

JAPAN - TAXES ON ALCOHOLIC BEVERAGES

Report of the Panel

I. INTRODUCTION

1.1 On 21 June 1995, the European Communities (“the Community”) requested consultations with Japan under Article XXII of the General Agreement on Tariffs and Trade 1994 (“GATT”) concerning the internal taxes levied by Japan on certain alcoholic beverages pursuant to the Japan's Liquor Tax Law (WT/DS8/1). On 7 July 1995, pursuant to Article 4.11 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (“DSU”), the United States (WT/DS8/2) and Canada (WT/DS8/3) requested to be joined in these consultations. Japan accepted these requests on 19 July 1995 (WT/DS8/4).

1.2 On 7 July 1995, Canada requested consultations with Japan under Article XXII of GATT 1994 concerning certain Japanese liquor taxation laws (WT/DS10/1). On 17 July 1995, pursuant to Article 4.11 of the DSU, the United States (WT/DS10/2) and the Community (WT/DS10/3) requested to be joined in these consultations. Japan accepted these requests on 19 July 1995 (WT/DS10/4).

1.3 On 7 July 1995, the United States requested consultations with Japan under Article XXIII of GATT 1994 regarding internal taxes imposed by Japan on certain alcoholic beverages pursuant to the Liquor Tax Law (WT/DS11/1).

1.4 On 20 July 1995, the Community, Canada and the United States jointly held consultations with Japan with a view to reaching a mutually satisfactory resolution of the matter, but they were unable to reach such a resolution. On 21 July 1995, the United States and Japan consulted under Article XXIII:1, but they did not reach a mutually acceptable resolution of the matter.

1.5 On 14 September 1995, pursuant to Article XXIII:2 of GATT 1994 and Article 6 of the DSU, the Community requested the Dispute Settlement Body (“DSB”) to establish a panel with standard terms of reference (WT/DS8/5). The Community claimed that:

“a) Japan had acted inconsistently with Article III:2, first sentence, of GATT 1994 by applying a higher tax rate on the category of ‘spirits’ than on each of the two sub-categories of shochu, thereby nullifying or impairing the benefits accrued to the European Communities under GATT 1994; and that

b) Japan has acted inconsistently with Article III:2, second sentence, of GATT 1994 by applying a higher tax rate on the category of ‘whisky/brandy’¹ and on the category of ‘liqueurs’ than on each of the two sub-categories of shochu, thereby nullifying or impairing the benefits accrued to the European Communities under GATT 1994.

In the event that the liquors falling within the category of ‘spirits’ 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] further claimed that:

c) Japan has acted inconsistently with Article III:2, second sentence, of

¹In the present Panel report the use of the term “whisky” includes also the term “whiskey” as used in the case of Irish whiskey and Tennessee whiskey.

GATT 1994 by applying a higher tax rate on the category of 'spirits' than on each of the two sub-categories of shochu, thereby nullifying or impairing the benefits accrued to the European Communities under GATT 1994".

1.6 On 14 September 1995, pursuant to Article XXIII of GATT 1994 and Articles 4 and 6 of the DSU, Canada requested the DSB to establish a panel with standard terms of reference (WT/DS10/5). Canada claimed that:

" ... the higher rates of taxation on imported alcoholic beverages including whiskies, brandies, other distilled alcoholic beverages and liqueurs than on Japanese shochu imposed pursuant to the Japanese Liquor Tax Law are:

- a) inconsistent with Article III:1 and III:2 of GATT 1994;
- b) nullifying and impairing the benefits accruing to Canada pursuant to the WTO".

1.7 On 14 September 1995, pursuant to Article XXIII:2 of GATT 1994 and Articles 4 and 6 of the DSU, the United States requested the DSB to establish a panel with standard terms of reference (WT/DS11/2). The United States claimed that:

" ... the internal taxes imposed by Japan [pursuant to the Liquor Tax Law] on these beverages, and in particular the preferential tax treatment accorded to shochu, are inconsistent with Article III of GATT 1994, and otherwise nullify and impair benefits accruing to the United States under the GATT 1994".

1.8 At its meeting of 27 September 1995, pursuant to the first request of the three complaining parties and with Japan's acceptance, the DSB established a single panel with the mandate to examine the requests of the Community, Canada and the United States, all of which related to the same matter, in accordance with Article 9 of the DSU (WT/DSB/M/7).

1.9 During the 27 September 1995 meeting of the DSB, Norway reserved its right as a third party to the present dispute. However, on 7 November 1995, Norway informed the Panel of the withdrawal of its request to participate as a third party in the dispute (WT/DS8/7, DS10/7 and DS11/4).

1.10 At the same meeting of the DSB on 27 September 1995, the parties agreed that the Panel should have standard terms of reference as follows:

"To examine, in the light of the relevant provisions of the covered agreements cited by the EC, Canada and US in documents WT/DS8/5, WT/DS10/5, WT/DS11/2, the matters referred to the DSB by the EC, Canada and the United States in those documents and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements".

1.11 On 30 October 1995, the Panel was constituted with the following composition:

Chairman: Mr. Hardeep Puri
Panelists: Mr. Luzius Wasescha
Mr. Hugh McPhail

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).

1. Terminology and Definitions

The Liquor Tax Law defines liquors involved in the present disputes - shochu, whisky/brandy, spirits and liqueurs - as follows:²

“Article 3

Paragraph 5 ‘Shochu’ shall mean liquors produced by the distillation of alcohol containing substances. Included in this definition are those produced by adding water, sugar or other substances stipulated in government ordinances to the above-mentioned liquors. They must have an alcoholic strength of 45% vol or less. The liquor must be less than 36% vol in case distilled by a ‘continuous still’, the definition of which is as follows: a machine that removes fusel oil, aldehyde and other impurities during the process of continuous distillation. The definition of the type of sugar which can be added is given by government ordinances. In case produced by adding substances other than water, the extract of the product ought to be less than 2g/100 ml.

Note that those enumerated below from (a) through (d) do not fall under the definition of ‘shochu’.

(a) Liquors produced in whole or in part from malted cereals or fruit (including dried fruit or boiled-down or concentrated must, but excluding dates or other fruit as stipulated in government ordinances. The same shall apply hereafter).

²These definitions (translations from the Liquor Tax Law) were submitted by Japan.

(b) Liquors produced by filtering it through white birch charcoal or other substances specified in government ordinances.

(c) Liquors produced in whole or in part from saccharized substances (e.g. molasses, sugar, syrup and honey; excluding sugar as defined by government ordinances) and by the distillation at less than 95% vol.

(d) Liquors produced by flavouring alcohol by way of steeping ingredients of other substances during distillation.

Paragraph 9

‘Whisky/Brandy’ shall mean the following liquors on condition that those listed in (a), (b) and (d) be excluded in case covered by (b) through (d) of Paragraph 5:

(a) Liquors produced by distillation of alcohol containing substance derived by first saccharifying malted cereals and water and then fermenting them. The above- mentioned liquors must be distilled at less than 95% vol.

(b) Liquors produced by the distillation of alcohol containing substance derived by first saccharifying unmalted cereals with malted cereals and water and then fermenting them. The above mentioned liquors must be distilled at less than 95% vol.

(c) Liquors produced by adding alcohol, spirits, flavouring substance, colorants, or water to liquors mentioned in above (a) and (b). Excluded from this provision are those in which the aggregate of the alcoholic contents of the liquors mentioned in above (a) and (b) is less than ten hundredth (10/100) of those of the liquors resulted from the addition of the above enumerated substances.

(d) Liquors produced by the distillation of alcohol containing substance obtained by the fermentation of fruit / fruit and water, or by distillation of wine (including wine lees). The above mentioned liquors must be distilled at less than 95% vol.

(e) Liquors produced by adding alcohol, spirits, flavouring substance, colorants or water to liquors mentioned in above (d). Excluded from this provision are those in which the aggregate of the alcoholic contents of the liquors mentioned in above (d) is less than ten hundredth 10/100) of those of the liquors resulted from the addition of above enumerated substances.

Paragraph 10

‘Spirits’ shall mean liquors other than those as listed from Paragraphs 3 to 9, the extract of which must be less than 2g/100ml. ‘Spirits’ does not include sparkling liquors made in part from malt other than those produced by the distillation of alcohol-containing substances made partly from malt. The same

exclusion shall apply in the next paragraph.

Paragraph 11 ‘Liqueurs’ shall mean liquors made from liquors and other substances such as saccharide (including liquors, but excluding those as stipulated in the government ordinances), the extract of which is not less than 2g/100ml (excluding liquors as listed from Paragraphs 3 to 9), and sparkling liquors made in part from malt, as well as the powdered one which can be dissolved to make a beverage with an alcoholic strength of not less than 1% vol.

Article 4:

The liquors of the categories as listed in the left column of the following table shall be split into the sub-categories described in the mid-column thereof, and the definition of each sub-category shall be shown at the right-column thereof.”

Category	Sub-Category	Definition
Shochu	Shochu A	Shochu which are distilled with a continuous still
	Shochu B	Shochu other than Shochu A

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

2.4 A special formula is applied to determine the rate applicable to beverages having an alcohol content below 13 per cent or, in the case of “liqueurs”, below 12 per cent (as a general rule, pre-mixes combining a liquor with water or with other non-alcoholic beverages). This formula yields the result that the tax rate per litre of pure alcohol levied on these beverages is the same as the tax per litre of pure alcohol that would be borne by a liquor of the same category at the legal standard strength.

B. The 1987 Panel Report on Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages (“1987 Panel Report”)

2.5 In 1986, the Community requested consultations with Japan in respect of Japan's Liquor Tax Law, as it then existed. The consultations failed to resolve the matter and in 1987 a panel was established to consider, among others, the Community's claim that the Liquor Tax Law violated Article III:2.

2.6 As of 1987, the Liquor Tax Law divided the whisky/brandy category into whisky and brandy, and subdivided whisky into three grades, i.e., Special Grade, First Grade and Second Grade. The category shochu was sub-divided into Groups A and B. Specific tax rates were provided for each category and sub-category of alcoholic beverages. In addition, an *ad valorem* tax was applicable to *inter alia*, Special, First and Second Grade whiskies where the price exceeded a certain threshold. This tax was not applicable to either shochu group.

2.7 The 1987 Panel Report concluded that some aspects of the Liquor Tax Law were inconsistent with Article III:2, first and second sentences, and suggested that the CONTRACTING PARTIES recommend that Japan bring its taxes on whiskies, brandies, other distilled spirits (such as gin and vodka), liqueurs, still wines and sparkling wines into conformity with its obligations under the General Agreement. In particular, the Panel reached the following conclusions:

“5.5 ... The Panel concluded that the ordinary meaning of Article III:2 in its context and in the light of its object and purpose supported the past GATT practice of examining the conformity of internal taxes with Article III:2 by determining, firstly, whether the taxed imported and domestic products are ‘like’ or ‘directly competitive or substitutable’ and, secondly whether the taxation is discriminatory (first sentence) or protective (second sentence of Article III:2). The Panel decided to proceed accordingly also in this case.

5.6 ... The Panel found that the following alcoholic beverages should be considered as “like products” in terms of Article III:2 in view of their similar properties, end-uses and usually uniform classification in tariff nomenclatures: imported and Japanese-made *gin*; imported and Japanese-made *vodka*; imported and Japanese-made whisky (including all grades classified as ‘whisky’ in the Japanese Liquor Tax Law) and ‘spirits similar to whisky in colour, flavour and other properties’ as described in the Japanese Liquor Tax Law; imported and Japanese-made *grape brandy* (including all grades classified as ‘brandy’ in the Japanese Liquor Tax Law); imported and Japanese-made *fruit brandy* (including all grades classified as ‘brandy’ in the Japanese Liquor Tax Law); imported and Japanese-made ‘classic’ liqueurs (not including, for instance, medicinal liqueurs); imported and Japanese-made unsweetened *still wine*; imported and Japanese-made *sparkling wines*.

5.7 The Panel did not exclude that also other alcoholic beverages could be considered as ‘like’ products. Thus, even though the Panel was of the view that the ‘likeness’ of products must be examined taking into account not only objective criteria (such as composition and manufacturing processes of products) but also the more subjective consumers' viewpoint (such as consumption and use by consumers), the Panel agreed with the arguments submitted to it by the European Communities, Finland and the United States that Japanese shochu (Group A) and vodka could be considered as ‘like’ products in terms of Article III:2 because they were both white/clean spirits, made of similar raw materials, and their end-uses were virtually identical (either as straight ‘schnaps’ type of drinks or in various mixtures). Since consumer habits are variable in time and space and the aim of Article III:2 of ensuring neutrality of internal taxation as regards competition between imported and domestic like products could not be achieved if differential taxes could be used to crystallize consumer preferences for traditional domestic products, the Panel found that the traditional Japanese consumer habits with regard to shochu provided no reason for not considering vodka to be a “like” product. The Panel decided not to examine the ‘likeness’ of alcoholic beverages beyond the requests specified in the complaint by the European Communities (see ...). The Panel felt justified in doing so also for the following reasons: Alcoholic drinks might be drunk straight, with water, or as mixes. Even if imported alcoholic beverages (e.g. vodka) were not considered to be ‘like’ to Japanese alcoholic beverages (e.g. shochu Group A), the flexibility in the use of alcoholic drinks and their common characteristics often offered an alternative choice for consumers leading to a competitive relationship. In the view of the Panel there existed - even if not necessarily in respect of all the economic uses to which the product may be put - direct competition or substitutability among the various distilled liquors, among various liqueurs, among unsweetened and sweetened wines, and among sparkling wines. The increasing imports of ‘Western-style’ alcoholic beverages into Japan bore witness to this lasting competitive relationship and to the potential products substitution through trade among various alcoholic beverages.

Since consumer habits *vis-à-vis* these products varied in response to their respective prices, their availability through trade and their other competitive inter-relationships, the Panel concluded that the following alcoholic beverages could be considered to be ‘*directly competitive or substitutable products*’ in terms of Article III:2, second sentence:

- imported and Japanese-made distilled liquors, including all grades of whiskies/brandies, vodka and shochu Groups A and B, among each other;
- imported and Japanese-made liqueurs among each other;
- imported and Japanese-made unsweetened and sweetened wines among each other; and
- imported and Japanese-made sparkling wines among each other.

...

5.9 a) ... The Panel concluded ... that (special and first grade) whiskies/brandies imported from the EEC were subject to internal Japanese taxes ‘in excess of those applied ... to like domestic products’ (i.e. first and second grade whiskies/brandies) in the sense of Article III:2, first sentence.

b) ... The Panel concluded ... that ... the imposition of *ad valorem* taxes on wines, spirits and liqueurs imported from the EEC, which are considerably higher than the specific taxes on ‘like’ domestic wines, spirits and liqueurs, was inconsistent with Article III:2, first sentence.

...

d) ... The Panel concluded that this imposition of higher taxes on ‘classic’ liqueurs and sparkling wines with higher raw material content was inconsistent with Article III:2, first sentence.

...

5.11 The Panel recalled its findings that distilled liquors, including all grades of shochu types A and B, were ‘directly competitive or substitutable products’ in terms of the interpretative note to Article III:2 (see above paragraph 5.7). The Panel noted that shochu was not subject to *ad valorem* taxes and that the specific tax rates on shochu were many times lower than the specific tax rates on whiskies, brandies and other spirits. The Panel noted that, whereas under the first sentence of Article III:2 the tax on the imported product and the tax on the like domestic product had to be equal in effect, Article III:1 and 2, second sentence, prohibited only the application of internal taxes to imported or

domestic products in a manner 'so as to afford protection to domestic production'. The Panel was of the view that also small tax differences could influence the competitive relationship between directly competing distilled liquors, but the existence of protective taxation could be established only in the light of the particular circumstances of each case and there could be a *de minimis* level below which a tax difference ceased to have the protective effect prohibited by Article III:2, second sentence. The Panel found that the following factors were sufficient evidence of fiscal distortions of the competitive relationship between imported distilled liquors and domestic shochu affording protection to the domestic production of shochu:

- the considerably lower specific tax rates on shochu than on imported whiskies, brandies and other spirits ... ;
- the imposition of high *ad valorem* taxes on imported whiskies, brandies and other spirits and the absence of *ad valorem* taxes on shochu;
- the fact that shochu was almost exclusively produced in Japan and that the lower taxation of shochu did 'afford protection to domestic production' (Article III:1) rather than to the production of a product produced in many countries (say, butter) in relation to another product (say, oleomargarine, as in the example referred to by Japan in paragraph 3.11 above);
- the mutual substitutability of these distilled liquors, as illustrated by the increasing imports into Japan of 'Western-style' distilled liquors and by the consumer use of shochu blended in various proportions with whisky, brandy or other drinks.

Since it has been recognized in GATT practice that Article III:2 protects expectations on the competitive relationship between imported and domestic products rather than expectations on trade volumes (see L/6175, paragraph 5.1.9), the Panel did not consider it necessary to examine the quantitative trade effects of this considerably different taxation for its conclusion that the application of considerably lower internal taxes by Japan on shochu than on other directly competitive or substitutable distilled liquors had trade-distorting effects affording protection to domestic production of shochu contrary to Article III:1 and 2, second sentence.

...

5.13 ... The Panel noted the Japanese submission that, for instance, the grading system for whisky was 'based on the circumstances of production and consumption of whiskies in Japan', and that generally 'taxes on liquors are levied according to the tax-bearing ability on the part of consumers of each category of liquor'. The Panel was of the view that the use of product and tax

differentiations with the view of maintaining or promoting certain production and consumption patterns could easily distort price-competition among like or directly competitive products by creating price differences and price-related consumer preferences which would not exist in case of non-discriminatory internal taxation consistent with Article III:2. The Panel noted that the General Agreement did not make provision for such a far-reaching exception to Article III:2, and that the concept of “taxation according to tax-bearing ability of prospective consumers” of a product did not offer an objective criterion because it relied on necessarily subjective assumptions about future competition and inevitably uncertain consumer responses. The Panel was of the view that a national policy of ‘taxation according to tax-bearing ability’ did not necessitate discriminatory or protective taxation of imported products and could be pursued by each contracting party in many ways in compliance with Article III:2. A national policy of promoting the domestic production of certain goods could likewise be pursued in conformity with the General Agreement (*e.g.*, by means of production subsidies) without discriminatory or protective taxation of imported goods. The Panel concluded therefore from the text, system and objectives of the General Agreement that, even though each contracting party retained broad freedom as to its internal tax policy also in respect of its internal taxation of goods, the General Agreement did not provide for the possibility of justifying discriminatory or protective taxes inconsistent with Article III:2 on the ground that they had been introduced for the purpose of ‘taxation according to the tax-bearing ability’ of domestic consumers of imported and directly competitive domestic liquors.”³

2.8 On 2 February 1989, the Government of Japan informed the CONTRACTING PARTIES that the *ad valorem* tax and the grading system had been abolished, resulting in a single rate for all grades of whisky/brandies, and that the existing differences in taxation of whisky/brandies and shochu had been considerably reduced by decreasing the specific tax rate for whisky/brandies and raising that on shochu. According to Japan, these changes had been instituted “with a view to implementing the recommendations adopted by the GATT Council on 10 November 1987 on the basis of the panel report on the Japanese customs duties, taxes and labelling practices on imported wines and alcoholic beverages”.⁴ Also in 1989, an interim measure was introduced under the Special Taxation Measures Law to ease the adjustment pain for small scale manufacturers of shochu up to an annual ceiling of 1,300 kl. Under the measure which was to expire within 5 years, small producers are eligible for a 30 per cent reduction in the liquor tax they pay for the first 200 kl of the products they produce. On 1 May 1994, the Liquor Tax Law was further amended to raise tax rates on shochu and on spirits, while tax rates on whisky remained unchanged. The application of the interim measure under the Special Taxation Measures Law was also extended by 3 years at the same time.

³Panel Report on “Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages”, adopted on 10 November 1987, BISD 34S/83.

⁴Follow up on the panel report on “Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages”, communication by Japan dated 27 January 1989, circulated on 2 February 1989, GATT Document L/6465.

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.

3.2 **Canada** claimed that whisky is a “directly competitive and substitutable product” to both categories of “shochu”, that by applying a higher tax rate on the categories of whisky/brandy than on each of the two sub-categories of shochu, the Liquor Tax Law distorts the relative prices of whisky and shochu, that in so doing the Liquor Tax Law distorts consumer choice between these categories of alcoholic beverages and thus distorts their competitive relationship. Canada claimed that consequently, the Liquor Tax Law is inconsistent with Article III:2, second sentence, of GATT 1994.

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. The United States concluded that irrespective of the legal analysis the Panel adopts, the Liquor Tax Law should be found to be inconsistent with Article III:2.

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.

[Parties' arguments in Section IV deleted from this version]

V. INTERIM REVIEW

5.1 On 28 May 1996, Japan, United States and Canada requested the Panel to review, in accordance with Article 15.2 of the DSU, precise aspects of the interim report that had been issued to the parties on 20 May 1996; Japan and the United States requested the Panel to hold a meeting for that purpose. The Panel met with the parties on 6 June 1996 to hear their arguments concerning the interim report. The Panel carefully reviewed the arguments presented by the parties.

5.2 In approaching the interim review stage, the Panel drew guidance from Article 15.2 DSU which states that “a party may submit a written request for the panel to review precise aspects of the interim report prior to circulation of the final report to the Members”. Whilst the Panel was willing to approach the interim review stage with the broadest possible interpretation of Article 15.2 DSU, it was of the view that the purpose of the review meeting is not to provide the parties with an opportunity to introduce new legal issues and evidence, or to enter into a debate with the Panel. In the view of the Panel, the purpose of the interim review stage is to consider specific and particular aspects of the interim report. Consequently, the Panel addressed the entire range of such arguments presented by the parties which it considered to be sufficiently specific and detailed.

5.3 The United States submitted to the Panel and the parties at the review meeting copies of press reports relating to the interim report. After a brief discussion on the need to maintain confidentiality, the Panel appealed and all parties to the dispute agreed, on the utmost importance of maintaining confidentiality so as to preserve the credibility and integrity of the dispute settlement process.

5.4 With respect to the legal status of adopted panel reports, the United States argued that nothing in GATT 1994 modified the status they had enjoyed under GATT 1947 and that they thus should not be considered as subsequent practice in the sense of Article 31 of the Vienna Convention on the Law of the Treaties (VCLT). The Panel drew the attention of the United States to paragraph 6.10 of the report. In order to clarify its position, the Panel introduced some drafting modifications in the panel report.

5.5 In respect of the discussion of Article III:2 in the interim report, both Japan and the United States argued that the Panel should not have rejected their approach according to which the benchmark to evaluate whether domestic legislation is in breach of the obligations contained in Article III:2 is the aim-and-effect test that they felt had its basis in the phrase “so as to afford protection” in Article III:1. The Panel took note of the arguments of the United States and Japan which had been the subject of detailed and serious considerations throughout its deliberations, but for the reasons spelled out in paragraph 6.11ff. the Panel decided not to take any further action in this respect.

5.6 Japan argued that with respect to Article III:2, the Panel's overall approach would lead to findings of violations of Article III:2 by virtually all tax distinctions. The Panel could not subscribe to Japan's position. The Panel reiterated that its task was circumscribed by its terms of reference which required it to review the consistency of the Japanese taxation system with respect to certain alcoholic beverages *vis-à-vis* Japan's obligation under Article III:2. The Panel consequently limited its conclusions to the subject-matter circumscribed by its terms of reference.

5.7 In respect of the Panel's discussion on "like products", Japan argued that under the Harmonized System (HS) nomenclature shochu and vodka no longer appear under the same heading. The Panel took note of the statement and, whilst not sharing the legal conclusion by Japan, the Panel proceeded to make certain drafting changes in paragraph 6.22 in order to clarify its point of view.

5.8 Japan argued that the tax/price ratio for domestic shochu A is higher than that for imported vodka, and, consequently, shochu A should be excluded from the Panel's finding in paragraph 6.27 that Japan violated its obligation under Article III:2, first sentence. The Panel did not share this opinion but felt that it should further explain its position. The additional discussion by the Panel of this point is reflected in paragraph 6.25.

5.9 In respect of the distinction between "like products" on the one hand, and, "directly competitive or substitutable products" on the other, the United States argued that the Panel did not offer any clear distinguishing criteria between the two categories. In response, the Panel expanded its analysis of this distinction in paragraph 6.23.

5.10 The United States argued that the Panel did not offer any useful criteria concerning the interpretation of the term "dissimilar taxation" that the Panel uses in the report. More particularly, the United States argued that the Interpretative Note ad Article III, second paragraph, contained language that could be considered as a necessary condition in order to establish a violation of Article III:2, second sentence, but that it was questionable whether the same language could be considered as sufficient for the same purpose. The Panel added language in paragraph 6.33 to address this argument.

5.11 Japan argued that the complainants did not offer any evidence on liqueurs and that, consequently, liqueurs should be excluded from the findings in paragraph 6.33 that Japan violated its obligations under Article III:2, second sentence. The Panel was not persuaded by the arguments advanced by Japan but added language in paragraph 6.28 in order to clarify the Panel's position.

5.12 The United States argued that the Panel's analysis of the phrase "directly competitive or substitutable products" established a requirement to show adverse trade effects as a condition for establishing a violation of Article III. The Panel added language in paragraph 6.33 to make it clear that it follows the reasoning and the conclusions of previous panel reports on this issue and that the Panel felt that there is no need to examine trade effects in the context of Article III, since Article III deals with conditions of competition. A factual determination of whether two products are directly competitive or substitutable is a necessary precondition in order to apply

the legal test of dissimilar taxation. In the Panel's view, this determination takes place in the marketplace and does not mean at all that Article III has been made subject to an effects test.

5.13 Japan requested the Panel to suggest specific ways to bring its measures into compliance with its obligations under Article III:2. The Panel recalled its recommendation in paragraph 7.2, which is consistent with Article 19 DSU, that Japan bring its measures into compliance with the provisions of Article III:2.

5.14 With regard to some other issues raised by the United States, the Panel recalled that the only panel report that contains an analysis of "like products" similar to that of 1992 Malt Beverages is an unadopted panel report that had followed the same reasoning. The Panel also recalled its findings in paragraph 6.21 where it stated that a product's description in a tariff binding is an "important criterion for confirming likeness" and that "this does not mean that the determination of whether products are 'like' should be based exclusively on the definition of products for tariff bindings".

5.15 Japan, the United States and Canada made a number of suggestions concerning language changes that the Panel accepted and introduced in its final report.

5.16 In respect of the interim report's descriptive section, Japan suggested further changes which the Panel took into account in re-examining that part of the report. The Panel revised the descriptive section of the final report where it accepted the need for these changes.

VI. FINDINGS

A. Claims of the Parties

6.1 The Community requests the Panel to find that vodka, gin, (white) rum, genever and shochu are like products and that Japan, by taxing the other four products in excess of shochu violates Article III:2, first sentence. In the event that the Panel does not find the aforementioned products to be like products, the Community requests the Panel to find that they are directly competitive and substitutable products and that Japan, by taxing vodka, gin, (white) rum and genever higher than shochu has failed to observe its obligations under Article III:2, second sentence. The Community further requests the Panel to find that whisky, brandy, liqueurs and shochu are directly competitive and substitutable products and that Japan, by taxing the first three products higher than the latter, violates its obligations under Article III:2, second sentence.

6.2 Canada requests the Panel to find that whisky, brandy, other distilled alcoholic beverages, and liqueurs on the one hand, and shochu, on the other, are directly competitive and substitutable products and that Japan by taxing the former higher than the latter violates its obligations under Article III:2, second sentence.

6.3 The United States requests the Panel to find that white and brown spirits are like products in the sense of Article III:2, first sentence, and, therefore, that the difference in tax

treatment by Japan between shochu and vodka, gin, rum and other white spirits, as well as whisky, brandy and other brown spirits, is inconsistent with Article III:2, first sentence. If the Panel is not able to make such a finding, the United States request, 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 products in terms of Article III:2, second sentence. In the latter case, the United States requests the Panel to find that the difference in taxation by Japan under its Liquor Tax Law in favour of shochu materially alters the conditions of competition between shochu and other distilled spirits and that Japan thus violates its obligations under Article III:2, second sentence. The United States further claims that the small-volume producer exemption from excise taxes provided under Japan's Taxation Special Measures Law is limited to Japanese producers and that Japan thus fails to respect its obligations under Article III:2, first sentence.

6.4 Japan requests the Panel to find that its taxation system does not violate Article III. Japan claims 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. Japan further argues that 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 or substitutable products” to shochu, within the meaning of Article III:2, second sentence. Finally, Japan requests the Panel to reject the claim by the United States with respect to its Taxation Special Measures Law because it lies outside the terms of reference of the Panel.

B. Preliminary Finding

6.5 The Panel first turned to the United States' claim with respect to the Japanese Taxation Special Measures Law. The Panel noted that Japan argued that the claim of the United States is not part of the terms of reference of the Panel. The Panel further noted that its terms of reference, following from Articles 7 and 11 DSU, are circumscribed in WT/DS8/6, WT/DS10/6 and WT/DS11/3. The Panel noted that no mention of the Japanese Taxation Special Measures Law is included in WT/DS8/6, WT/DS10/6 and WT/DS11/3. The Panel concluded that its terms of reference do not permit it to entertain the claim of the United States with respect to the Japanese Taxation Special Measures Law and it proceeded, therefore, to examine the other claims.

C. Main Findings

6.6 The Panel noted that the complainants are essentially claiming that the Japanese Liquor Tax Law is inconsistent with GATT Article III:2 (hereinafter “Article III:2”). Article III:2 reads:

“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*.”⁷⁹

GATT Article III:1 (hereinafter “Article III:1), which is referred to in Article III:2, reads:

“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*.”⁸⁰

In addition, the Panel noted that there is an Interpretative Note ad Article III, Paragraph 2, which is relevant to this case. The Note reads:

“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 Panel noted that the Interpretative Note ad Article III, Paragraph 2, is contained in Annex I to GATT 1994. The Panel noted, in this respect, that Article XXXIV of GATT 1994 provides:

“The annexes to this Agreement are hereby made an integral part of this Agreement”.

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

⁷⁹The asterisk in Article III:2 refers to the Interpretative Note ad Article III, Paragraph 2 that is quoted infra.

⁸⁰The asterisk in Article III:1 refers to the Interpretative Note ad Article III, Paragraph 1 that is not quoted because it refers to an unrelated issue.

have previously interpreted the GATT in accordance with the VCLT.⁸¹ The Panel 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.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
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.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32 Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order

⁸¹See, 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 Conventional Gasoline”, WT/DS2/AB/R, adopted on 20 May 1996.

to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable”.

6.9 Consequently, the Panel concluded that the starting point of an interpretation of an international treaty, such as the General Agreement on Tariffs and Trade 1994, in accordance with Article 31 VCLT, is the wording of the treaty. The wording should be interpreted in its context and in the light of the object and the purpose of the treaty as a whole and subsequent practice and agreements should be taken into account. Recourse to supplementary means of interpretation should be made exceptionally only under the conditions specified in Article 32 VCLT. The Panel noted that none of the parties to the present dispute argued that recourse to supplementary means of interpretation was necessary.

6.10 In this respect, the Panel noted that no formal subsequent agreement as to the interpretation of Article III:2 exists among the WTO Members. The Panel noted that other GATT and WTO panels have interpreted Article III and that panel reports adopted by the 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”. The Panel noted that Article 1(b)(iv) does not provide a hierarchy among “other decisions of the CONTRACTING PARTIES to GATT 1947”. Moreover, the Panel noted that the panel report on “European Economic Community - Restrictions on Imports of Dessert Apples - Complaint by Chile”⁸² (hereinafter “the 1989 Panel”) had concluded that:

“...It would take into account the 1980 Panel report and the legitimate expectations created by the adoption of this report, but also other GATT practices and panel reports adopted by the CONTRACTING PARTIES and the particular circumstances of this complaint. The Panel, therefore, did not feel it was legally bound by all the details and legal reasoning of the 1980 Panel report”.

As a consequence, the 1989 Panel independently examined whether certain EEC measures restricted the marketing of products and reached a different conclusion than had the 1980 Panel.⁸³ In light of the foregoing, 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

⁸²Panel report adopted on 22 June 1989, BISD 36S/93, para. 12.1.

⁸³See the panel report on “EEC - Restrictions on Imports of Apples from Chile”, adopted on 10 November 1980, BISD 27S/98.

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. Article III

6.11 The Panel proceeded on the basis of the interpretative rule of the VCLT by turning first to the wording of Article III:2. The Panel noted that Article III:2 is concerned with two different factual situations: Article III:2, first sentence, is concerned with the treatment of like products, whereas Article III:2, second sentence, is concerned with the treatment of directly competitive or substitutable products, i.e., products other than like products, since no mention of like products is made in Article III:2, second sentence. In the Panel's view, the inclusion of the words “moreover” and “otherwise” in the second sentence of Article III:2 makes this point clear. The Interpretative Note ad Article III:2 further clarifies this distinction by providing an example where the first sentence of Article III:2 is not violated whereas the second is, thus confirming the existence of two distinct obligations in Article III:2.

6.12 The Panel, having established the basis for interpretation of Article III:2, turned to an examination of its elements. 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 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.

6.13 The Panel then turned to other contextual elements that have to be taken into account, as required by Article 31 VCLT. The Panel noted in this respect the relationship between Articles II and III of GATT 1994. The Panel concluded, as had previous panels that dealt with the same issue, 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. The Panel noted in this respect that an adopted panel report that had dealt with this issue had stated that:

“... one of the basic purposes of Article III was to ensure that the contracting parties' internal charges and regulations were not such as to frustrate the effect of tariff concessions granted under Article II ...”⁸⁴

The Panel further took note of the fact that another adopted panel report concluded on the same issue that:

“...The most-favoured-nation requirement in Article I, and also tariff bindings under Article II, would become ineffective without the complementary prohibition in Article III on the use of internal taxation and regulation as a discriminatory non-tariff trade barrier”⁸⁵.

3. Article III:2, First Sentence

a) Overview

6.14 In light of the foregoing, the Panel then proceeded to an analysis of how the legal obligations imposed by Article III:2, first sentence, should be interpreted. In this context, the Panel recalled the divergent views of the parties to the dispute: the Panel noted that, with respect to like products, the Community essentially argued in favour of a two-step procedure whereby the Panel should establish first whether the products in question are like and, if so, then proceed to examine whether taxes imposed on foreign products are in excess of those imposed on like domestic products. The Community had stated that physical characteristics of the products concerned, their end-uses, as well as consumer preferences could provide relevant criteria for the Panel to judge whether the products concerned were like. The Panel noted in this respect, that complainants have the burden of proof to show first, that products are like and second, that foreign products are taxed in excess of domestic ones.

6.15 The Panel further took note of the statements by Japan that essentially argued that the Panel should examine the contested legislation in the light of its aim and effect in order to determine whether or not it is consistent with Article III:2. According to this view, in case the aim and effect of the contested legislation do not operate so as to afford protection to domestic production, no inconsistency with Article III:2 can be established. The Panel further took note of the statement by the United States that essentially argued that, in determining whether two products that were taxed differently under a Member's origin-neutral tax measure were nonetheless “like products” for the purposes of Article III:2, the Panel should examine not only the similarity in physical characteristics and end-uses, consumer tastes and preferences, and tariff classifications for each product, but also whether the tax distinction in question was “applied ... so as to afford protection to domestic production”: that is, whether the aim and effect of that distinction, considered as a whole, was to afford protection to domestic production. According to this view, if the tax distinction in question is not being applied so as

⁸⁴See the panel report on “Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies”, adopted on 18 February 1992, BISD 39S/27, paras. 5.30 - 5.31.

⁸⁵See the panel report on “United States - Measures Affecting Alcoholic and Malt Beverage”, adopted on 19 June 1992, BISD 39S/206, para. 5.9 (the “1992 Malt Beverages” report). See also the discussion in para. 6.21.

to afford protection to domestic production, the products between which the distinction is drawn are not to be deemed “like products” for the purpose of Article III:2. The Panel noted that the United States and Japan reached opposite results by applying essentially the same test. Japan concluded that its legislation did not have the aim or effect of affording protection, while the United States concluded that the categorization made in that legislation did have such an aim and effect. Lastly in this context, the Panel noted that the United States also argued that independently of the legal test chosen and applied, the Panel should find that Japan in this case is in violation of its obligations under Article III:2. It was also the view of Japan that independently of the legal test chosen and applied, the Panel should find that Japan is not in violation of its obligations under Article III:2.

6.16 The Panel first turned to the test proposed by Japan and the United States. The Panel noted, in this respect, 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:1.⁸⁶ 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. The Panel also noted that very often there is a multiplicity of aims that are sought through enactment of legislation and it would be a difficult exercise to determine which aim or aims should be determinative for applying the aim-and-effect test.⁸⁷ Moreover, access to the complete legislative history, which according to the arguments of the parties defending the aim-and-effect test, is relevant to detect protective aims, could be difficult or even impossible for a complaining party to obtain. Even if the complete legislative history is available, it would be difficult to assess which kinds of legislative history (statements in legislation, in official legislative reports, by individual legislators, or in hearings by interested parties) should be primarily determinative of the aims of the legislation.⁸⁸ The Panel recalled in this respect the argument by the United States that the aim-and-effect test should be applicable only with respect to origin-neutral measures. The Panel noted that neither the wording of Article III:2, nor that of Article III:1 support a distinction between origin-neutral and origin-specific

⁸⁶See paras. 4.16 - 4.19 and 4.24ff. of the Descriptive Part.

⁸⁷The Panel noted, in this respect, an interesting parallel with the legal status of “supplementary means” of interpretation of treaties -- that comprise preparatory work -- and their relevance for interpreting treaties. The Panel noted that according to Article 32 VCLT recourse to supplementary means of interpretation is required only as an exception in specific circumstances. The Panel noted in this respect the commentary of the International Law Commission: “The Commission considered that the exception must be strictly limited, if it is not to weaken unduly the authority of the ordinary meaning of the terms.” The Panel further noted the statement of the International Law Commission that “...the preparatory work...does not, in consequence, have the same authentic character as an element of interpretation, however valuable it may sometimes be in throwing light in the expression of the agreement in the text. Moreover, it is beyond question that the records of treaty negotiations are in many cases incomplete or misleading, so that considerable discretion has to be exercised in determining their value as an element of interpretation. D. Rauschnig and R.G. Wetzel, *The Vienna Convention on the Law of Treaties*, *Travaux Préparatoires* (Frankfurt: Alfred Metzner Verlag, 1978), pp. 255, 252. The Panel noted that considerable differences exist between preparatory work of international treaties and preparatory work of domestic legislation that preclude the automatic transposition of the reasoning of the International Law Commission to the case before it. Nevertheless, in the Panel's view, the analysis and reasoning of the International Law Commission could be relevant even in the context of preparatory work of domestic legislation.

⁸⁸See para. 4.17 of the Descriptive Part.

measures.

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.⁸⁹ The purpose of Article XX is to provide a list of exceptions, subject to the conditions that they “are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction of international trade”, that could justify deviations from the obligations imposed under GATT. Consequently, in principle, a WTO Member could, for example, invoke protection of health in the context of invoking the aim-and-effect test. The Panel noted that if this were the case, then the standard of proof established in Article XX would effectively be circumvented. WTO Members would not have to prove that a health measure is “necessary” to achieve its health objective.⁹⁰ 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.⁹¹ In sum, the Panel concluded that for reasons relating to the wording of Article III as well as its context, the aim-and-effect test proposed by Japan and the United States should be rejected.

6.18 The Panel turned at this point to the relevance of the two GATT panel reports that, according to the arguments of Japan and the United States, have espoused the aim-and-effect test. With respect to the panel report on “United States - Taxes on Automobiles” (US Auto Taxes)⁹², the Panel noted that the report remains unadopted and that, for the reasons stated in paragraph 6.10, it did not have to take it into account since it does not constitute subsequent practice. At any rate, for the reasons mentioned in paragraphs 6.16 and 6.17, the Panel was not persuaded by the reasoning contained in the panel report on US Auto Taxes. With respect to the 1992 Malt Beverages report, the Panel first noted that it interpreted the term “like product” as it appears in Article III:2 in a manner largely consistent with the interpretation of the 1987 Panel Report that had previously interpreted the same term. The Panel noted that the 1992 Malt Beverages report, when interpreting the term “like product”, took into account the product's end-uses, consumer tastes and habits, and the product's properties, nature and quality. However, the 1992 Malt Beverages report also considered whether product differentiation is being made “so as to afford protection to domestic production”.⁹³ The Panel was not in a position to detect how the 1992 Malt Beverages panel weighed the different criteria that it took into account in order to determine whether the products in dispute were like. In the Panel's view, however, an interpretation of the term “like product” as it appears in Article III:2, first

⁸⁹In 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.

⁹⁰See, for example, the panel report on “Thailand - Restrictions on Importation of and Internal Taxes on Cigarettes”, adopted on 7 November 1990, BISD 37S/200.

⁹¹See para. 4.32 of the Descriptive Part.

⁹²DS31/R, report dated 11 October 1994.

⁹³See the 1992 Malt Beverages report, paras. 5.25 - 5.26.

sentence, that conditions likeness on the criterion whether a domestic legislation operates so as to afford protection to domestic production, is inconsistent with the wording of Article III:2, first sentence. The Panel recalled its conclusions reached in this respect in paragraphs 6.16 and 6.17. For this reason, the Panel decided not to follow the interpretation of the term “like product” as it appears in Article III:2, first sentence, advanced by the 1992 Malt Beverages report in so far as it incorporates the aim-and-effect test.

6.19 The Panel, having decided not to apply the aim-and-effect test proceeded to develop the legal test that it would apply in this case in order to determine whether Japan had acted inconsistently with its obligations under Article III. More specifically, in the view of the Panel, the wording of Article III:2, first sentence, requires it to make three determinations: (i) whether the products concerned are like, (ii) whether the contested measure is an “internal tax” or “other internal charge” (not an issue in this case) and (iii) if so, whether the tax imposed on foreign products is in excess of the tax imposed on like domestic products. If these three determinations are in the affirmative, such a tax would result in the WTO Member imposing it being in violation of the obligation contained in Article III:2, first sentence. Moreover, in the Panel's view, the only relevant contextual elements supported this interpretation. The Panel recalled in this respect its conclusions reached in paragraph 6.12 concerning the limited relevance of Article III:1 to the interpretation of Article III:2. The Panel further recalled that past GATT panels had followed this approach.⁹⁴ Thus, the Panel decided to proceed on the basis outlined in this paragraph.

⁹⁴See for example, the panel report on “United States - Taxes on Petroleum and Certain Imported Substances”, adopted on 17 June 1987, BISD 34S/136; the 1987 Panel Report; see also the panel report on “United States - Standards for Reformulated and Conventional Gasoline”, WT/DS2/R, adopted on 20 May 1996.

b) Like Products

6.20 The Panel noted that the term “like product” appears in various GATT provisions. The Panel further noted that it did not necessarily follow that the term had to be interpreted in a uniform way. In this respect, the Panel noted the discrepancy between Article III:2, on the one hand, and Article III:4 on the other: while the former referred to Article III:1 and to like, as well as to directly competitive or substitutable products (see also Article XIX of GATT), the latter referred only to like products. If the coverage⁹⁵ 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. This is precisely why, in the Panel's view, its conclusions reached in this dispute are relevant only for the interpretation of the term “like product” as it appears in Article III:2.

⁹⁵By the term “coverage”, the Panel means whether Article III:4 regulates the treatment of both categories of products mentioned in Article III:2, namely both “like” and “directly competitive or substitutable” products.

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.⁹⁶ 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.⁹⁷ 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. This approach is dictated, in the Panel's view, by two independent reasons: (i) because Article III:2 distinguishes between like and directly competitive or substitutable products, the latter obviously being a much larger category of products than the former; and (ii) because of the Panel's conclusions reached with respect to the relationship between Articles III and II. As to the first point, the distinction between “like” and “directly competitive or substitutable products” is discussed in paragraph 6.22. As to the second point, as previous panels had noted, one of the main objectives of Article III:2 is to ensure that WTO Members do not frustrate the effect of tariff concessions granted under Article II through internal taxes and other internal charges, it follows that a parallelism should be drawn in this case between the definition of products for purposes of Article II tariff concessions and the term “like product” as it appears in Article III:2. This is so in the Panel's view, because 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 does not mean that the determination of whether products are “like” should be based exclusively on the definition of products for tariff bindings, but in the Panel's view, especially where it is sufficiently detailed, a product's description for this purpose is in this case an important criterion for confirming likeness for the purposes of Article III:2. The Panel noted that its proposed interpretation does not unduly restrict the possibility offered to WTO Members to challenge internal taxes that discriminate against foreign products, since Article III:2, second sentence, effectively prohibits the taxation of “directly competitive or substitutable products” “so as to afford protection to domestic production”. As explained in the next paragraph, the phrase “directly competitive or substitutable products”, should be interpreted more broadly than the phrase “like products”. In the Panel's view, its interpretation of Article III:2, first sentence, is in accordance with the requirements of Article 31 VCLT.

⁹⁶See, 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.

⁹⁷See 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.

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. Such an approach is in conformity with the principle of “effective treaty interpretation” as laid down in the “general rule of interpretation” of the Vienna Convention on the Law of Treaties. The Panel recalled in this respect the conclusions of the Appellate Body in its report on “United States - Standards for Reformulated and Conventional Gasoline” where it stated that “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.”⁹⁸ In the view of the Panel, like products should be viewed as a subset of 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. Giving a narrow meaning to “like products” is also justified by the inescapability of violation in case of taxation of foreign products in excess of like domestic products⁹⁹. Moreover, in the Panel’s view, the wording makes it clear that the appropriate test to define whether two products are “like” or “directly competitive or substitutable” is the marketplace. The Panel recalled in this respect the words used in the Interpretative Note ad Article III, paragraph 2, namely “where competition exists”: competition exists by definition in markets. 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. The Panel recalled, in this respect, that previous panels had pronounced in favour of a case-by-case approach when defining like or directly competitive or substitutable products.¹⁰⁰ In the view of the Panel, descriptions used in the context of tariff classifications and bindings whilst by themselves not providing decisive guidance on likeness, can be used nevertheless in considering the content of “like products” in the context of Article III:2, first sentence. Such an approach is in line with previous panel reports that concluded that the purpose of Article III was to avoid that “the value of the bindings under Article II of the Agreement and of the general rules of non-discrimination as between imported and domestic products could be easily evaded.”¹⁰¹ Previous panels that dealt with the same issue have used a series of criteria in order to define likeness or substitutability.¹⁰² In the view of the Panel, the wording of the term “directly competitive or substitutable” does not suggest at all that physical resemblance is required in order to establish whether two products fall under this category. This impression, in the Panel’s view, was further supported by the words “where competition exists” of the Interpretative Note; competition can and does exist among products that do not necessarily share the same physical characteristics. 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

⁹⁸See WT/DS2/AB/R, at p.23.

⁹⁹The panel report on “United States - Taxes on Petroleum and Certain Imported Substances”, op. cit., at para. 5.1.9 made it clear that no *de minimis* defense can be raised in case of taxation of foreign products in excess of domestic like products. The Panel agreed with this statement.

¹⁰⁰See footnote 96 and accompanying text.

¹⁰¹See the panel report on “Italian Discrimination Against Imported Agricultural Machinery”, adopted on 23 October 1958, BISD 7S/60 at p.64, para. 15; see also the 1987 Panel Report op. cit.

¹⁰²See footnote 96 and accompanying text.

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. In the Panel’s view, the suggested approach can guarantee the flexibility required, since it permits one to take into account specific characteristics in any single market; consequently, two products could be considered to be directly competitive or substitutable in market A, but the same two products would not necessarily be considered to be directly competitive or substitutable in market B. The Panel proceeded to apply this approach to the products in dispute in the present case.

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, except for filtration, there is virtual identity in the definition of the two products. The Panel noted that a difference in the physical characteristic of alcoholic strength of two products did not preclude a finding of likeness especially since alcoholic beverages are often drunk in diluted form. The Panel then noted that essentially the same conclusion had been reached in the 1987 Panel Report, which

“... agreed with the arguments submitted to it by the European Communities, Finland and the United States that Japanese shochu (Group A) and vodka could be considered as 'like' products in terms of Article III:2 because they were both white/clean spirits, made of similar raw materials, and the end-uses were virtually identical”.¹⁰³

¹⁰³Para. 5.7. The same paragraph further reads: “... the Panel found that the traditional Japanese consumer habits with regard to shochu provided no reason for not considering vodka to be a 'like' product. ... Even if imported alcoholic beverages (e.g vodka) were not considered to be 'like' to Japanese alcoholic beverages (e.g shochu Group A), the flexibility in the use of alcoholic drinks and their common characteristics often offered an alternative choice for consumers leading to a competitive relationship.

Following its independent consideration of the factors mentioned in the 1987 Panel Report, the Panel agreed with this statement. The Panel then recalled its conclusions concerning the relationship between Articles II and III. In this context, it noted that (i) vodka and shochu were currently classified in the same heading in the Japanese tariffs, (although under the new Harmonized System (HS) Classification that entered into force on 1 January 1996 and that Japan plans to implement, shochu appears under tariff heading 2208.90 and vodka under tariff heading 2208.60); and (ii) vodka and shochu were covered by the same Japanese tariff binding at the time of its negotiation. Of the products at issue in this case, only shochu and vodka have the same tariff applied to them in the Japanese tariff schedule (see Annex 1). The Panel noted that, with respect to vodka, Japan offered no further convincing evidence that the conclusion reached by the 1987 Panel Report was wrong, not even that there had been a change in consumers' preferences in this respect. The Panel further noted that Japan's basic argument is not that the two products are unlike, in terms of the criteria applied in the 1987 Panel Report, but rather that they are unlike because the Japanese tax legislation does not have the aim and effect to protect shochu. The Panel noted, however, that it had already rejected the aim-and-effect test. Consequently, in light of the conclusion of the 1987 Panel Report and of its independent consideration of the issue, the Panel concluded that vodka and shochu are like products. 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 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. The Panel lastly noted that the 1987 Panel Report had also considered these products only under Article III:2, second sentence.

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

6.24 The Panel then proceeded to examine whether vodka is taxed in excess of the tax imposed on shochu under the Japanese Liquor Tax Law. The Panel noted that what was contested in the Japanese legislation was a system of specific taxes imposed on various alcoholic drinks. In this respect, 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.¹⁰⁴ The Panel further noted that Article III:2 does not contain any presumption in favour of a specific mode of taxation. Under Article III:2, first sentence, WTO Members are free to choose any system of taxation they deem appropriate provided that they do not impose on foreign products taxes in excess of those imposed on like domestic products. The phrase “not in excess of those applied ... to like domestic products” should be interpreted to mean at least identical or better tax treatment. 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.¹⁰⁵ 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.

¹⁰⁴See para. 2.3 of the Descriptive Part for a complete description of the Japanese liquor tax rates.

¹⁰⁵See para. 4.132ff. of the Descriptive Part.

(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 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 record¹⁰⁶ 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.¹⁰⁷

(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.

6.26 The Panel then turned to the arguments put forward by Japan concerning taxation systems in other countries. The Panel noted that its terms of reference were strictly confined to the Japanese legislation. The Panel could not, therefore, consider the domestic taxation systems of other countries since they lie outside its terms of reference.

6.27 Consequently, the Panel concluded that, by taxing vodka in excess of shochu, Japan is in violation of its obligation under Article III:2, first sentence.

4. Article III:2, Second Sentence

a) Directly Competitive or Substitutable Products

¹⁰⁶See paras. 4.100, 4.142-4, 4.159, 4.160-1 of the Descriptive Part.

¹⁰⁷See paras. 4.100, 4.159, 4.160 and 4.165 of the Descriptive Part.

6.28 The Panel then turned to an analysis of the issues arising under Article III:2, second sentence. In the view of the Panel, the wording of Article III:2, second sentence, requires it to make two determinations: (i) whether the products concerned (whisky, brandy, gin, genever, rum and liqueurs) are directly competitive or substitutable, and (ii) if so, whether the treatment afforded to foreign products is contrary to the principles set forth in paragraph 1 of Article III. In the view of the Panel, the complainants have the burden of proof to show first, that the products concerned are directly competitive or substitutable and second, that foreign products are taxed in such a way so as to afford protection to domestic production. The Panel recalled that the term “directly competitive or substitutable product”, in accordance with its ordinary meaning, should be interpreted more broadly than the term “like product”. In this sense the Interpretative Note ad Article III:2, second sentence, speaks about products “where competition was involved between...” them. The Panel noted, in this respect, that independently of similarities with respect to physical characteristics or classification in tariff nomenclatures, greater emphasis should be placed on elasticity of substitution. In this context, factors like marketing strategies could also prove to be relevant criteria, since what is at issue is the responsiveness of consumers to the various products offered in the market. Such responsiveness, the Panel recalled, may vary from country to country,¹⁰⁸ but should not be influenced or determined by internal taxation.¹⁰⁹ The Panel noted the conclusions in the 1987 Panel Report,¹¹⁰ that a tax system that discriminates against imports has the consequence of creating and even freezing preferences for domestic goods. In the Panel’s view, this meant that consumer surveys in a country with such a tax system would likely understate the degree of potential competitiveness between substitutable products.

¹⁰⁸See the 1970 Working Party report, op. cit., at para. 18.

¹⁰⁹In this respect, note para. 5.7 of the 1987 Panel Report “since consumer habits are variable in time and space and the aim of Article III:2 of ensuring neutrality of internal taxation as regards competition between imported and domestic like products could not be achieved if differential taxes could be used to crystallize consumer preferences for traditional domestic products, the Panel found that the traditional Japanese consumer habits with regard to shochu provided no reason for not considering vodka to be a like product”. (emphasis added).

¹¹⁰See the 1987 Panel Report, op. cit., at para. 5.9.

6.29 In examining whether the products at issue were directly competitive or substitutable, the Panel first noted that the 1987 Panel Report that dealt with this issue concluded that both “white” and “brown” spirits were directly competitive or substitutable products to shochu, according to Article III:2, second sentence. The Panel noted in this respect, that the 1987 Panel Report had reached its conclusion based essentially on the substitutability among the products in dispute as a result of “their respective prices, their availability through trade and their other competitive inter-relationships”.¹¹¹ 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.¹¹² 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. At best, the argument by Japan, if proven, could eventually lead to the conclusion that the three products mentioned by Japan have a greater degree of price-elasticity with shochu. It would not, however, in the Panel's view, amount to a rejection of the existence of a significant directly competitive or substitutable relationship between shochu and the examined eight products.

6.30 The Panel further noted that as a result of the 1989 Japanese tax reform, the distinction between “premium whisky”, “first grade whisky” and “second grade whisky” was abolished. This tax reform disadvantaged domestically produced whisky, by substantially increasing the tax rate on second grade whisky compared to the other alcoholic beverages at issue in the present case.¹¹³ The market share of domestic whisky including second grade fell from 26.7 per cent in 1988 to 19.6 per cent in 1990. This, according to the Community's evidence, led to a rise of both shochu's and foreign produced whisky's market shares in Japan.¹¹⁴ This proves to the Community that there is elasticity of substitution between whisky and shochu. The Panel further noted that Canada and the United States provided evidence to the same effect, that is showing that elasticity of substitution between whisky and shochu was evident as a result of the 1989 Japanese tax reform.¹¹⁵ The Panel took note that in its response, Japan argued that the combination of the expansion of shochu consumption and the declining whisky prices rather indicated the lack of a competitive relationship between the two commodities. In the Panel's view, Japan failed to take account of the fact that shochu and foreign whisky were in fact capturing the market share lost by domestically produced whisky. 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.

¹¹¹See the 1987 Panel Report, *op. cit.*, para. 5.7.

¹¹²See paras. 4.171ff. of the Descriptive Part.

¹¹³See para. 4.82 of the Descriptive Part.

¹¹⁴The Panel noted that this rise was short-lived, since as of 1992 the Japanese economy entered into recession and there was a shift of demand towards the less expensive categories of liquors.

¹¹⁵See paras. 4.73, 4.77-8, 4.90-2, 4.111, 4.113, 4.115, 4.117, 4.171-2, 4.174 of the Descriptive Part.

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. If at all, according to Japan, the evidence the complainants provided to the Panel shows elasticity of substitution between shochu and beer. 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 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. The Panel noted that Japan further provided an econometric study in which no elasticity of substitution could be found between shochu, on the one hand, and spirits or whisky, on the other. This study attempted to evaluate the extent to which the relevant products are directly competitive.¹¹⁶ In considering the study, the Panel took account of the views of the parties and of general econometric principles. The Panel noted that the extent to which two products are competitive in economics is measured by the responsiveness of the demand for one product to the change in the demand for the other product (cross-price elasticity of demand). The more sensitive demand for one product is to changes in the price of the other product, *all other things being equal*, the more directly competitive they are. This is related to the substitutability of one product for another (elasticity of substitution). Under national antitrust and trade law régimes, the extent to which products directly compete is measured by the elasticity of substitution. Formal statistical methods are employed to measure, with a reasonable degree of certainty, the magnitude and direction of variables, based on actual observations. The greater the number of observations, the greater the degree of certainty. In the case of product demand and product substitutability (i.e., the direct competitiveness of products), the relevant information includes prices, quantities, and incomes. Ideally, one would like to test for the relationship between the price of one product and the demand for another, *all other things being equal*. Under these conditions, relatively simple statistical methods can be employed. This is the approach taken in the Japanese econometric study. However, all other things are not equal. When working with a set of (potentially) substitutable products, it is necessary to recognize that underlying trends in the data may affect the apparent relationship between the variables examined (serial and autocorrelation). In addition, the variables may in actuality be closely related. For example, outside factors (i.e., those not measured directly) may affect the markets that are examined jointly (multicollinearity). Moreover, changes in income may affect demand in all of the product markets studied, and this effect may vary systematically across the markets. In statistical studies of related markets involving time series data (as in the present study), one could normally expect to encounter all of these problems. Relatively standard methods can be employed to control for serial and autocorrelation and multicollinearity. Failure to account for these effects can render the results of simple statistical analysis meaningless. According to the complainants, this is the case of the study submitted by Japan. The Panel accepted the validity of these criticisms and noted that Japan had not

¹¹⁶See paras. 4.83ff. of the Descriptive Part.

succeeded in rebutting the criticism advanced by complainants and thus Japan's study did not refute the evidence of substitutability submitted by complainants.

6.32 The Panel then concluded that in deciding whether shochu and the other products in dispute were directly competitive or substitutable products, it noted that the products concerned were all distilled spirits and it would give particular emphasis to the following factors: the findings of the 1987 Panel Report; the studies put forward by the complainants (the ASI study) that contained persuasive evidence that there is significant elasticity of substitution among the products in dispute; the survey submitted by Japan that, notwithstanding the fact that it failed to take into account price distortions caused by internal taxation, still shows elasticity of substitution among the products in dispute; and, lastly, the evidence submitted by complainants concerning the 1989 Japanese tax reform which showed that whisky and shochu are essentially competing for the same market. In the view of the Panel, the conclusions of the 1987 Panel Report, buttressed by any of the other three factors, were sufficient for the Panel to conclude that shochu and the other products subject to dispute are directly competitive or substitutable according to Article III:2, second sentence.

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 the Panel's view, the Interpretative Note ad Article III:2 explains how a national measure operates "so as to afford protection to domestic production" and thus runs counter to the principles set forth in Article III:1. In other words, 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. Although the 1987 Panel Report did not focus on the Interpretative Note, its conclusions on the issue of "so as to afford protection" was essentially the same, as it concluded that the higher (i.e., dissimilar) Japanese taxes on imported alcoholic beverages and the existence of substitutability were "sufficient evidence of fiscal distortions of the competitive relationship between imported distilled liquors and domestic shochu affording protection to domestic producers of shochu".¹¹⁷ The Panel agrees with this conclusion. 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*.¹¹⁸ In the Panel's view, it is appropriate to conclude, as have other GATT panels including the 1987 panel, that it is not necessary to show an adverse effect on the level of imports, as Article III generally is aimed at providing imports with "effective equality of opportunities" in "conditions of competition".¹¹⁹ In line with these interpretations of Article III, the Panel concluded that it is not necessary for complainants to establish the purpose or aim of tax legislation in order for the Panel to conclude that dissimilar taxation affords protection to domestic production. In the Panel's view, the Interpretative Note interpreted in this respect the term "so as to afford protection" which appears in Article III:1. 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. 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:¹²⁰

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*.

¹¹⁷See the 1987 Panel Report, op. cit., para. 5.11.

¹¹⁸The Panel decided that it did not have to further define "*de minimis*", because in this case the differences in taxation were significant.

¹¹⁹See the panel report on "United States - Taxes on Petroleum and Certain Imported Substances", op. cit., para. 5.1.9; see also the panel report on "Italian Discrimination Against Imported Agricultural Machinery", op. cit., para. 12.

¹²⁰See para. 2.3 of the Descriptive Part.

b) With respect to taxation per degree of alcohol the Panel noted that the amounts were:¹²¹

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. Moreover, 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 and whisky/brandy 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 ones, this exclusion has the impact of reducing considerably the tax/prices 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 market. Moreover, the Panel noted that the Japanese statistics were based on suggested retail prices and there was evidence in the record 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.

The Panel consequently concluded that the products in dispute are not similarly taxed and the taxes on shochu are lower than the taxes on the other products subject to dispute, leading the Panel to the conclusion that protection is afforded to shochu inconsistently with Japan's obligations under Article III:2, second sentence.

¹²¹Based on calculations upon information included in para. 2.3 of the Descriptive Part.

6.34 The Panel then addressed the argument put forward by Japan that the Japanese legislation is trade-neutral, and thus guarantees equality of competitive conditions, since it maintains a “roughly constant” tax/price ratio and no protective aim or effect of the legislation can be detected. In this connection, the Panel recalled the argument by Japan that its aim was to achieve horizontal tax equity.¹²² The Panel further recalled in this context that it had already dismissed the aim-and-effect test put forward by Japan. The Panel noted that to the extent that Japan's argument could be considered as an argument that Japan's Liquor Tax Law taxed directly competitive or substitutable products similarly, in the Panel's view, the argument should be rejected for the following reasons:

(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. However, in the Panel's view, it is not at all clear that maintaining a “roughly constant” tax/price ratio avoids violating this requirement.

(ii) The statistics on the tax/price ratio show that significant differences exist between shochu and the other directly competitive or substitutable products¹²³ and that there are significantly different tax/price ratios within the same product categories. Therefore, the tax/price ratios could not be regarded as being “roughly constant”, and horizontal equity could not be demonstrated. Moreover, as noted in paragraph 6.33 above, 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 and whisky/brandy 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 ones, this exclusion has the impact of reducing 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 market. Moreover, the Panel noted that the Japanese statistics were based on suggested retail prices and there was evidence in the record 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.

(iii) Finally, the Panel noted that nowhere in the contested legislation was it mentioned that its purpose was to maintain a constant tax/price ratio. This is 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 at a constant (or “roughly constant”) level. 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 of Japan's Liquor Tax Law there has been only one instance of adjustment.

¹²²See para. 4.132ff. of the Descriptive Part.

¹²³See paras. 4.100, 4.159, 4.160, 4.161 and 4.165 of the Descriptive Part.

Consequently, in the Panel's view, the argument by Japan that its legislation by keeping the tax/price ratio "roughly constant" is trade neutral and does not operate "so as to afford protection to domestic production" should be rejected.

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:

(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.

7.2 The Panel recommends that the Dispute Settlement Body request Japan to bring the Liquor Tax Law into conformity with its obligations under the General Agreement on Tariffs and Trade 1994.