.
[196] Appellate Body Report, para. 22.
[197] Appellate Body Report, para. 27, citing *Japan—Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/, WT/DS11/AB/R, adopted 1 November 1996; *Korea—Taxes on Alcoholic Beverages*, WT/DS75/AB/R, WT/DS84/AB/R, adopted 17 February 1999.
[198] Appellate Body Report, para. 48.
[199] Appellate Body Report, para. 52.
[200] *Ibid*, emphasis in original.

these goods were not similarly taxed within the meaning of *ad* Article III(2) of GATT 1994.

The Appellate Body also followed *Japan—Alcoholic Beverages* in its evaluation of whether the Chilean measure was applied 'so as to afford protection'. Here, the Appellate Body held that states are free to structure their tax systems as Chile had done, distinguishing beverages on the basis of alcohol content, so long as these classifications are not applied so as to protect domestic production.[201] The Appellate Body rejected consideration of the subjective intentions of legislators or regulators. Rather, the 'protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure.'[202] '[A] measure's purposes, objectively manifested in the design, architecture and structure of a tax measure, *are* intensely pertinent to the task of evaluating whether or not that measure is applied so as to afford protection to domestic production'.[203] Thus, the Appellate Body directs that attention be focused on a particular kind of evidence of intent. Given the evidence of a discriminatory structure, it was for Chile to present countervailing explanations.[204] The Appellate Body approved the panel's application of a kind of means-ends rationality test, implying that a necessity test might have exceeded the panel's authority under Article III(2).

The Appellate Body found that :

In practice . . . the New Chilean System will operate largely as if there were only two tax brackets: the first applying a rate of 27 per cent *ad valorem* which ends at the point at which most domestic beverages, by volume, are found, and the second applying a rate of 47 per cent *ad valorem* which begins at the point at which most imports, by volume, are found.[205]

However, this fact alone was not decisive as a basis for characterization of the Chilean system.

4. Conclusions

This decision provides a further articulation of the jurisprudence developed in Japan—Alcoholic Beverages and Korea—Alcoholic Beverages. It is notable for its extension of the critiques of domestic regulatory categories structured around types of beverages in the previous decisions to regulatory categories structured around alcohol content. It is also notable for its clarification of the role of legislative intent in decision-making under Article III. It is permissible to consider aim and effects, but only as evidenced by the actual structure of the measure.

Joel P. Trachtman

---

[201] Appellate Body Report, para. 60.
[202] Appellate Body Report, para. 62, quoting *Japan—Taxes on Alcoholic Beverages,* at 29.
[203] Appellate Body Report, para. 71.
[204] *Ibid.*
[205] Appellate Body Report, para. 66.