

Korea - Taxes on Alcoholic Beverages

Report of the Panel

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I. PROCEDURAL BACKGROUND

1.1. This proceeding has been initiated by two complaining parties, the European Communities and the United States.

1.2. On 2 April 1997, the European Communities requested consultations with Korea under Article XXII:1 of GATT and Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU") (WT/DS75/1). The United States (WT/DS 75/2) and Canada 6(WT/DS75/3) requested to be joined in those consultations, pursuant to Article 4.11 of the DSU on 17 and 21 April 1997, respectively. Korea agreed to those requests (WT/DS75/4 and WT/DS75/5). Consultations between the European Communities and Korea were held in Geneva on 29 May 1997, in which the United States and Canada participated.

1.3. On 23 May 1997, the United States requested consultations with Korea under Article XXII:1 of GATT and Article 4 of the DSU with respect to the same matter (WT/DS84/1). Canada (WT/DS84/2) and the European Communities (WT/DS84/3) requested to be joined in those consultations, pursuant to Article 4.11 of the DSU, on 29 May and 5 June 1997, respectively.

1.4. Consultations were held in Geneva on 24 June 1997, between the United States and Korea, and the European Communities and Canada participated as third-parties. Another set of consultations were held on 8 August 1997, to address US requests for further clarifications, but the parties were unable to settle the dispute.

1.5. On 10 September 1997, the European Communities (WT/DS75/6), and the United States (WT/DS84/4), each requested the establishment of a panel pursuant to Article 6.1 of the DSU.

1.6. In its panel request, the European Communities claims that:

Korea, by according a preferential tax treatment, through the Liquor Tax Law and the Education Tax Law, to soju vis-a-vis certain alcoholic beverages falling within HS heading 2208, has acted inconsistently with Article III:2 of GATT 1994, therefore nullifying or impairing the benefits accruing to the European Communities under the GATT 1994.

1.7. In its panel request the United States claims that:

Korea, under its general Liquor Tax Law, imposes a lower tax on the traditional Korean distilled spirit soju than the high taxes it applies to other distilled spirits such as whisky, brandy, vodka, rum, gin and "ad-mixtures". This difference in tax burden is made even more dramatic by the application of an Education Tax.

1.8. The Dispute Settlement Body (DSB) agreed to these two requests for a panel at its meeting of 16 October 1997, establishing a single panel pursuant to Article 9.1 of the DSU with the following standard terms of reference:

"To examine, in light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS75/6 and the United States in document WT/DS84/4, the matter referred to the DSB by the European Communities 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".

1.9. Canada and Mexico reserved their rights to participate in the Panel proceedings as third-parties.

1.10. On 26 November 1997, the United States and the European Communities jointly requested the Director-General to determine the composition of the panel, pursuant to paragraph 7 of Article 8 of the DSU. On 5 December 1997, the Director-General composed the Panel as follows:

Chairman: Mr. Åke Lindén

Panelists: Professor Frédéric Jenny

Mr. Carlos da Rocha Paranhos

1.11. The Panel had substantive meetings with the parties on 5 and 6 March 1998, and on 21 and 22 April 1998.

II. MEASURES IN ISSUE

2.1. Korea maintains a multi-tiered taxation regime on the sale of alcoholic beverages. Under the Liquor Tax Law of 1949, as amended, Korea creates various categories of distilled spirits, on which it imposes different *ad valorem* taxes. Under the Education Tax Law of 1982, as amended, Korea assesses a surtax on certain of these sales, determined as a percentage of the established liquor tax.

2.2. Both the liquor tax and the education tax on alcoholic beverages are imposed at the wholesale level. The tax is payable by the manufacturer of the beverages or, in the case of imports, by the importer. Tax liability accrues at the time of shipment from the factory (in the case of alcoholic beverages made in Korea) or of withdrawal from the bonded warehouse (in the case of imported alcoholic beverages).

A. THE LIQUOR TAX LAW

2.3. The Liquor Tax Law lays down a system of excise taxes applicable to all alcoholic beverages (whether manufactured in Korea or imported) intended for consumption in Korea. The taxes applied to the categories in dispute are in the form of *ad valorem* taxes.

2.4. For the purposes of assessing the tax, the value of imported alcoholic beverages includes transport and insurance costs as well as the import duty imposed. In other words, the tax base for imports is the price noted on the import declaration when the goods are withdrawn from the bonded warehouse (i.e., the CIF import value plus duty).¹

2.5. Domestic alcoholic beverages are taxed on the value of production costs, sales costs (including advertising), extraordinary costs, and profits, i.e., the tax base is the price of the goods when they are shipped from the production site.² The categories of distilled spirits established by the Liquor Tax Law, and the applicable tax rates, are described below.

1. Categories

2.6. Liquor Tax Law divides alcoholic beverages into eleven categories, some of which are further divided into sub-categories, and assigns to each of them a different tax rate. These categories include "soju," "whisky," "brandy," "general distilled liquors" (which covers beverages such as vodka, gin, rum and tequila), "liqueurs," and "other liquors" (to the extent that liquors falling within this category may contain distilled spirits or liqueurs falling within any of the preceding categories). Article 3 of the Liquor Tax Law sets forth definitions of these categories.³

(a) Soju

2.7. Article 3.6 has four sub-categories of soju. Sub-categories A and B apparently refer to "distilled soju," while sub-categories C and D apparently refer to "diluted soju."

2.8. Article 3.6.A and 3.6.B states the legal definition of soju as:

- (a) Soju may be produced from discontinuous distillation of a fermented mash developed from the basic constituents of a starch source, yeast and water.

¹ Article 19.2 of the Liquor Tax Law.

² Presidential Decree, Article 26.

³ A translation of the relevant provisions of Article 3 is provided as US Exhibit A.

- (b) Soju may be produced from discontinuous distillation as in Paragraph A above, but during the fermentation and production process other ingredients may be added as determined by Presidential decree.

2.9. Thus paragraphs (A) and (B) describe two "types" of soju: (i) soju created by fermentation and discontinuous distillation, but without additives; and (ii) soju created by fermentation and discontinuous distillation and containing additives.

2.10. According to Article 3.6.A, distilled soju cannot

- (a) be produced from sprouted grain;
- (b) be filtered through charcoal of white birch; or
- (c) be produced in a process whereby water is mixed with grain and the mash sealed for fermentation and subsequent distillations.

2.11. The chapeau of Article 3.6 specifies that soju must have an extract content of 2% or less.

2.12. The legal definition of diluted soju in Article 3.6.C and 3.6.D is as follows soju:

- (a) Soju may be produced by diluting neutral spirits with water or by adding thereto those ingredients as determined by Presidential Decree;
- (b) Soju may be produced by adding to the products produced in accord with paragraphs A through C immediately above the product of paragraph A, when determined by Presidential Decree, or other grain spirits as determined by Presidential Decree.

2.13. The definition of diluted soju in 3.6.C and D relies on "neutral spirits," which is defined by Article 3.1 of the Liquor Tax Law as follows:

- (a) Neutral spirits may be produced from the distillation of a fermented mash developed from the basic constituents of a starch source and a sugar source that results in a product that is 85 percent or more alcohol;
- (b) Neutral spirits may be produced from the distillation of ingredients containing alcohol, resulting in a product that is 85 percent or more alcohol.

(b) Whisky, brandy, and "general distilled liquors"

2.14. Whisky, brandy and "general distilled liquors" are defined in Articles 3.7, 3.8 and 3.9, respectively. The definitions include a 2% extract limitation that distinguishes them from liqueurs. All three include fermentation and distillation as the manufacturing process. However, unlike the definition for soju, they generally specify starch sources.

2.15. Article 3.7 of the Liquor Tax Law, the "whisky" category, includes all types of whisky made totally or partly from sprouted grain and aged in wooden casks, as well as, under certain conditions, admixtures of whisky and other spirits or ingredients.⁴

⁴ See Article 3.7 of the Liquor Tax Law. The whisky definition includes three subparagraphs. Paragraph (A) specifies only sprouted grains and thus addresses malt whisky. Paragraph (B) appears to broaden the starch source to normal grain as well as sprouted and thus addresses ordinary grain whisky. Both (A) and (B) provide for aging in wooden barrels and thus address premium brands of whisky. Paragraph (C) addresses

2.16. Article 3.8, the "brandy" category, includes all liquors distilled from a fermented mash of fruit or fruit wine and aged in wooden casks. Subject to certain conditions, it includes also admixtures of those liquors with other spirits or ingredients.⁵

2.17. The category of "General Distilled Liquors" is a miscellaneous category comprising several kinds of distilled spirits. It consists of six paragraphs.

- Paragraph (A) specifies kaoliang-ju lees as a starch source, and the manufacturing process includes sealing prior to fermenting and distilling; it is designed to address *kaoliang-ju*, which can be imported from China.
- Paragraph (B) specifies sugar cane, sugar beet, sugar, and/or molasses as a starch source; it addresses *rum*.
- Paragraph (C) specifies "fruits of juniper tree" as an ingredient; it addresses *gin*.
- Paragraph (D) specifies filtering of the alcohol; it addresses *vodka*.
- Paragraph (E) merely concerns "materials mainly containing starch or sugar produced by fermentation and distillation." It covers *tequila* and any distilled spirit. Its wording is the same as that used in the first part of the definition of "neutral spirits".⁶
- Paragraph (F) addresses *mixed distilled drinks* (e.g., gin and rum mixed drinks).

(c) Liqueurs

2.18. Article 3.10, the "liqueurs" category, covers liquors with more than 2% extract content produced by distillation of a starch or sugar source to which ginseng juice, fruits or fruits extracts are added.⁷

2.19. Article 3.11 sets forth the category of "other liquors," a residual category including all liquors (whether fermented or distilled) not falling within any of the other categories defined by the Liquor Tax Law.⁸ It includes *inter alia* admixtures of whisky and brandy.

premium blended whisky and/or whisky with sugars, acids, seasonings, fragrances, colouring, or carbon dioxide added.

⁵ See Article 3.8 of the Liquor Tax Law.

⁶ See Article 3.1 of the Liquor Tax Law.

⁷ See Article 3.10 of the Liquor Tax Law.

⁸ See Article 3.11 of the Liquor Tax Law.

2. Tax rates

2.20. The Korean law imposes different *ad valorem* tax rates on the various categories and sub-categories of distilled spirits. Pursuant to the definitions, soju is given a tax rate of 35 to 50 percent, while other distilled alcoholic beverages are taxed at 80 to 100 percent. The applicable liquor tax rates are:⁹

Item	Ad Valorem Tax Rate (%)
Diluted soju	35
Distilled soju	50
Whisky	100
Brandy	100
General distilled liquors (vodka, gin, rum)	80
General distilled liquors containing whisky or brandy	100
Liqueur	50
Other liquors:	
-With 25% or more alcohol	80
-With less than 25% alcohol	70
-Which contain 20% or more whisky or brandy	100

B. THE EDUCATION TAX LAW

2.21. The Education Tax Law of 1990 is assessed as a surtax on the sale of a variety of items, including most alcoholic beverages. For alcoholic beverages, the applicable rate is determined by reference to another tax -- the applied liquor tax rate.¹⁰ For those assessed a liquor tax rate of 80% or greater, the law imposes an education surtax calculated as 30% of the liquor tax imposed.¹¹ For alcoholic beverages assessed a liquor tax rate of less than 80%, the law imposes an education surtax calculated as 10% of the liquor tax imposed.

⁹ The applicable tax rates are set forth in Article 19.2, and Korean Taxation: 1997, § 3(b) p. 188 (Korean Ministry of Finance and Economy).

¹⁰ In addition to the liquor tax, other taxes upon which the Education Tax is levied include the Special Excise Tax, the Per Capita Inhabitant Tax, the Registration Tax, the Horse Race Tax, the Property Tax, the Aggregate Land Tax, the Tobacco Consumption Tax, the Automobile Tax and the Transportation Tax.

¹¹ Education Tax Law, Art. 5.

2.22. This tax structure results in a 30% surtax for imported distilled alcoholic beverages, including whisky, brandy and general distilled liquors (vodka, rum, gin, tequila, shochu, etc.) except for imports of Japanese shochu, which are classified for tax purposes and taxed at 10%. Of all distilled alcoholic beverages, only soju and liqueurs are subject to the lesser 10% surtax. Prior to 1995, soju was exempted from the Education Tax. However, after negotiations between Korea and the European Communities that Korea agreed to subject soju to the Education Tax at a rate of 10%.

2.23. The applicable rates on the categories concerned by this dispute, expressed as a percentage of the amount payable pursuant to the Liquor Tax, is as follows:

Tax rates applied pursuant to the Education Tax Law	
Product	As % Liquor Tax
Diluted soju	10
Distilled soju	10
Whisky	30
Brandy	30
General distilled liquors	30
General distilled liquors containing whisky or brandy	30
Liqueurs	10
Other Liquors:	
-more than 25% alcohol content	30
-less than 25% alcohol content	10
-containing whisky or brandy	30

III. FACTUAL ARGUMENTS

A. EUROPEAN COMMUNITIES

3.1. The European Communities proceeds from the premise that in response to its reiterated requests, Korea has reluctantly acceded to make a number of changes to its liquor tax system which have reduced (but by no means eliminated) the difference between the internal taxes applied to soju and those applied to other categories of distilled liquors.

3.2. The European Communities states that as of 1 January 1991, Korea abolished the Customs Defence Tax, which until then had been applied only to imported liquors. It further states that on the same date, Korea also abolished the Liquor Defence Tax, which had been levied at a lower rate on soju than on other distilled spirits and liqueurs. Further, the European Communities states that Korea eliminated an uplift ratio of 1.0:1.1 (the so-called "times 1.1 multiplier") which had been applied in order to inflate artificially the import duty paid value on which the Liquor Tax is assessed in the case of imported beverages.

3.3. The European Communities adds that these amendments were followed by a reduction of the Liquor Tax rates on the category of "whisky" from 200% to 150%, and on the category of "general distilled liquors" from 100% to 80%, both effective from 1 July 1991. According to the European Communities, this decrease, however, was partially nullified by a simultaneous increase in the Education Tax rates, which were raised to 30% for most distilled liquors other than "soju". At the same time, the category of "soju" was divided into the sub-categories of "distilled soju" and "diluted soju" and the rate on "distilled soju" raised from 35% to 50%.

3.4. According to the European Communities, in June 1993, it reached an agreement with Korea (the "1993 Agreement") whereby Korea undertook to reduce progressively over a period of two years the liquor tax rate applicable to the "whisky" and "brandy" categories from 150% to 100%. The European Communities asserts that Korea further agreed to levy the Education Tax on both sub-categories of soju (which had until then been exempt from such tax) at a rate of 10% as from 1 January 1994¹² and to increase the tax on admixtures containing whisky or brandy (which are mainly bottled in Korea) from 80% to 100%.

3.5. The European Communities further asserts that the 1993 Agreement envisaged that a new round of consultations would take place in 1996 in order to discuss further reductions of the remaining tax differences. According to the European Communities, as compensation for the continued application in the meantime of much lower taxes to soju, Korea agreed to further reduce the effectively applied import duties on whisky, brandy other than wine brandy (which already benefited from a 15% applied rate), rum, gin, vodka and liqueurs (but not on soju) from 30% to 20%.

3.6. The European Communities allege that the consultations provided for by the 1993 Agreement eventually took place in January 1997. Nevertheless, according to the European Communities, Korea did not meet the EC's request to eliminate the remaining tax differentials so as to bring its liquor tax system in conformity with the GATT.

The Korean market for distilled liquors

3.7. The European Communities states that the Korean market for distilled spirits and liqueurs was virtually closed to imports until the late eighties. According to the EC's argument, until 1 January 1989, imports of distilled spirits in bulk were subject to quotas, whereas imports of distilled spirits in

¹² The EC claims that Korea did not implement this commitment until 1 January 1995.

bottles were prohibited until 1 July 1989, and thereafter subject to quantitative restrictions until 1 January 1990.

3.8. The European Communities further argues that, Korea applied prohibitively high import duties: 150% until 1984; 100% until 1988; and 50 % until 1991. According to the European Communities, until March 1990 Korea applied an import deposit requirement. The EC's position is that, currently the applied import duty rate is 20% for all distilled spirits and liqueurs, except brandy (which is subject to a 15% import duty) and soju (which is subject to a 30% import duty).¹³

3.9. The European Communities further argues that, following the elimination of the import quotas and a substantial reduction of import duties and internal taxes, imports of distilled spirits and liqueurs have grown steadily but still represent only around 3.5% of the market. According to the European Communities, this share is unusually low. The European Communities is of the view that in most other OECD countries the share of imported spirits is between 30% and 40% of the market for distilled liquor. By comparison, the European Communities states that in Japan the share of imported spirits was 8% in 1995, despite the fact that at that time Japan applied a system of discriminatory internal taxes similar to the one in dispute.

3.10. According to the European Communities, the Korean spirits market is overwhelmingly dominated by soju. In 1996 sales of soju amounted to 90 million 9L cases (810 million litres), which represents as much as 94% of the distilled spirits market.¹⁴ Soju's position, however, is allegedly being eroded by growing sales of imported spirits and liqueurs, and in particular of whisky. Over the past few years, sales of soju have allegedly increased at a lower pace than the total spirits market (between 1993 and 1994 sales of soju even decreased in absolute terms). As a result, the market share of soju fell from 96.37 % in 1992 to 94.39 % in 1996.¹⁵

3.11. The European Communities states that imports of soju are insignificant. In 1997, Korea allegedly imported just 1,625 litres.¹⁶ In contrast, argues the European Communities, Korea exports large quantities of soju. The European Communities further asserts that during the first eleven months of 1996, exports of soju totalled 43 million litres of soju, which represents about 5% of the Korean soju production. According to the European Communities, the main export market is Japan, where soju is considered for customs and tax purposes as being the same product as local "shochu".

3.12. The European Communities further asserts that almost all soju sold in Korea is diluted soju. Distilled soju is estimated to account for just over 1% of the total sales of soju. While diluted soju is generally an inexpensive liquor, distilled soju may fetch very high prices, similar to those paid for imported premium brands of whisky.

3.13. The European Communities argues that, confronted with growing sales of western-style liquors, the manufacturers of diluted soju have been forced to address what are generally perceived by Korean consumers as negative attributes of that liquor as compared with the "western style" distilled liquors: inferior quality, harsh taste, hangover effects.

3.14. According to the European Communities, this has led to the emergence of new so-called "premium soju" brands, whose distinctive characteristics are a milder taste, the use of flavouring (e.g. with honey) and/or ageing processes, and more sophisticated packaging. The European Communities asserts that the prices for premium soju brands are between two and three times higher than those for

¹³ A table summarising the recent evolution of the tariff treatment of the products concerned by this dispute is included in EC Annex 4.

¹⁴ EC Annex 5.

¹⁵ EC Annex 6.

¹⁶ EC Annex 7.

standard diluted soju. According to the European Communities, in spite of that, sales of premium soju are growing very rapidly. By EC estimates, in 1996 they represented 6% of soju sales and reached 10% in 1997.

3.15. The European Communities points out that whisky is the largest category of distilled spirits after soju. Sales of whisky allegedly increased from 11 million litres in 1992 to 27 millions in 1996, i.e. by almost 140%. As a result, the European Communities argues that the share of whisky rose from 1.53% in 1992 to 3.14% in 1996. According to the European Communities, one of the main reasons for this increase is the progressive reduction in the applicable liquor tax rate from 200% in 1990 to 100% in 1996. The European Communities further argues that Scotch whisky imported from the European Communities, whether in bottles or in bulk, accounts for virtually all of the sales within this tax category.

3.16. The European Communities further argues that the category of brandy is still very small but growing rapidly. The increase has allegedly been particularly remarkable in the case of cognac, which went up from just 13,000 litres in 1992 to 193,000 litres in 1996. As in the case of whisky, the argument goes, this increase is in part due to the progressive reduction of the Liquor Tax rate from 150% in 1990 to 100% in 1996. Almost all brandy sold in Korea is imported, whether in bottles or in bulk.

3.17. According to the European Communities, the category of "General Distilled Liquors" is also very small. In the EC view, unlike sales of whisky and brandy, sales of liquors falling within this category have stagnated and in some cases even declined. One of the reasons for this, according to the European Communities is that, unlike whisky and brandy, this category has benefited only from a marginal reduction of taxes. The European Communities alleges that. Although the liquor tax rate on this category was lowered from 100% to 80% as from 1 July 1991, this reduction was almost totally offset by a simultaneous increase of the applicable Education tax rate from 10% to 30%.¹⁷ A significant proportion of sales within this category is imported. According to estimates of the EC industry, imports would represent approximately 20% of the sales of gin, 50% of the sales of rum and 70% of the sales of vodka.

3.18. The European Communities further alleges that pre-mixes of distilled liquors and non-alcoholic beverages account for a major portion of sales (95% according to the estimates of the EC industry) within the category of "liqueurs". According to this argument, soju-based cocktails (e.g. lemon flavoured soju, cherry flavoured soju) account for the vast majority of the sales of pre-mixes. The EC view is that soju cocktails are a relatively new product targeted at the young generation and enjoy considerable success. According to the European Communities, during 1995 alone, sales of soju cocktails increased by 1250%. There are no imports of soju cocktails.

3.19. In contrast, the European Communities argues that it may be estimated that as much as 90% of the sales of "authentic" or "single item" liqueurs are imported. Sales of this type of "liqueurs" have been growing off a small base at 15-20% every year and are currently estimated to represent 300,000 litres out of total market for liqueurs of 13.5 million litres.

3.20. The European Communities further argues that although no official sales figures have been made available by the Korean Government, the EC industry estimates that while sales of whisky and other imported liquors declined during 1997, sales of soju would have increased. As a result, the European Communities argues, soju may have regained its lost share of the market. This new development is the result of extraordinary circumstances.

¹⁷ EC Annex 2.

3.21. According to the European Communities, in the first place, the depreciation of the Korean won, which has made imported liquors more expensive¹⁸. To this, states the European Communities, it must be added the effects of the boycotts against imported products orchestrated by civic groups and by business associations such as the Central Council of Korean Night-spots' Operators during the first months of 1997. Finally, according to the European Communities, the financial crisis which broke in October of last year, and the ensuing slow down in the Korean economy has made consumers much more price conscious and further depressed the sales of imported liquors to the benefit of the less taxed and less expensive soju.

3.22. The European Communities argues that western-style liquors used to be perceived by Korean consumers as "luxury" items. According to the European Communities, at present the prices for western-style liquors remain much higher than the prices for diluted soju. Nevertheless, according to the European Communities, following the lifting of the import quotas and the lowering of import duties and liquor taxes, there has been a clear trend towards lower consumer prices, broader availability in all sales channels and consumption patterns which are more similar to those of soju.

3.23. The European Communities concludes that the remaining tax differentials stand as an obstacle to that trend and hinder further competition between soju and imported western-style distilled spirits and liqueurs.

B. UNITED STATES

3.24. From the US perspective, the products concerned by this dispute are soju, a locally produced distilled liquor, on the one hand, and imported distilled spirits classified under the Harmonized System (HS) heading 2208, on the other hand,¹⁹ including spirits such as vodka, whisky, gin, rum, brandy and liqueurs. Exports in 1996 of U.S. distilled spirits to Korea were allegedly only \$1.8 million compared to an average export level in recent years of \$90 million to Japan.

3.25. The United States alleges that the current tax system and the state of the Korean market grows out of many years of protecting soju. It claims that although Korea has dismantled some of its trade barriers to imports over the last ten years (an effort that has produced inroads for imported spirits in the Korean market), Korea retains two tax laws that categorises liquor products arbitrarily, and imposes corresponding discriminatory tax rates.

3.26. The United States further alleges that Korea's current tariff and tax regime governing the sale of alcoholic beverages has grown out of a historically restrictive market for alcoholic beverages that has shaped the Korean market as it stands today.

3.27. The United States asserts that after 1949, high tariffs, quotas and other measures were used by the Korean government to discourage the importation of distilled alcoholic beverages and conserve the country's foreign exchange reserves. It cites, for example, that in the 1970's Korea assessed a duty of 150% C.I.F. on whisky imports. Until January 1989, Korea maintained quota restrictions on bulk imports of whisky, and it prohibited the importation of bottled whisky until July 1989. Importers were required to pay a deposit on the value of their imports, and the government permitted only twelve licensed importers until 1989.

¹⁸ The average monthly exchange rate between the Korean Won and the ECU fell from 1028.35 Wons to an ECU in January 1997 to 1616.28 wons in December 1997, i.e. by almost 60 %.

¹⁹ Undenatured ethyl alcohol of an alcoholic strength by volume of less than 80 percent vol.; spirits, liqueurs and other spirituous beverages; compound alcoholic preparations of a kind used for the manufacture of beverages.

3.28. The United States further alleges that in the 1980's, Korea began to liberalize these barriers to distilled spirits imports by reducing applied rates on whisky. In 1982, the government reduced the rate of duty imposed on whisky from 150% to 100% for products certified for use in tourist hotels. In 1984, the government extended this rate reduction to all whisky imports regardless of destination. In 1988 the customs duty was further cut to 50%, where it remained until a reduction to 40% in 1991, followed by 30% in 1993. In 1996, Korea applied a tariff rate of 20% on whisky. Korea's WTO bound rate, as a result of negotiations during the Uruguay Round, descends from a base of 100% in 1995 to a final rate of 30% in 2004 in equal annual instalments.

3.29. The United States also alleges that, following pressure from the European Communities, Korea has also recently dismantled a number of its non-tariff barriers against distilled alcoholic beverages. In 1988, Korea eliminated the import deposit requirements for small and medium sized importers. In 1989, it reduced this deposit for large importers from 10% to 5%; increased the number of licensed importers from 12 to 25; lifted quota restrictions on the import of bulk whisky; and permitted the import of whisky bottled abroad for the first time, albeit subject to a quota. In 1990, the government removed this quota, abolished the import deposit requirement for large importers, and removed government limitations on the number of licensed importers. In 1991, Korea allowed foreign investment in the importation and distribution of spirits.

3.30. The thrust of the US case is that concurrent with these tariff and non-tariff measures, Korea maintained a discriminatory system of internal taxes weighted against imported alcoholic beverages. According to the United States, after World War II, taxes on whisky and beer provided the government with a steady and easily collected form of revenue. However, in the face of increasing pressure, especially from the EC, Korea enacted a series of tax reductions on some imported distilled alcoholic beverages. Korea allegedly decreased the liquor tax rate on whisky and brandy from 200% to 150% in July 1991, 120% in January 1994, and 100% in January 1996.

The current Korean market for distilled liquors

3.31. The United States submits that the Korean market for distilled alcoholic beverages, valued at approximately 2 trillion won in 1989, has been one of the largest in Northeast Asia. However, the United States adds that the Korean market for distilled spirits and liqueurs was virtually closed to imports until the late eighties. Until 1 January 1989, imports of distilled spirits in bulk were subject to quotas, and imports of distilled spirits in bottles were prohibited and thereafter subject to quantitative restrictions until 1 January 1990. Applied tariffs were prohibitive until 1991. Currently, the applicable import duty is 20% for all distilled spirits and liqueurs, except brandy (which is subject to a 15% import duty) and soju (which is subject to a 30% import duty).

3.32. The United States argues that in light of this background, the Korean market for alcoholic beverages has been dominated by traditional beverages, such as soju, with a relatively low alcohol content (25%) and bottled for mass consumption. In 1996 sales of soju amounted to 89.825 million nine-litre cases (i.e., 808 million litres), which represents as much as 94% of the distilled spirits market.

3.33. The United States further argues that imports of soju into Korea are insignificant. Last year Korea allegedly imported less than 2000 (1,625) litres. However, Korea exports large quantities of soju. During the first eleven months of 1996, exports of soju totalled 43 million litres, which represents about 5% of Korean soju production. The main export market is alleged to be Japan.

3.34. According to the United States, almost all soju sold in Korea is diluted soju. Distilled soju is estimated to account for less than 1% of the total sales of soju. The United States claims that although diluted soju is generally inexpensive, distilled soju can fetch very high prices, similar to those paid for imported premium brands of whisky.

3.35. The United States asserts that in the last ten years, the Korean government's relaxation of several import barriers has increased the competitiveness of the domestic market for alcoholic beverages, even though the retail prices for Western-style liquors remain much higher than the prices for diluted soju.

3.36. The United States argues that manufacturers of soju have addressed what are generally perceived by Korean consumers as its negative attributes compared with the imported liquors: poor quality, bad flavour, hangover effects, etc. This has led to the emergence of a new segment of so-called "premium soju" brands, whose distinctive characteristics are a milder taste, the use of flavouring (e.g., with honey), and/or ageing processes and more sophisticated bottle designs. The prices for premium diluted soju brands are between two and three times higher than those for standard diluted soju. It is estimated that sales of premium soju represented 6% of soju sales in 1996 and probably reached 10% in 1997.

3.37. The United States further argues that in addition to developing new types of soju for consumption in Korea, soju makers have also begun to exploit the export market for soju. Exports have risen dramatically in the last few years.

3.38. According to the United States, Korean consumption of whisky has increased by about 30% annually since 1994. Between 1992 and 1996, the Korean market for whisky increased from 315 million won to 880 million won. Moreover, whisky bottled abroad makes up an increasing share of this market, growing from 1.7% of this market in 1992 to 46.7% of the market in 1996.

3.39. However, the United States adds that although imports of distilled spirits have grown steadily, they still represent only around 3.5% of the Korean market. In most other OECD countries, the share of imported spirits is allegedly between 30% and 40%.

C. KOREA

3.40. According to Korea, the complainants spend considerable time arguing that Korea has a history of protecting its soju industry. Korea states that no case has been brought against it for these alleged violations. In Korea's view, therefore, these allegations are irrelevant to the case at hand, and they should be disregarded.

3.41. Korea also notes that in the same way that the complainants wish to gloss over the differences between the Korean and Japanese markets, they also wish to gloss over the characteristics of the Korean market and products that do not fit their line of argument. Korea notes for example, that the complainants treat 'soju' as one product. According to Korea, however, Korean distilled soju is very different from what the complainants refer to as 'diluted' soju. In Korea's view, the latter is certainly not a 'dilution' of the former.

3.42. Korea further argues that no Korean producer or consumer would consider distilled and diluted soju to be substitutes. Korea further states that although the complainants mention the existence of important differences between a 'diluted' soju and 'distilled' soju, the complainants dismiss these differences by saying that distilled soju occupies less than 1% of the soju market.

3.43. Korea argues that, having so dismissed distilled soju, the complainants proceed to use examples drawn from the exceptions in order to support general statements about all soju.

3.44. According to Korea, this dispute is about 'diluted' soju, ('standard' soju),²⁰ which represents more than 99% of all 'soju' sold in Korea. Further, according to Korea, the question in this case is whether Korea's system of taxing distilled beverages discriminates against imported distilled alcoholic beverages, to the advantage of standard soju. Of those western-type liquors, Korea argues that the Panel must be cognisant that whisky is by far the most important, representing the greatest proportion of all the imported distilled beverages.

3.45. Korea seeks to show that its system for the taxation of alcoholic beverages is not discriminatory, because the products at issue in this case are simply not in competition. According to Korea, the United States and the European Communities try to establish that competitive relationship by making generalisations such as "all are drunk with the same purposes: thirst-quenching, socialization", that they are made from the oxymoronic "same large variety of raw materials", by drawing specific examples from clearly exceptional cases, or -- their last resort-- by arguing that the products are in 'potential' competition with each other.

3.46. Korea gives a general background about alcoholic drinks. Korea states that if one travels around the world, one will encounter a seemingly infinite variety of alcoholic beverages, many having a long and interesting history. Korea further argues that throughout the ages, virtually every culture in the world discovered that the natural process of decomposition of certain raw materials, typically fruits and vegetables, led to sometimes tasty results. Over time, through trial and error, the process of creating certain alcoholic beverages has become increasingly refined.

1. Features of distilled alcoholic beverages

3.47. Korea states that within the broad category of alcoholic beverages, one can distinguish distilled beverages. According to Korea, to make a distilled alcohol, one first starts with fermented raw material. That fermented matter is put through a process of refinement and concentration, called distillation.²¹ Beverages that have been distilled are generally referred to as 'spirits', and spirits are the products at issue in this case.

3.48. Korea further states that distilled liquors can be derived from materials as varied as grain, corn, rice, fruit, sugar cane or beets, potatoes, or tapioca. Korea asserts that the selection of raw materials for the manufacture of distilled alcoholic beverages may be traced to different geographical, cultural and consumer requirements and can play an important role in determining the ultimate qualities of the finished product.

3.49. Korea notes that another distinction is sometimes drawn between 'brown' and 'white' spirits. According to Korea, this distinction refers to the production process and appearance of the beverages: brown spirits are brown (e.g., whisky or cognac); white spirits are clear (e.g., Korean soju or gin). Korea further states that brown spirits are generally matured in wooden casks and derive their flavour mainly from this process and from the original distilled ingredients. White spirits are not aged before bottling and instead rely on the addition of ingredients during the distillation process, or afterwards, to provide their distinctive flavour. These ingredients differ from one drink to another (e.g., gin derives its special flavour from the juniper berry).

²⁰ There is a disagreement between the complainants and Korea on whether to use the term diluted soju or standard soju. For purposes of clarity, we adopt the term diluted soju. Within the category of diluted soju are two sub-categories of premium diluted soju and standard diluted soju. No substantive determination is implied by this decision regarding terminology. We also note that this appears to be the terminology used by the Korean Fair Trade Commission in the decision submitted by Korea (Attachment 1 to Korea's first submission).

²¹ Distillation is defined in Webster's dictionary as 'a process that consists of driving gas or vapour from liquids or solids by heating and condensing to liquid products. . .'

2. Consumer behaviour

3.50. Korea argues that consumer preferences for alcoholic beverages vary from country to country. Certain countries have their own national drink. For instance, argues Korea, in France, wine is the national drink, in Germany it is beer, and in Japan it is sake. Korea adds that some national drinks are virtually unknown in other countries. According to Korea, this is the case for Korean soju, which is hardly known outside Northeast Asia and Korean communities abroad.

3.51. Korea further argues that these national drinks reflect the different cultures and traditions of the various countries. In addition, argues Korea, the climate, food and history of a country also determine the customs of its people and the way they drink alcoholic beverages. Thus, according to Korea, in hot countries one drinks certain alcoholic beverages to quench one's thirst, while in cold countries one drinks certain alcoholic beverages to keep warm. In other countries people drink particular alcoholic beverages for mere entertainment purposes, i.e., in bars, night clubs or posh hotels. In other countries one drinks particular alcoholic beverages as an accompaniment to a meal.

3.52. Korea further asserts that in France, for instance, it is common to drink wine over a meal. In Korea's view, this is because the nuanced flavour of wine complements the food French people eat. However, with spicy food one is unlikely to order a beverage such as wine, because such food would overwhelm wine's subtle flavours. In Korea, the argument goes, Koreans drink soju with their spicy food. Soju goes well with Korean barbecue and other Korean meals, because the drink's harshness cuts the spiciness of the food.

3.53. Korea further argues that people can also drink alcoholic beverages either mixed, on the rocks or straight, cold or hot or a combination of both. According to Korea, soju is never drunk mixed, whereas whisky, vodka and Japanese shochu are drinks which commonly are drunk both straight and mixed.

3. Price

3.54. Korea further argues that alcoholic beverages can vary widely in price. Korea gives as an example, a bottle of bordeaux which has allegedly been known to fetch thousands of dollars at auction, while a bottle of potato-based alcohol can be very cheap. In Korea's view, one of the factors affecting the price of an alcoholic beverage is the type of raw materials used to produce it. Additional manufacturing processes, such as ageing, increase the value and price of a product, partly because only a selected portion of the product is suitable for ageing. Prices will also be affected by distribution costs and margins, product image, consumer demand, etc.

4. Korean soju

3.55. Korea notes that despite their similarity in names, a sharp distinction must be drawn between 'diluted' or 'standard' soju on the one hand, and distilled soju on the other hand. Standard soju is *not* a diluted form of distilled soju.²²

3.56. According to Korea, standard soju is a very common beverage, and millions of litres are sold each year.²³ Korea asserts that it is made from cheap raw materials: joojung (ethyl alcohol), which is drawn from fermented sweet potatoes, tapioca or corn and distilled so as to obtain as pure an alcohol

²² Korea asserts that the word 'soju' is a term which has become generic.

²³ The exact figure for standard soju taxed volume in 1996 is 787 195 kl. (Sources: National Tax Administration, *Statistical Yearbook of National Tax 1996* (1997); Customs Administration & Korean Traders Association, *Statistical Yearbook of Trade 1996* (1997)). The exact figure for standard soju taxed volume in 1997 is 814 159 kl. (Source: National Tax Administration, not yet published.)

as possible. To make standard soju, that alcohol (joojung) is not further distilled, but is diluted with water, and six to seven additives are added.²⁴ Korea adds no further ageing or colouring is permitted by law. Korea asserts that this drink has a relatively low alcoholic strength for a spirit: 25%.

3.57. Korea further argues that another unusual characteristic of standard soju is that, unlike other spirits, it is commonly consumed with meals. This is also recognised outside Korea, in areas with important Korean communities. Korea cites as an example Santa Clara, California, where Korean restaurants that only have a license to sell low alcohol drinks are permitted a special exemption to sell standard soju as well. According to Korea, this is a recognition of the fact that it is customary for Koreans to drink a distilled beverage (of 25% alcohol content) with their meals.²⁵

3.58. Korea argues that distilled soju, on the other hand, is an artisanal product,²⁶ sold in tiny quantities (0.2% of the volume of standard soju).²⁷ According to Korea, distilled soju is usually made from grain or rice.²⁸ Korea states that the production process is quite sophisticated, no additives are added. By law, argues Korea, distilled soju can be aged for up to two years prior to sale. Korea also asserts that the alcoholic strength of distilled soju is 40% to 45%, which is considerably stronger than standard soju. Korea also argues that moreover, distilled soju has a distinct taste, which is smoother than standard soju. Distilled soju is 10 to 20 times more expensive than standard soju, pre-tax, and is packaged in special ceramic bottles, and is often offered as a gift.

3.59. Korea states that it should be noted that the Korean liquor tax law classifies standard soju and distilled soju separately and attaches a different tax rate to each, 35% and 50% respectively. Korea also notes that while the United States acknowledges that standard soju and distilled soju have the same rate of Education Tax (10%), it fails to mention that the liquor tax on distilled soju is 50%, while the liquor tax on standard soju is 35%. Korea also notes that another mistaken attempt at trivialising the distinctions between distilled and standard soju is the EC assertion that the distinction in the tax law was introduced only in 1991, and that this was in response to pressure from the European Communities. According to Korea, the distinction was made as early as 1962.

3.60. Korea notes that in recent years certain "up-market" varieties of standard soju have been introduced, which are commonly referred to as 'premium' soju. The composition of "premium" is slightly different from standard soju, giving the drink a somewhat milder taste.²⁹ The producers charge a higher price for this variety, up to twice the price for standard soju before tax. According to Korea, to justify this higher price, they sometimes make exaggerated claims.

²⁴ Sugar, citric acid, amino acid, solbitol, mineral salt, stevioside, and aspartame. These additives all serve a particular purpose to enhance the taste of soju, i.e., sugar, to make it sweet; citric acid, to give soju a sour taste; amino acid, to enhance its flavour and act as a sweetener, adding a seaweed-like taste; solbitol, a form of sweetener which has a thick sweet taste; mineral salt, which acts as a catalyst to bring a change of taste to all the additives; stevioside, which has strong light sweet taste 150 to 300 times sweeter than sugar; and aspartame (nutrasweet), which is a chemical flavour enhancement 200 times sweeter than sugar.

²⁵ According to Korea, 'Today, soju and a platter of barbecued meat are as inseparable in South Korea as beer and hot dogs or margheritas and chips in the United States', San Jose Mercury News, http://infi.net/global/cgi-bin/sj/slwebcli_post.pl.

²⁶ The artisans who make distilled soju are recognised as 'Human Treasures' by Korean Governmental Decree. Their skill is recognised as an 'Intangible Cultural Asset'. One such example (Moon Bae-Sool) is shown in US Exhibit D.

²⁷ The exact figure for distilled soju consumption in 1996 is 1325 kl. Source: National Tax Administration, Statistical Yearbook of National Tax 1996 (1997).

²⁸ The complainants state that distilled soju is made of potato or grain. Korea claims that in reality potatoes are not used. The leading brands of distilled soju (Moon Bae-Sool and Andong Soju) are made from grain or rice.

²⁹ For instance, in the leading brand of 'premium' soju, Kimsatgat, honey replaces stevioside as one of the seven additives.

3.61. Korea also argues that the complainants focus on these claims to draw inferences for the entire soju market,³⁰ or even to question the credibility of information Korea gave during the consultations which took place prior to this Panel proceeding, implying that Korea drew a false distinction between distilled and standard soju.³¹ In Korea's view, the reality is, however, that premium soju is no more than an upgraded commodity. It is classified as standard soju in the liquor tax law. Premium soju only represented 4.46% of standard soju sales in 1996 and 5.39% in 1997.³²

5. Changes since 1990

3.62. Korea asserts that there is a strong undertone in the complainants' submissions that there has always been something wrong with Korea's liquor and education taxes, and under pressure from the EC and the US, Korea finally came to recognise this. Korea further states that the complainants suggest that the changes Korea introduced since 1990 came too slowly, and ultimately did not remove the illegal nature of the taxes.

3.63. According to Korea, the European Communities and the United States have indeed gone to great lengths to influence Korea's domestic policies in the recent past. Korea submits that in the interest of avoiding friction with important trading partners and allies, Korea has tried to accommodate US and EC demands by foregoing tax revenue. In Korea's view, this was not an admission of fault.

3.64. Korea notes that the European Communities alleges that decreases in Korea's liquor tax were 'almost totally offset by a simultaneous increase of the applicable education tax rate'.³³ According to Korea, the European Communities should have also mentioned that at the time that the education tax was increased from 10% to 30%, the defence tax (30%) was repealed. Thus, in Korea's view, there was an overall reduction in the applicable tax rate.

³⁰ To illustrate, the 15 pages of advertisements included in the EC first submission only include two advertisements for standard soju (about 95% of the soju market), all the rest being advertisements for premium soju (4 to 5% of the soju market).

³¹ According to Korea, the EC, in support of this suggestion, cited advertisements for a standard soju brand which claimed that this soju was aged. However, the Korean Fair Trade Commission, in a decision of 30 November 1996, found that this claim constituted false advertising. The decision is reproduced in Attachment 1.

³² According to Korea, in 1996, total taxed volume of premium soju was 35 108 kl (including the leading brands 'Chamnamoo' produced by Jinro, 'Kimsatgat' produced by Bohae and 'Chungsanri' produced by Kyoungwoul). In 1997, total taxed volume was 43 873 kl (including the same brands). (Source: National Tax Administration). The EC and US estimate, unsubstantiated, that premium soju sales represented 6% of total soju sales in 1996 and increased to 10% in 1997 is therefore incorrect. (See EC first submission at para. 54 and US first submission at para. 41.) Note that the total taxed volume of standard soju was 787 195 kl in 1996 and 814 159 kl in 1997.

³³ EC first submission, para. 57.

3.65. Korea presents the following table that purports to show the reduced tax burden on whisky since 1991:

(in %)	Whisky liquor tax	Education tax	Defence tax	Combined surtax burden	Combined tax burden
Before 1991	200	10	30	80	280
Before 1994	150	30	-	45	195
Before 1996	120	30	-	36	156
Since 1996	100	30	-	30	130

IV. CLAIMS OF THE PARTIES

4.1. The European Communities claims that:

- (i) Korea is in breach of its obligations under GATT Article III:2, first sentence, by applying internal taxes on imported vodka pursuant to the Liquor Tax Law and the Education Tax which are in excess of those applied on soju; and
- (ii) Korea is in breach of its obligations under Article III:2, second sentence, by applying higher internal taxes pursuant to the Liquor Tax Law and the Education Tax Law on imported liquors falling within the categories of 'whisky', 'brandy', 'general distilled liquors', 'liqueurs', and 'other liquors' (to the extent that they contain other distilled spirits or liqueurs) than on soju, so as to afford protection to its domestic production of soju.

4.2. The United States claims that the Korean laws outlined above differentiate among distilled spirits on the basis of arbitrary characteristics, resulting in great disparities in the treatment of soju and imported distilled spirits. According to the United States, at the very minimum:

- (i) Korea's application of internal taxes on vodka that exceed taxes applied to soju is inconsistent with the first sentence of GATT Article III:2; and
- (ii) Korea's application of higher internal taxes to imported distilled spirits classified under HS heading 2208 falling within its legal categories of "whisky," "brandy," "general distilled liquors," "liqueurs" and "other liquors" (to the extent that they contain other distilled spirits) afford protection to its domestic production of soju, inconsistent with the second sentence of Article III:2.

V. LEGAL ARGUMENTS

A. PRELIMINARY ISSUES

1. General

5.1. The complainants argue that Korea's request for preliminary rulings was not properly formulated and it was unclear what provisions of the WTO Agreement, if any, Korea considers to have been violated by the complainants, and that it was also unclear what precisely is the issue being addressed by Korea to the Panel.

5.2. According to the European Communities, it is unclear whether Korea is asking the Panel to find that the European Communities has violated certain procedural provisions of the DSU, or whether it is asking the Panel to dismiss the complaint because certain procedural pre-requisites were not fulfilled, or whether it is asking the Panel to discharge itself.

5.3. The United States was of the view that given the scarce information provided by Korea in Korea's oral statement (which formed the basis of its request for preliminary rulings) it considers that any preliminary ruling by the Panel would not be warranted. The United States adds that to the extent the request for a preliminary ruling warrants any attention, it may be addressed in the Final Panel report.

2. Specificity of the panel requests

5.4. Korea takes issue with the specificity of the requests for a panel made by both the European Communities and the United States.

5.5. Korea notes that the European Communities, in its request for a panel, has referred to a preferential tax rate on 'soju' vis-a-vis 'certain' alcoholic beverages falling within HS heading 2208. Korea states that the European Communities has not clarified its position even in its written submission. Korea further notes that the European Communities claim that 'all other distilled spirits and liqueurs' other than 'soju' falling within HS 2208 are within the purview of this dispute.

5.6. Korea states that the US' request for a panel lacks specificity as well. Korea notes that the United States, in its request for a panel, refers to higher tax rates on 'other distilled spirits', while specifically mentioning 'whisky, brandy, vodka, rum, gin, and all mixtures'. Korea further notes that the United States, in its first submission, seeks to broaden the dispute to all distilled spirits, other than soju, that are classified under HS 2208.

5.7. Korea argues that such vaguely worded complaints violate its rights of defence. According to Korea, HS 2208 is a very broad tariff classification, which covers a wide variety of alcoholic beverages, including non-western liquors such as koryangu, Korean soju, Insam ju, Ogapiju, and Japanese shochu. Korea notes that it is surprising that both complainants refer to 'western-style liquors', yet HS 2208 also includes non-'western-style liquors'.

5.8. Korea argues that this lack of specificity of the complainants' claims is improper for two reasons -

- (i) it frustrates Korea's right of defense, which is a general principle of due process implicit in the DSU; and

- (ii) it violates a clear obligation of the DSU, which is that such a request should 'identify' the specific measures at issue, and 'present the problem clearly', as stipulated in Article 6.

5.9. Korea, therefore, requests the panel to issue a preliminary ruling, limiting the products at issue in this dispute. Korea submits that the only imported liquors whose tax rates are to be compared with the tax rate on the domestic soju products are: whisky, brandy, vodka, gin, and rum. According to Korea, these are the liquors identified specifically by the United States in its request for a panel. In Korea's view, parties to a dispute cannot unilaterally alter the terms of reference by expanding, in their first submission, on issues not previously raised.

5.10. Korea also submits that it is unable to identify which items the United States is referring to by its reference to 'ad mixtures' in its request for a panel.

5.11. Korea also claims that the complainants have not clearly distinguished the domestic liquors that are supposed to be more favourably taxed in Korea. Korea states, in particular, that the complainants have not distinguished between Korea's distilled soju, an artisanal product sold at very high prices in tiny quantities, and subject to a 50% tax rate, on the one hand, and, on the other hand, diluted or standard soju, which is a large volume, inexpensive drink, consumed with meals and taxed at a rate of 35%.

5.12. Korea argues that both complainants, in their requests for a panel, have referred to one 'soju' product, without acknowledging that there are, in reality, two different products, with two different tax rates. Korea also states that the complainants have not recognized that one group of western-style spirits ('liqueurs'), which they have mentioned in passing, is taxed at the same rate as distilled soju (50%).

5.13. The European Communities argues that its panel request is more than sufficiently specific to meet the minimum requirements of Article 6.2 of the DSU. According to the European Communities, the mere fact that HS 22.08 covers many different types of liquors is no basis to consider that it lacks specificity.

5.14. The European Communities also rejects Korea's assertion that it has, through its first submission, broadened the scope of its complaint as contained in the request for a panel. According to the European Communities, its request for a panel refers to '.. certain alcoholic beverages falling within HS 22.08'. In the EC's view, that HS position does not cover only 'spirits' but also 'undistilled ethyl alcohol of an alcoholic strength by volume of less than 80% 'liqueurs' and 'other spirituous beverages' not falling within any other position of chapter 22 of the HS.

5.15. The European Communities notes that its first submission refers to 'soju and all other distilled spirits and liqueurs falling within HS 22.08. In the EC's view, therefore, its first submission if anything narrows rather than broadens the scope of its complaint.

5.16. The United States argues that Article 6.2 of the DSU requires, inter alia, that the request for a panel "identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly." According to the United States, its panel request satisfied both these requirements, and it also clearly includes all distilled spirits within HS heading 2208, as maintained in the first US submission.

5.17. The United States argues that in accordance with Article 6.2 of the DSU, its request for the establishment of a panel defined the Korean measures at issue: the general liquor tax law and the Education Tax; and provided a brief summary of the legal basis of the complaint. The United States refers to *Bananas III*, where the Appellate Body allegedly noted that this provision concerning the

legal basis requires that the request for a panel must be sufficiently specific with respect to the claims being advanced, but need not lay out all the arguments³⁴ that will subsequently be made in the party's submission. The United States argues that with respect to its request in this dispute, the legal claim is clear: that Korea's taxes are higher on imported distilled spirits than on its domestic product "soju," in violation of Article III:2 of the GATT.

5.18. The United States argues that Korea's request that the Panel limit the proceeding to five specific products -- whisky, brandy, vodka, rum, and gin, is equally without basis. According to the United States, the panel request, which defines the terms of reference of the panel, refers to taxation of "other distilled spirits" -- *i.e.*, distilled spirits other than soju. By using the term "such as," it sets forth the five products and "ad mixtures"³⁵ as examples, and not as an exclusive list. According to the United States, the extent to which the United States and European Communities establish to the Panel that all such products are "like" or "directly competitive or substitutable" is a matter to be determined through the course of these proceedings, beginning with the first submission. The United States notes that, under Article 7 of the DSU, the Panel may not decline to address products that are clearly within its terms of reference, but must base its findings on the entirety of the proceeding.³⁶

5.19. As regards the challenge of defining which soju is referred to, the European Communities states that it regards all the varieties of soju as one product, with the necessary result that 'liqueurs' are more heavily taxed than some soju. According to the European Communities, the question of whether soju is or is not a single product is a substantive issue which cannot be decided by the panel in a preliminary ruling.

5.20. The United States also argues that with respect to the use of the word "soju," its panel request made it clear that the tax preference for all soju was covered, giving Korea ample objective notice that the entire category was to be challenged. According to the United States, given the major emphasis in Korea's first submission concerning the differences between diluted and distilled soju, it is evident that Korea in fact did have ample notice -- sufficient to structure its entire first submission on the basis of alleged differences in the two kinds of soju.

3. Adequacy of consultations

5.21. Korea also submits that explicit obligations of the DSU - namely 3.3, 3.7 and 4.5 - have been violated. Korea in effect alleges that the complainants did not engage in consultations in good faith with a view to reaching a mutual solution as envisaged by the DSU.

5.22. Korea alleges that there was no meaningful exchange of facts because the complainants treated the consultations as a one-sided question and answer session, and therefore, frustrated any reasonable chance for a settlement.

³⁴ Appellate Body Report on *European Communities - Regime for the Importation, Sale and Distribution of Bananas (Bananas III)*, adopted on 25 September 1997, WT/DS27/AB/R, para. 141.

³⁵ According to the United States, ad-mixtures are generally low grade distilled spirits composed of a percentage of high grade spirits combined with neutral spirits and water. They are taxed as "other liquors" under Article 3.11 of the Korean Liquor Law, and are thus well within the terms of reference. For instance, in Korea, there are many brands of ad mixes, such as Black Joker malt whisky. The alcohol in Black Joker contains 19.9% whisky, with the other 80.1% coming from neutral spirits. The product then looks and tastes like whisky, but is considerably cheaper. This is due to the fact that neutral spirits do not undergo any post distillation processing, unlike whisky which must be aged in wooden barrels for two years, or more.

³⁶ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages* adopted on 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R at 27; Appellate Body Report, *Bananas III*, paras. 145-147.

5.23. Korea considers this non-observance of specific provisions of the DSU as a "violation of the tenets of the WTO dispute settlement system" and requests the Panel for a ruling (no indication is made as to what relief Korea is seeking on this point).

5.24. Both complainants assert that Korea's claim would appear to be that they have infringed Articles 3.3, 3.7 and 4.5 of the DSU because they did not attempt to reach a mutually acceptable solution to the dispute in the course of the consultations that preceded the establishment of this Panel. They note that at the first meeting with the Panel, Korea asserted that the United States and the European Communities have "ignored":

- (i) Article 3.3 of the DSU, which provides that the "prompt settlement of disputes is essential to the effective functioning of the WTO";
- (ii) Article 3.7 of the DSU, to the extent it calls for a "mutually acceptable" and "positive" solution; and
- (iii) Article 4.5 of the DSU, which states that in the course of consultations, Members should attempt to "obtain satisfactory adjustment" of the matter.

5.25. The complainants refer to the panel decision in *Bananas III* in which it was stated

[...] Consultations are, however, a matter reserved for the parties. The DSB is not involved; no panel is involved; and the consultations are held in the absence of the Secretariat. In these circumstances, we are not in a position to evaluate the consultation process in order to determine if it functioned in a particular way. While a mutually agreed solution is to be preferred, in some cases it is not possible for the parties to agree upon one. In those cases, it is our view that the function of the panel is only to ascertain that consultations, if required, were in fact held or, at least, requested.

As to the EC argument that consultations must lead to an adequate explanation of the complainants' case, we cannot agree. Consultations are the first step in the dispute settlement process. While one function of the consultations may be to clarify what the case is about, there is nothing in the DSU that provides that a complainant cannot request a panel unless its case is adequately explained in the consultations. The fulfilment of such a requirement would be difficult, if not impossible for the complainant to demonstrate if a respondent chose to claim a lack of understanding of the case, a result which would undermine the automatic nature of the panel establishment under the DSU. The only per-requisite for requesting a panel is that consultations have 'failed to settle a dispute within 60 days of receipt of the request for consultations... Ultimately, the function of providing notice to a respondent of a complainant's claims and arguments is served by the request for the establishment of a panel and by the complainants' submissions to that panel.³⁷

The complainants point out that Korea cannot dispute the fact that consultations were in fact held on three separate occasions between itself and both the United States and the European Communities.

5.26. The complainants state that, in any event it is not true that they refused to engage in a 'meaningful exchange of facts' during the GATT Article XXII consultations. They allege that it was Korea's attitude during the consultations which prevented such exchange from taking place.

³⁷ Panel Report on *Bananas III*, WT/DS27/R, paras. 7.18-7.19.

5.27. The United States further argues that Korea's complaints about the alleged inadequacy of the complainants' attempts to settle the dispute or engage in good faith consultations have no bearing on the authority of the Panel or the progress of this proceeding.

5.28. The United States asserts that Korea's assertion that the United States and the European Communities failed to engage in good faith consultations is belied by the record. According to the United States, the three parties to this dispute (Korea, the United States and the European Communities) held consultations on three separate occasions over a six-week period, in which numerous factual and legal issues were discussed, including the fact that the Korean Liquor Law applies to all types of distilled spirits covered by HS 2208. The United States asserts that it presented detailed factual questions to Korea and requested that the answers be provided in writing. According to the United States, Korea refused to reply in writing but did agree to provide oral answers. The United States also states that Korea acknowledged that it was in possession of a market study commissioned by Korean producers of distilled spirits, but declined to provide a copy.

5.29. The United States asserts that with the European Communities, it requested Korean data for 1990-1996 on all distilled spirits under HS heading 2208, by both volume and value, Korea initially stated at the 24 June consultation that it would try to provide this information. According to the United States, however, during the consultations held on 8 August 1997, the Korean delegation refused to provide copies of this information, stating that it was only for the use of its private lawyers for defensive purposes in the event a panel proceeding was initiated.

5.30. The United States, therefore, believes that these events make all the more baffling Korea's request for a procedural ruling, given that the United States failed to obtain sufficient factual information from Korea.

4. Confidentiality

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

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

5.33. It is also the EC view that, if the interpretation by Korea of Article 4.6 were correct, it is Korea which has violated Article 4.6 of the DSU by making extensive reference to the consultations in support of its claim under Article 3.3, 3.7, and 4.5 of the DSU.

5.34. The European Communities concludes that it is not the purpose of Article 4.6 of the DSU to limit the possibilities available to a panel to be apprised of information on the dispute before it. In the EC's view, there can be no 'artificial wall' between the consultation and the panel proceeding through which the transfer of information is blocked.

5.35. The United States considers that Korea's claim concerning a breach of confidentiality in the U.S. and EC submission is unclear concerning the relief it requests. to the extent it alleges a violation of the DSU, such a claim is not within the panel's terms of reference. Moreover, according to the United States, the citation in a footnote in the first U.S. submission cited by Korea attempted to

highlight a factual issue concerning which there was confusion in the Korean law, a point that was rectified by the first submission and is of no consequence as a factual or legal matter.

B. PANEL AND APPELLATE BODY REPORTS ON *JAPAN - TAXES ON ALCOHOLIC BEVERAGES*

1. Complainants

5.36. According to the European Communities, the Korean liquor tax system at issue in this dispute is very similar to the system in place in Japan until very recently. The European Communities argues that, like Korea in the instant situation, Japan applied a much lower rate to shochu (a local distilled liquor which, the European Communities consider is "like" Korean soju) than to "western-style" distilled spirits and liqueurs which are "like" or "directly competitive or substitutable" with shochu.

5.37. The European Communities notes that the Japanese liquor tax system was found to violate Article III:2 of GATT by the 1987 Panel Report on *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*³⁸ (*Japan - Taxes on Alcoholic Beverages I*) and again by the 1996 Panel and Appellate Body Reports on *Japan - Taxes on Alcoholic Beverages*³⁹ (*Japan - Taxes on Alcoholic Beverages II*).

5.38. The European Communities concedes that, in accordance with the Panels' terms of reference, that finding was limited to the Japanese market. In the EC view, however, this does not mean that it is irrelevant to the present dispute. The EC view is that although there may still subsist superficial differences between the Japanese and the Korean market, the underlying dynamics of both markets are very similar. According to the European Communities, there is no good reason why the findings made by prior Panels with respect to the Japanese market should not be considered as pertinent in the present dispute.

5.39. The United States argues that the Korean liquor tax system at issue in this dispute is very similar to the system in place in Japan until very recently. The United States further argues that like Korea, Japan has long protected shochu, a local distilled liquor which, in its pure form, is identical to Korean soju. According to the United States, until recently, Japan applied a much lower tax rate to shochu than to other categories of Western distilled spirits that -are "like" or "directly competitive or substitutable with" shochu. The United States alleges that the structure of its law is remarkably similar to the Korea tax law, including a broad definition for shochu from which beverages such as those using a birch filter (i.e., vodka) are arbitrarily excepted.

5.40. According to the complainants, the main difference between the Korean liquor tax system and the Japanese system is that in the Korean system the taxes take the form of an *ad valorem* duty whereas Japan applied specific taxes. In the complainants view, for the purposes of this dispute, however, this has the consequence only of rendering even more transparent the protective effects of the Korean system as compared to those of the Japanese system. According to the complainants, in *Japan - Taxes on Alcoholic Beverages II*,⁴⁰ Japan's main line of defence was that while the rates on shochu were lower, the "tax/price ratios" (i.e. the tax burden expressed as a percentage of the retail price) for all categories were "roughly the same". In the complainants view, in the present case, since the taxes are *ad valorem*, Japan's attempted defence is not available to Korea.

³⁸ Panel Report on *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, (*Japan - Taxes on Alcoholic Beverages I*) adopted on 10 November 1987, BISD 34S/83.

³⁹ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, WT/DS8/R, WT/DS10/R, WT/DS11/R, as modified by the Appellate Body Report, *supra*.

⁴⁰ *Ibid.* paras 4.154-4.166.

5.41. The European Communities states that during the consultations Korea claimed, although without providing any supporting evidence, that current consumption patterns in Korea differ from consumption patterns in Japan. According to the European Communities, even if the alleged differences were proved to be significant, they would merely reflect the fact that western-style liquors became a mass product in Japan earlier than in Korea, to a large extent as a result of an earlier liberalisation of imports.

5.42. The European Communities further argues that the Korean market has no inherent or permanent characteristic which makes it so different from the Japanese market as to warrant the conclusion that the very same liquors which were found to be "substitutable and competitive" on the Japanese market in 1987 and 1996 cannot be regarded as such in Korea. To the contrary, the EC argument goes, the current Korean market for distilled spirits and liqueurs is in many ways reminiscent of the Japanese market in the early eighties.

5.43. The European Communities argues that, as in Japan one decade before, since the early nineties an increase in the levels of disposable income, coupled with the lifting of import quotas and a reduction in the applicable tariffs and internal taxes, have led to a spectacular increase in sales of western-style liquors on the Korean market, and in particular of whisky.

5.44. According to the European Communities, Korean consumers, like their Japanese neighbours, at first perceived western-style liquors as "luxury" items to be offered as gifts or to be consumed only on special occasions and at special places. Over time, however, the argument goes, there has been, both in Japan and in Korea, a clear trend towards lower prices, greater availability in all sales channels, and consumption patterns which are more similar to those of the "traditional" local liquor.

5.45. The European Communities further states that there has also been a trend towards the "internationalisation" of the local liquors, which in Korea is illustrated by the recent emergence of the premium soju segment and in Japan by the proliferation of whisky-like and vodka-like shochu. The result of these two converging trends is an ever increasing degree of competition between shochu/soju and western-style liquors.

5.46. The European Communities concludes, that given the close resemblance between the Korean liquor tax system and the Japanese measures at issue in *Japan - Taxes on Alcoholic Beverages I and II*, the Panel and Appellate Body reports adopted in those disputes are particularly relevant and should provide decisive guidance to this Panel. It is submitted by the European Communities, in particular, that the findings of those two Panels and of the Appellate Body to the effect that vodka and shochu/soju are "like" products and that shochu/soju and all other distilled spirits and liqueurs are "substitutable" and "competitive" products, are equally relevant for this dispute.

5.47. The United States also takes the position that the development of the distilled spirits markets in Japan and Korea are very similar. According to the United States, since the early 1990's an increase in the levels of disposable income, coupled with the lifting of the import restrictions and a reduction in the applicable tariffs and internal taxes, have led to a spectacular increase in sales of Western-style spirits on the Korean market, in particular whisky.

5.48. The United States further asserts that, like their Japanese neighbours, Korean consumers at first perceived Western-style liquors as "luxury" items to be offered as gifts or to be consumed only on special occasions and at special places. Over time, however, there has been, both in Japan and in Korea, a clear trend towards consumption of all types of distilled spirits on more and varied occasions, and in different methods of consumption, i.e. in mixed drinks, warm, cold, etc. According to the United States, the expanding methods and venues of consumption have also been aided by greater availability of all types of spirits in all sales channels.

5.49. According to the United States, the result of expanded purposes for spirits, and the burgeoning styles of soju is an ever increasing degree of competition between soju and Western-style liquors. Those trends are converging in Korea, as in Japan.

5.50. The United States also concludes that the close similarity between the Korean liquor tax system and the Japanese measures at issue in the recent WTO/GATT disputes make the Panel and Appellate Body findings in that case very pertinent to this Panel's examination of Korean tax measures. In particular, the United States argues that the findings of those two panels and of the Appellate Body to the effect that vodka and shochu/soju are "like" products and that shochu/soju and all other distilled spirits are directly competitive or substitutable products are especially relevant for this dispute.

2. Korea

5.51. Korea notes that both the United States and the European Communities demonstrate the desire simply to superimpose the results of the 1996 *Japan - Taxes on Alcoholic Beverages* Panel on this case. In Korea's view, the complainants attempt to equate Japan and Korea, their markets, and the products at issue. According to Korea, they do so by asserting that soju and shochu are 'identical', and that the 'underlying dynamics of both [the Japanese and Korean] markets are very similar', save some 'superficial differences'. Korea argues that this approach is not compatible with Article III:2 GATT.

5.52. Korea argues that Korean soju is not identical to Japanese shochu, irrespective of statements made in the context of the Japan case, to which Korea was not a party. Korea cites the example from the complainants to say that Korean companies are exporting soju to Japan. According to Korea, when Korean soju is exported to Japan, it is destined for the Korean community in Japan,⁴¹ and sold in Korean stores and restaurants. However, argues Korea, Korean producers exporting to Japan are primarily aiming to capture Japanese consumers. For this purpose, they export a different product, a sort of 'Korean shochu'. These two products are taxed differently under the Japanese liquor tax law. Korea adds that 'Korean shochu' is not sold in Korea.

5.53. Korea further argues that despite the complainants' contentions, the Korean case is not a 'mirror image' of the Japanese case, and Korea will not entertain arguments in that vein. Korea argues that it need only point to the *Japan - Taxes on Alcoholic Beverages II* Panel report itself, which repeatedly stresses that an Article III examination must be carried out on a 'case-by-case basis',⁴² noting in particular that 'consumers' tastes and habits . . . change from country to country'.⁴³

5.54. Korea acknowledges that the *Japan - Taxes on Alcoholic Beverages II* case sets forth the legal framework for the application and interpretation of Article III of GATT. Korea accepts that it will follow that framework in its analysis, but adds that when these legal rules are applied to the facts of this case, the result is completely different than under the dissimilar set of facts of the Japanese case.

Korea and Japan: differences between their products and markets

5.55. According to Korea, the first noticeable difference between soju and shochu is taste. Korea argues that Japanese shochu has a neutral taste compared to Korean soju, which is sweeter.⁴⁴

⁴¹ Korean residents in Japan numbered 699 847 persons as of June 1997.

⁴² Panel Report, paras. 6.21, 6.22, and 6.28 of the 1996 .

⁴³ Panel Report, paras. 6.21.

⁴⁴ Korea argues that soju contains six to seven additives whereas shochu only has up to two (citric acid and sugar). Korea notes that this distinction is not recognised in the 'test report' by the Scotch Whisky Research Institute, appended as EC Annex 8. Korea further notes that according to this 'test report', Korean standard soju

Consumers easily recognise that taste difference; Koreans prefer soju and will not accept shochu as a substitute; the Japanese feel the same way about shochu.

5.56. Secondly, according to Korea, soju is allegedly only drunk straight at a cold temperature. In Japan, on the other hand, different consumption patterns exist for the consumption of shochu: one can drink it straight or mixed with warm or cold water.⁴⁵

5.57. Korea argues that these differences are so important that Korean companies attempting to sell Korean soju in Japan have had to make a special product to appeal to the Japanese consumer. As an example Korea refers to the Korean company Jinro, which sells two products on the Japanese market, Jinro Gold and Jinro Export. According to Korea, the first product is exported to Japan in very small quantities (32 kl in 1997) with the primary purpose of targeting the Korean residents in Japan. This brand is only distributed to Korean restaurants and Korean supermarkets in Japan. The second brand, Jinro Export, targets Japanese consumers and represents the bulk of Jinro's exports to Japan (27 182 kl in 1997).⁴⁶ Korea argues that it is made to suit the Japanese taste,⁴⁷ sold in differently shaped bottles,⁴⁸ at much higher prices,⁴⁹ and is not available on the Korean market.

5.58. Korea also alludes to the EC contention that in Japan, soju is considered for tax purposes as being the same product as local 'shochu', which Korea argues is incorrect. According to Korea, when Korean standard soju (such as Jinro Gold) is exported to Japan, it is treated as a 'spirit' for tax purposes. Only the specially-produced 'Korean shochu', such as Jinro Export, is treated like Japanese shochu by the Japanese tax authorities. The tax rate for Korean standard soju exports is higher than for 'Korean shochu' exports.⁵⁰

5.59. Korea also argues that there are notable differences in the way shochu is marketed in Japan and the way that standard soju and distilled soju are marketed in Korea. Shochu is marketed more like western-type liquors that can be drunk as cocktails.

5.60. Korea further argues that Japanese shochu producers even make a shochu A (the standard version) that is aged and is brown in colour, and they make an effort to convince consumers that there are a plethora of similarities between brown shochu and whisky. Korea states for example, that the leading brand of brown shochu A in Japan, Takara Legend, closely resembles whisky in colour and packaging. Korea also asserts that in Korea, it is legally prohibited to add colour to standard soju.⁵¹

5.61. Korea contends that another important difference is the pricing structure of the Japanese market. Shochu B (the distilled version) and shochu A are similarly priced, and are selling in comparable volumes. This contrasts to the Korean soju market in which distilled soju is selling in much smaller volumes and at much higher prices than standard soju. According to Korea, in the Japanese shochu market, shochu A and shochu B have comparable market shares, whereas in the

and Japanese standard shochu are 'like' products (see para. 5). Thus, Korea concludes the report is not relevant because it does not distinguish the different additives.

⁴⁵ Korea argues that this difference is further illustrated by US Exhibit I, which shows advertisements for Japanese shochu for Japanese consumers, in which several types of uses are proposed for shochu which do not exist for soju in Korea, i.e., shochu can be drunk warm, mixed with chilled soda or on the rocks.

⁴⁶ Source: manufacturer's information. The total amount of Korean soju and 'shochu' exports to Japan in 1997, covering other manufacturers as well, was 36 478 kl (source: National Tax Administration).

⁴⁷ Unlike Jinro Gold, Jinro Export contains only two additives: sugar and citric acid.

⁴⁸ As is shown by US Exhibit H.

⁴⁹ According to Korea, by at least a factor of 5, before Japanese taxes and charges are applied.

⁵⁰ The current tax rate on standard soju and general spirits in Japan amounts to 367 188 yen/kl. The current rate for Japanese shochu is 201 900 yen/kl.

⁵¹ Standard soju by law must have a coloration level of less than 0.1 degree. (Whisky has a higher coloration level.)

Korean market distilled soju takes up 0.2% of the soju market and standard soju takes up 99.8% of the market.

5.62. Korea notes that as the European Communities argued in the *Japan - Taxes on Alcoholic Beverages II* case, the prices of imported liquors and Japanese shochu were within a relatively short range, with the tax removed.⁵² Korea further notes that in contrast, as the EC experts have recognised in this case, the pre-tax prices for imported liquors in Korea are much higher than the prices for standard soju.⁵³

5.63. In its rebuttal submissions, the European Communities argues that Korea is understandably anxious to escape the clear implications for this dispute of the Panel Report on *Japan - Taxes on Alcoholic Beverages I*,⁵⁴ and the Panel and Appellate Body Reports on *Japan - Taxes on Alcoholic Beverages II*.⁵⁵ The EC view is that Korea unjustly accuses it of trying to apply mechanically the conclusions of those reports to the present case. According to the European Communities, that is an obvious misrepresentation of its position.

5.64. According to the European Communities, the present dispute must be determined on its own merits. The EC view, however, is that this Panel must take into account any adopted Panel and Appellate Body reports which are relevant to this dispute. The European Communities refers to the Appellate Body decision in *Japan - Taxes on Alcoholic Beverages II*, wherein it was stated:

Adopted Panel reports are an important part of the GATT acquis. They are often considered by subsequent Panels. They create legitimate expectations among members, and, therefore should be taken into account where they are relevant to any dispute.⁵⁶

5.65. The EC position is that it has demonstrated that the two Panel reports and the Appellate Body report on *Japan - Taxes on Alcoholic Beverages II* are particularly relevant for the present dispute because:

- (a) the tax measures are very similar;
- (b) the products concerned are the same; and
- (c) there is no fundamental difference between the Japanese market and the Korean market.

The European Communities argues that Korea fails to refute any of those similarities.

5.66. In its rebuttal submission, the United States recalls that its first submission cited the reports of the WTO panel and Appellate Body in the *Japan - Alcoholic Beverages II* case as setting forth the applicable legal standards and factual findings concerning a market, tax measures and products that are identical or analogous to those presented in this dispute. The United States argues that it has not called for a "mechanical" application of the analysis of the Japanese market to the Korean market, as suggested by Korea.⁵⁷

⁵² Panel Report, para. 4.82.

⁵³ EC Annex 13, p.20.

⁵⁴ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra*.

⁵⁵ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*.

⁵⁶ Appellate Body Report, p. 14.

⁵⁷ See Appellate Body Report., *Japan - Alcoholic Beverages II*, *supra*, at 20; see also *Canada - Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, at 21; *The Australian Subsidy on Ammonium Sulphate*, adopted on April 3, 1950, BISD II/188; *EEC - Measures on Animal Feed*

5.67. According to the United States, it is well established that the issue of what is a "like" or "directly competitive or substitutable" product for purposes of Article III:2 must be determined on a case-by-case basis on its own merits. However, in the US view, given the similarities of the tax measures and products involved in the Japanese and Korean markets, this Panel should consider that the conclusions of the panel concerning the products, measures, and extent of competition in the Japanese market can also be reasonably drawn with respect to the facts presented here.

5.68. The United States notes that Korea has contested any similarities between soju and shochu, and between the Korean and Japanese markets and disputes the US point that soju and shochu are "identical." According to the United States, while Korea understandably is entitled to dispute the point, the source for the point made by the United States was the government of Japan, which in *Japan - Taxes on Alcoholic Beverages II* stated that, "Essentially shochu and soju are identical products."⁵⁸ With respect to the fundamental similar qualities of the product, Japan noted that:

These [shochu/soju] products have the following common three features: First, they use grains or potatoes as the base material, which is readily available at low cost in this part of the world. Second, they have a relatively low alcoholic strength. . . . Third, they are consumed directly after distillation. They do not normally undergo further post-distillation processing.⁵⁹

5.69. According to the United States, as the largest importer of Korean soju (Korean imports account for 8 percent of Japan's shochu A market), Japan would appear to be reasonably authoritative regarding the objective characteristics of the products.

5.70. The United States further argues that, even using the marketplace approach, the similarities between the present Korean market and the Japanese market make the Japan panel's findings analogous for purposes of this proceeding. In the US view, in both markets, Western distilled spirits are more expensive and considered premium types of spirits compared to local shochu/soju, and in both markets Western spirits are used for gift-giving more frequently than the local product, although in this dispute, Korea has characterized distilled soju as uniquely suited to gift-giving. The marketplace reacted similarly in Japan and Korea, as consumption of Western spirits increased with the lifting of trade barriers and the narrowing of tax disparities. The United States notes for instance, that US exports of Bourbon to Japan have increased from 6.3 million litres in 1987 to 12.2 million litres in 1997 due to 1989 reforms in the Japanese liquor tax, and US exports of distilled spirits to Korea increased from 170,000 litres in 1990 to 644,000 litres in 1996 following the removal of quota restrictions on bottled imported spirits.

5.71. The United States also notes that the evolution of the marketplace in Korea and Japan also bears great similarity. Only a decade ago, Japanese "izakayas" (the Japanese equivalent of traditional Korean restaurants) used to serve only shochu, sake and beer, whereas western style "snack bars" would serve western distilled spirits, but not shochu. Today, shochu and western distilled spirits are usually available at both the "izakayas" and "snack bars." Korea is beginning to resemble the Japanese market of today, with increasing availability of western spirits in traditional, casual Korean restaurants and bars. According to the United States, Korea's greater constraint of choice of distilled

Proteins, adopted on March 14, 1978, BISD 25S/49; *Spain - Tariff Treatment of Unroasted Coffee*, adopted on June 11, 1981, BISD 28S/102; *Japan - Alcoholic Beverages I*, *supra*; *U.S. - Taxes on Petroleum and Certain Imported Substances*, adopted on June 17, 1987, BISD 34S/136.

⁵⁸ Panel Report, para. 4.178. Japan also stated that "the tax legislation of the Republic of Korea defines soju into two sub-categories of diluted soju, which is equivalent to shochu A, and 'distilled soju, which is equivalent to shochu B, in a manner similar to Japan's definition.'" *Ibid*.

⁵⁹ *Ibid.*, para. 4.175.

spirits availability in various bar and restaurant venues bears a closer resemblance to Japan before its last round of market liberalization in 1989.

5.72. The United States notes that the marketplace does reveal some differences between Korea and Japan. The market for Western spirits in Korea is predominantly served by one type of imported spirit (whisky), while Japan has matured into a market for many types of imported spirits, with the most recent spirit to become popular being tequila. According to the United States, Korean consumption patterns are much more fixed in traditional, family-type restaurants than in Japan, where a wider range of distilled spirits is consumed. However, most of these differences between shochu/soju consumption in Korea and Japan are a function of market maturity and evolution of drinking tastes and styles.

5.73. The United States further states that Korea has conceded that it classifies both soju and shochu in the same HS classification at the eight-digit level -- item 2208.90.40. The fact that Korean manufacturers may export two kinds of soju to Japan (namely, Jinro Gold and Jinro Export) does not make these products any less similar. It is common for companies to modestly differentiate their products in order to meet the needs of different sets of consumers -- one version for expatriates and another, seasoned differently, to meet local tastes and customs. Korean manufacturers do the same when they market two versions of soju in Japan. In fact the differences in the two kinds of soju exports probably reflect Japanese laws and cost considerations more than anything else. Most of the additives in Korean soju are sweeteners with varying thickening qualities (fructose, oligosaccharide and stevioside) -- functions served by sugar in the version for Japanese consumers. Most importantly though, these are clearly additives, as opposed to ingredients. Liquor laws around the world, including Korea's, recognize the distinction by placing a limit on the percentage of sugar that may be added to a distilled spirit (on the order of 2 percent), after which it becomes yet another competitive product, a *liqueur*. At the same time, there is no requirement in Korean law to use any sweetener at all in soju, thus making it possible for soju to contain no additives at all. Korea also classifies soju and shochu identically for both tax and tariff purposes.

5.74. Furthermore, according to the United States, Korea's reliance on differences in the additives between shochu and soju as establishing that they are fundamentally different is contradicted by its description of premium soju. Even though premium soju differs from standard soju by its additives, such as honey, Korea states that premium soju is "only an upgraded version of standard soju." Why are differences in additives critical in the context of vodka and shochu, but irrelevant with respect to premium and standard soju? Clearly, Korea's conclusion concerning premium soju is the legally correct one: such additives should not be decisive in examining these products under Article III.

C. THE BURDEN OF PROOF

1. Korea

5.75. Korea proceeds from the premise that to prove a violation of the first sentence of Article III:2, the Appellate Body in the Japanese Liquor Taxes case clearly stated that there are two limbs that must be proved by the complainant. First the complainants must prove that the products concerned are in fact 'like'. Secondly, the complainants must prove that the imported product was taxed in excess of the domestic 'like' product.

5.76. According to Korea, regarding Article III:2 second sentence, the complainants must prove three things: first, that the imported and domestic products are directly competitive and substitutable products, second, that foreign products are subject to tax differentials that are more than '*de minimis*', and third that tax was applied 'so as to afford protection' to domestic production.

5.77. Korea further argues that under both the first sentence and second sentence, the obligation rests on the complainant to prove all the requirements of the respective sentences. In Korea's view, this burden cannot be discharged by making inadmissible analogies to another case and another set of facts. Korea emphasizes that the burden must be discharged with regard to the facts of the case at hand.

5.78. According to Korea, the Panel can make no ruling about the tax rates of all products falling under HS 2208 in the abstract. Therefore, the complainants must prove, on a product-by-product basis, that the products at issue are directly competitive or substitutable, or even 'like', products.

5.79. Korea points out that the complainants have only submitted evidence regarding a limited number of imported alcoholic drinks falling under HS 2208: whisky, brandy, vodka, gin, and rum. They have also mentioned by name a few other, though by no means all, alcoholic beverages (liqueurs, tequila, and mixtures, koryangju, Japanese shochu) covered by HS 2208, without providing an intelligible argument or evidence in their regard.⁶⁰ In Korea's view, the complainants have not met their burden of proving that these are 'like', or directly competitive or substitutable products with the Korean sojus.

5.80. Korea submits that the complainants' principal and theoretical argument that all distilled spirits necessarily compete everywhere in the world, because of some similarities in physical characteristics and end use, runs counter to the controlling precedent. This precedent, *Japan – Taxes on Alcoholic Beverages II*, clearly requires a concrete market analysis. Furthermore, to the extent the complainants have analysed the Korean market, this analysis is demonstrably poor. Accordingly, the complainants have not met their burden of proof; and they cannot meet their burden by quibbling with Korea's positions.

5.81. Korea submits that it is not up to Korea to prove that the western-style liquors are not DCSP or 'like' any of the Korean sojus. It is up to the complainants to show that they are. Korea does not need to prove that there is no cross-elasticity of demand. In Korea's view, the complainants brought this case; they ought to carry their burden of proving that such cross-elasticities exist. All Korea has to do is rebut the proof brought by the complainants.⁶¹

5.82. Korea further argues that there is not much evidence in the complainants' documents. According to Korea, the complainants make many assertions without any attempt at evidence. Korea further argues that, absent an intelligible argument and supporting evidence, Korea has had no way to defend itself so that this part of the complaint also infringes a fundamental principle of due process.⁶²

5.83. Korea therefore submits that the Panel should reject any such broad-ranging complaints out of hand.

⁶⁰ Korea argues that these products are granted only the most perfunctory mentions by the EC and the US. They do not even figure on the comparative charts that the US and EC have provided (see, for example, EC Annex 9, which only shows standard soju, distilled soju, whisky, brandy, gin, and rum, and the US first submission, table at page 20, which only shows whisky, brandy, gin, rum, vodka, soju and shochu).

⁶¹ According to the European Communities, this case is not like *US - Measure Affecting Imports of Woven Wool Shirts and Blouses from India*, adopted on 23 May 1997, WT/DS33/AB/R. & WT/DS33/R. There the defendant bore the burden of proof in invoking an exception to the GATT.

⁶² See *India-Patent Protection for Pharmaceutical and Agricultural Chemical Products*, adopted on 16 January 1998, WT/DS50/AB/R, at p. 33 (Korea states that due process is a principle implicit in the WTO Dispute Settlement Understanding).

2. Complainants

5.84. The European communities notes that Korea alleges that it has only submitted evidence regarding a limited number of imported alcoholic beverages (namely whisky, brandy, vodka, gin and rum) and claims that the Panel should reject the EC complaint as far as other distilled spirits falling within HS 2280 are concerned.

5.85. According to the European Communities, Korea's claim is factually wrong. In the EC view, Korea appears to have derived its list of products from Annex 9 of the EC submission, yet that Annex is by no means the only piece of evidence submitted by the EC in this case. Other pieces of evidence submitted by the European Communities allegedly do cover specifically other types of distilled spirits.

5.86. In particular, the European Communities takes issue with the proposition that, in order to meet its burden of proof in this case, it is required to provide specific evidence with respect to each and every single type of distilled liquor falling within HS 2208.

5.87. The European Communities refers to Korea's assertion that, "if one travels around the world, one will encounter a seemingly infinite variety of alcoholic beverages." In the EC view, even a much shorter trip within the borders of the EC would suffice to convince the Panel of the large variety of distilled spirits produced in the EC.

5.88. According to the European Communities, had the EC submitted specific evidence with regard to each and every known type of distilled spirit manufactured in the European Communities, the Panel would have been unnecessarily overburdened. Further, the EC view is also that in some cases it would have been materially impossible to gather such evidence. The European Communities refers to one of the criticisms levelled by Korea against the Dodwell study, that the respondents may have been confused by an allegedly too complex set of questions. What, asks the European Communities, if the respondents had been asked to look at the prices of forty or fifty different types of western distilled spirits instead of just seven?

5.89. The European Communities reiterates that all distilled spirits are produced according to the same method and, as a result, share the same basic physical characteristics. The European Communities states that the distilled spirits for which it has submitted specific evidence are those traded in largest volumes, both between the European Communities and Korea, and globally. They are allegedly representative of the full spectrum of distilled spirits. According to the European Communities, there is virtually no distilled spirit whose production process and physical characteristics do not resemble closely those of at least one of the spirits for which the EC has provided specific evidence.

5.90. The European Communities concludes, therefore, that if the Panel found, as it should, that those spirits for which specific evidence has been submitted are "directly competitive and substitutable" with soju, it should infer that all other distilled spirits falling within HS 2208 also are "directly competitive and substitutable" with soju.

5.91. According to the European Communities, this approach has been endorsed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*. In that case, the complainants claimed that shochu was "directly competitive or substitutable" with all other distilled spirits falling within HS 2208. Nevertheless, like the complainants in this case, they submitted specific evidence only with respect to a limited number of representative spirits. The Panel concluded that only certain spirits falling within HS 2208 were "directly competitive or substitutable" with shochu.⁶³ According to the European

⁶³ Panel Report, para. 7.1.

Communities, on appeal, this finding was reversed by the Appellate Body which ruled that the Panel's failure to incorporate in its conclusions all the liquors falling within its terms of reference (i.e. all distilled spirits falling within 2208) was an error of law.⁶⁴

5.92. The United States noted Korea's claim that product-specific evidence must be submitted for every conceivable type of distilled spirit classified under Heading 2208. The United States clarified that the Dodwell study covered the full spectrum of distilled spirits in this dispute and those currently being exported by the United States. While there may be other products of importance, such as pre-mixed cocktails and admixtures, these are only variations of the products employed in the Dodwell study. There is no distilled spirit produced in the United States that is not akin to those employed in the Dodwell study.

5.93. More importantly, argues the United States, given the fundamental similarities between all distilled spirits, it is not necessary to provide specific evidence, even less a market study, for every conceivable product that might fall within HS heading 2208. The products are all fairly highly concentrated forms of distilled alcohol consumed for socialization and relaxation, and all markets recognize them as being in competition. The Korean measures themselves group these products together in the same law, mostly as exceptions to soju. In the Korean tax law, to the extent the Western spirits are not designated in specific categories such as whiskey and brandy, most are lumped in the general category of "general distilled spirits,"⁶⁵ with the same tax rate. Given Korea's own recognition of the similarities of the products, and the other evidence presented in this dispute that the products in the Dodwell study are directly competitive or substitutable with soju, it is reasonable to conclude that all imported distilled spirits are equally so. The Appellate Body in the *Japan* case took precisely this approach. In the *Japan* case, the panel had not included all products within HS heading 2208 in its findings under Article III:2, second sentence, having specified only whisky, brandy, rum, gin and liqueurs.⁶⁶ The Appellate Body found the limited finding was in error and modified it to include all distilled spirits in HS 2208.⁶⁷

D. ARTICLE III ARGUMENTS

1. Complainants

5.94. In this sub-section, the arguments of the European Communities and the United States are combined as the arguments of the "complainants".

(a) GATT Article III:2, first sentence

i) *General*

5.95. The complainants draw the attention of the Panel to GATT Article III:2, first sentence, which provides *that*:

"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"

⁶⁴ Appellate Body Report, p. 26.

⁶⁵ Korean Liquor Tax Law, Article 3.9.

⁶⁶ Panel Report in *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 7.1

⁶⁷ Appellate Body Report in *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at pp. 26, 32.

5.96. The complainants state that as confirmed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*,⁶⁸ in order to establish whether an internal tax is applied in violation of Article III:2, first sentence, it is necessary to make two determinations:

- (i) whether the taxed imported and domestic products are "like"; and
- (ii) whether the taxes applied to the imported products are "in excess of" those applied to the like domestic products.

5.97. According to the complainants, before making those two determinations, it must be ascertained whether the taxes in question constitute an "internal tax".

5.98. The complainants refer to the decision by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, wherein the Appellate Body stated that the general principle contained in Article III:1 informs also the first sentence of Article III:2. Nevertheless, in order to establish a violation of Article III:2, first sentence, it is not necessary to show that the measure at issue is applied "so as to afford protection to domestic production" separately from the above requirements.⁶⁹

ii) *The Liquor Tax and the Education Tax are "internal taxes"*

5.99. The complainants state that the Liquor Tax and the Education Tax are levied on all distilled spirits and liqueurs intended for consumption in Korea, whether locally manufactured or imported, and not just "on" or "in connection" with the importation of distilled spirits and liqueurs. Accordingly, in the EC view, they constitute "internal taxes" in terms of GATT Article III:2, and not "import charges" within the purview of GATT Articles II and VIII.

iii) *Vodka is "like" soju*

5.100. The complainants state that GATT does not define the notion of "like product". According to the complainants, the approach followed by previous Panels has been to examine whether products are "like" on a case-by-case basis in light of factors such as the physical characteristics of the products concerned, their end uses and their customs classification. This approach was endorsed expressly by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*⁷⁰ and in *Canada - Certain Measures Concerning Periodicals*.⁷¹

5.101. The complainants note that in the same reports the Appellate Body held that the terms "like products" should be construed "narrowly" for the purposes of Article III:2, first sentence⁷². The complainants further notes that "like" products need not be identical in all respects⁷³. Thus, it has been established by a previous Panel that in the case of alcoholic beverages:

⁶⁸ Ibid. at pp.18-19. See also Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra*.

⁶⁹ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, pp. 18-19. See also Appellate Body Report on *European Communities – Bananas III*, *supra*, para 216.

⁷⁰ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, p.20.

⁷¹ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra*, p. 21.

⁷² Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, pp 19-20; See also Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra*, p.21

⁷³ See Panel report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, para 6.21. See also the Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra*, para 5.5, referring to the Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances*, *supra*, para 5.11, where the Panel found that some of the imported and domestic products, albeit not identical, were like products since they served substantially the same uses.

[m]inor differences in taste, colour and other properties (including different alcohol contents) do not prevent products from qualifying as like products.⁷⁴

5.102. The complainants take the position that in this instance, vodka and soju are "like" products because they have the same physical characteristics and, consequently, are objectively apt to serve identical end uses. Furthermore, according to the complainants, Korean soju is the same liquor as Japanese shochu, which has already been found by the two Panels on *Japan - Taxes on Alcoholic Beverages* to be "like" vodka.

(a) **Soju and vodka have virtually the same physical characteristics and, therefore, serve for the same end uses**

5.103. According to the complainants, the essential characteristics of vodka and soju can be summarised as follows:

Table 3

	Vodka	Distilled soju	Diluted soju
<u>Raw materials</u>	Potatoes, grains Neutral spirits	Potatoes, grains	Neutral spirits
<u>Process</u>	Continuous	Pot Still	Continuous
<u>Distillation</u>	distillation	distillation	Charcoal filtration excluded
<u>Usual bottling strength</u>	37.5-40% ABV	40-45% ABV	20-30% ABV
<u>Appearance</u>	Clear	Clear	Clear

5.104. According to the complainants, from the above table, it emerges that the main differences between soju and vodka are confined to the following:

- (i) diluted soju is usually bottled at an alcoholic strength of 25 % ABV whereas vodka is sold at 37.5%-40% ABV
- (ii) unlike vodka, distilled soju is obtained by non-continuous distillation and cannot be filtered through white birch charcoal, although it can be filtered through any other materials.

5.105. At the request of the EC industry, the Scotch Whisky Research Institute has conducted a series of analyses on a sample of well known brands of soju and vodka, which prove that the manufacturing processes and the physical characteristics of the two liquors are nearly identical⁷⁵ According to the European Communities the analyses indicate that:

- (i) all the sampled brands had been fermented from similar carbohydrate sources;
- (ii) all of them had been distilled to concentrate alcohols;
- (iii) none had been matured in wood post-distillation;
- (iv) none contained significant levels of residue;

⁷⁴ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para 5.9.

⁷⁵ See EC Annex 8

- (v) none had significant levels of obscurity;
 - (vi) the major volatile congeners were at similar levels in vodka and diluted soju. They are only marginally higher in distilled soju; and
 - (vii) all contained similar levels of methanol.
- (b) **The differences between vodka and soju are the same as between vodka and Japanese shochu**

5.106. According to the complainants, the differences between vodka and soju are clearly minor and do not prevent soju and vodka from being "like" products. In the EC view, the existence of the very same differences between vodka and Japanese shochu did not prevent the two Panels on *Japan - Taxes on Alcoholic Beverages* from reaching the conclusion that those two liquors were "like" in the sense of Article III:2, first sentence.

5.107. The complainants state that the average alcoholic strength of shochu A is, as that of Korean diluted soju, around 25%. In spite of that, notes the complainants, the two Panel Reports on *Japan - Taxes on Alcoholic Beverages* concluded that shochu A was like vodka. The Panel Report on *Japan - Taxes on Alcoholic Beverages II* noted in this regard that:

"... a difference in the physical characteristics of alcoholic strength of two products did not preclude a finding of likeness especially since alcoholic beverages are often drunk in the diluted form..."⁷⁶

5.108. The complainants further note that like distilled soju, both shochu B and shochu A may not, by law, be filtered through white birch charcoal. In addition, the complainants note that the Japanese Liquor Tax Law requires that shochu B must be obtained through discontinuous distillation. In the EC view, however, these differences were not an obstacle for the Panel Report on *Japan - Taxes on Alcoholic Beverages II* to conclude that both types of shochu were like vodka.

(c) **Korean soju is treated as shochu in Japan**

5.109. As mentioned above, Korean soju is exported in large quantities to Japan, where it is treated for all purposes as being the same product as shochu. Diluted soju corresponds to Japanese shochu A, whereas distilled soju is the equivalent to Japanese shochu B.

5.110. The complainants note that in *Japan - Taxes on Alcoholic Beverages II*, the Japanese Government stated that:

"... the largest producer of shochu is either the Republic of Korea or the People's Republic of China ... the liquor tax legislation of the Republic of Korea defines soju in two sub-categories of 'diluted soju', which is equivalent to shochu A, and 'distilled soju', which is equivalent to shochu B, in a manner similar to Japan's definition. Essentially, shochu and soju are identical products"⁷⁷.

5.111. The complainants further note that in response to these claims, 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..."⁷⁸ In the US view, the similarities in the

⁷⁶ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para 6.22

⁷⁷ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para 4.178.

⁷⁸ *Ibid.*, para 6.35.

way Japanese shochu and Korean soju are advertised further confirm the "equivalence" of these products.

5.112. The complainants conclude that the "likeness" of soju and shochu is further confirmed by the results of the analytical tests conducted by the Scotch Whisky Research Institute.⁷⁹

iv) *Imported vodka is taxed "in excess of" soju*

5.113. The complainants argue that the prohibition of discriminatory taxes in Article III:2, first sentence, is not conditional on a trade effects test nor is it qualified by a *de minimis* standard⁸⁰. The complainants refer to the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, which stated that "even the smallest amount of 'excess' is too much"⁸¹.

5.114. The Table below is presented by the complainants purportedly to summarise the differences in taxation between vodka and soju. It purportedly indicates that both the Liquor Tax and the Education Tax are applied to vodka at a much higher rate than to diluted soju and distilled soju. In all, the combined tax rate applied on vodka is 1.9 times higher than the combined rate on distilled soju and 2.7 times higher than the combined tax rate on diluted soju.

Table 4

Comparison of the tax rates on soju and vodka

	<u>Liquor Tax</u>	<u>Education Tax</u> (As % of Liquor Tax Base)	<u>Combined Tax Rate</u>	<u>Discrimination Index</u>
Diluted soju	35 %	3.5 %	38.5 %	1.00
Distilled soju	50 %	5 %	55 %	1.43/1.00
Vodka	80 %	24 %	104 %	2.70/1.89

5.115. The complainants conclude that it is indisputable that the taxes applied to imported vodka pursuant to both the Liquor Tax Law and the Education Tax Law are "in excess of" those applied to soju.

(b) GATT Article III:2, second sentence

i) *General*

5.116. The complainants note that GATT Article III:2, second sentence, reads as follows:

[M]oreover, 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 I.

5.117. The complainants further note that GATT Article III:1 provides in relevant part that:

The contracting parties recognise that internal taxes should not be applied to imported or domestic products so as to afford protection to domestic production.

⁷⁹ See EC Annex 8.

⁸⁰ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 23.

⁸¹ *Ibid.*

5.118. The complainants further note that the Interpretative Note to Article III:2 states that:

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.

5.119. According to the complainants, in *Japan - Taxes on Alcoholic Beverages II*,⁸² the Appellate Body confirmed that in order to determine whether an internal tax measure is inconsistent with Article III:2, second sentence it is necessary to address the following three issues:

- (i) whether the imported products and the domestic products are "directly competitive or substitutable products" which are in competition with each other;
- (ii) whether the directly competitive or substitutable imported and domestic products are "not similarly taxed"; and
- (iii) whether the dissimilar taxation of the directly competitive or substitutable imported products is "applied ... so as to afford protection to domestic production".

5.120. The European Communities in particular note that, in addition, it must be determined whether the measures at issue are "internal taxes". As already discussed above in connection with the application of Article III:2, first sentence, both the Liquor Tax and the Education Tax are internal taxes within the meaning of Article III:2, rather than import charges within the purview of GATT Articles II and VIII. That conclusion, in the complainants' view, is equally valid for the purposes of applying Article III:2, second sentence.

ii) *Soju and all other distilled spirits and liqueurs are competitive and substitutable products*

5.121. According to the complainants, in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body stated that a determination whether two products are "competitive or substitutable" must be made on a case-by-case basis and in light of "all the relevant facts in that case".⁸³

5.122. The complainants further argue that in the same report, the Appellate Body found that in deciding whether two products are directly competitive or substitutable, it may be appropriate to look not only at such matters as physical characteristics, end uses and customs classification but also "at competition in the relevant markets".⁸⁴ In doing so, it is appropriate, according to the Appellate Body, to examine the "elasticity of substitution".⁸⁵

5.123. The complainants argue that it is important to note that Article III:2, second sentence is concerned not only with differences in taxation between products which are actually competitive on a given relevant market but also with differences in taxation between products which are potentially competitive. Indeed, according to the complainants, whereas consumer tastes and habits may differ from one market to another, tax measures should not be used to "freeze" consumers' preference for a domestic product. For that reason, the complainants argue, evidence that two products are not

⁸² Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 24; See also Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, pp. 24-25.

⁸³ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 25

⁸⁴ *Ibid.*

⁸⁵ *Ibid.*

competing actually in a market at a given point in time is not a defense if the absence of actual competition is due, at least in part, to the tax measures in dispute.⁸⁶

(a) Soju and all other distilled spirits and liqueurs have the same basic physical characteristics and are apt for the same end uses

5.124. The complainants argue that the notion of "directly competitive and substitutable" products is broader in scope than that of "like" products. According to the complainants, two products which are too "different" in terms of physical properties or of end uses to qualify as "like" for the purposes of Article III:2, first sentence, may still be "competitive or substitutable" in the sense of Article III:2, second sentence. The complainants note that as recently recalled by the Appellate Body in *Canada - Certain Measures Concerning Periodicals*⁸⁷, a case of "perfect substitutability" would no longer fall within the second sentence of Article III:2, but within the first sentence.

5.125. The complainants further note that the Panel Report on *Japan - Taxes on Alcoholic Beverages I* indicated that:

[t]he 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.⁸⁸

5.126. According to the complainants, the basic physical properties of soju and the other categories of liquors concerned in this dispute are essentially the same. All distilled spirits are concentrated forms of alcohol produced by the process of distillation. In the complainants' view, at the point of distillation, all spirits are nearly identical, which means that raw materials and method of distillation have almost no impact on the final product. Post-distillation processes such as ageing, dilution with water or addition of flavourings, do not change the basic fact that the product sold is still a concentrated form of alcohol.

5.127. The complainants present a table below which compares the key characteristics of soju and the main types of distilled spirits at issue in this dispute. This table purports to show that all of them have essentially the same physical characteristics. For instance, according to the complainants, the main differences between soju and whisky, the largest category after soju, are limited to the following:

- (i) whisky must be made, at least in part, from sprouted grain;
- (ii) whisky has an average alcoholic strength of 37-40% ABV, whereas diluted soju is generally sold at 25%ABV (in contrast, the alcoholic strength of distilled soju is similar to that of whisky); and
- (iii) whisky must be aged in wooden casks.

⁸⁶ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para 6.28. See also Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, p.28.

⁸⁷ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, p. 28.

⁸⁸ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.7

DISTILLED SPIRITS – COMPARISON OF PHYSICAL CHARACTERISTICS AND MANUFACTURING PROCESSES

	WHISKY	BRANDY	GIN	RUM	VODKA	SOJU	SHOCHU
Raw Material	Grain	Grapes	Grain; neutral spirits*	Sugar Cane; Molasses	Grain; Potatoes; neutral spirits*	Grain; Potatoes; neutral spirits*	Grain; Potatoes; neutral spirits*
% of Alcohol at Distillation	†Less than 95%	†Less than 95%	†At or above 95%	†Less than 95%	At or above 95%	Not less than 85%	Not less than 85%
% of Alcohol at Bottling	†Not less than 40%	†Not less than 40%	†Not less than 40%	†Not less than 40%	Not less than 40%	Not less than 20%	Not less than 20%
Method of Distillation	Continuous or Pot Still	Continuous or Pot Still	Continuous	Continuous	Continuous	Continuous or Pot Still	Continuous or Pot Still
Aged in Wooden Casks	Yes	Yes	Yes/no	Yes/no	No	Yes/no	Yes/no
Color	Amber	Amber, Clear ¹	Clear to Amber	Clear to Amber	Clear ²	Clear	Clear to Amber
% of Alcohol	37-50	36-50	37-50	37-50	37-50	20-45	20-45
Added Flavorings	Variety ³	Peach, Blackberry, Cherry, Apricot, Coffee	Spice, Lemon	Spice, Lemon	Currant, Lemon, Orange	Lemon, Honey	Lemon, Variety of Fruit Flavors
Body/Taste Intensity	Medium	Medium	Light to Medium	Light to Medium	Light	Light to medium	Light to Medium

¹ Examples of clear brandies include grappa, pisco

² Addition of flavoring adds color, e.g. red/purple

³ US and Canadian regulations permit the addition of flavorings; EU regulations do not

*Vodka, gin, soju and shochu may be produced from neutral spirits, which is an alcoholic spirit distilled at not less than 95% alcohol by volume from any material of agricultural origin.

†Based on U.S. standards of identity (Title 27 Code of Federal Regulations, part 5); EU and other countries allow bottling of brandy at 36% and vodka, gin and rum at 37.5%, Australia allows whisky to be bottled at 37 per cent. Japan maintains no minimum alcohol requirements for these products.

5.128. The complainants argue that in practice, the above differences are even less important than they might appear at first sight:

- (i) soju can be made and is often made from the same type of cereal grains as whisky, even if they are not sprouted;
- (ii) whisky is often served on the rocks or mixed with water or other non-alcoholic beverages and is therefore consumed at a similar strength as diluted soju;
- (iii) distilled soju can and is sometimes aged for up to two years in wooden casks. Some brands of diluted premium soju claim to be aged in oak barrels.

5.129. The complainants argue that the above differences are clearly not sufficient to prevent soju and whisky from being directly "substitutable" or "competitive" products in the sense of Article III:2, second sentence. According to the complainants, the existence of similar differences between whisky and Japanese shochu did not preclude the 1987 and 1996 Panels on *Japan - Taxes on Alcoholic Beverages* from finding that those liquors were in competition on the Japanese market.⁸⁹

5.130. The complainants further argue that having essentially the same basic physical properties, soju and all the other distilled spirits and liqueurs are objectively apt to serve the same end-uses:

- (i) all of them are drunk with the same purposes: thirst quenching, socialisation, relaxation, etc.
- (ii) all of them may be drunk in similar ways: "straight", diluted with water or other non-alcoholic beverages or mixed with other alcoholic beverages;
- (iii) all of them may be consumed before, after or during meals; and
- (iv) all of them may be consumed at home or in public places such as restaurants, bars, etc.

5.131. In the complainants' view, the above reasons alone are more than sufficient to conclude that soju and all other distilled spirits and liqueurs are objectively "substitutable" and potentially "competitive" in the Korean market. In addition, the complainants argue that there is conclusive evidence that, despite the distortions introduced by the Korean liquor tax system, competition between soju and other distilled liquors on the Korean market is not just potential but, to a significant degree, also actual.

(b) Soju and the other distilled spirits and liqueurs are sold in the same sales channels and are promoted and advertised in a similar way

5.132. The complainants assert that the consumption of western-style liquors used to be confined to upmarket restaurants and entertainment establishments. However, the argument goes, over the past few years western-style liquors have gained considerable distribution penetration. According to the complainants, with the main exception of traditional Korean-style restaurants, where soju and other traditional local liquors continue to predominate, western-style liquors are now widely available alongside soju in most sales channels, both for on-premise and off-premise consumption.

⁸⁹ See Panel Reports on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para 5.7; and on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, paras 6.28 to 6.32.

5.133. As evidence of the increasing availability of western-style liquors, the complainants point to a recent survey completed by Hankook Research in May 1997 and covering more than 700 sales outlets, which allegedly found that the leading brands of whisky were sold in a majority of outlets within each relevant category. More specifically, the survey established that 'Imperial', 'Passport' and 'Dimple', the "three big" brands of whisky, were sold in 76%, 81% and 61%, respectively, of the surveyed on-premise outlets and in 64%, 98 % and 85%, respectively, of the surveyed off-premise outlets.⁹⁰

5.134. The complainants further purport to show by the photographs included in their exhibits⁹¹ that off-premise outlets often display soju and other distilled spirits and liqueurs side-by-side on the same shelves, thus providing evidence in their view, that both the retailers and the public regard them as being in competition.

5.135. According to the complainants, the advertising of soju, and especially of premium soju, is very similar to the advertising of western-style liquors and tends to emphasise precisely those characteristics which are generally attributed by Korean consumers to western-style liquors, such as pureness, mild taste, maturity, no-hangover effects, etc.⁹²

5.136. The complainants assert that likewise, the packaging of soju, and in particular of premium soju, is similar to the packaging of western-style spirits and liqueurs.

5.137. The complainants state that, like their Japanese neighbours, Korean consumers at first perceived Western-style liquors as "luxury" items to be offered as gifts or to be consumed only on special occasions and at special places. Over time, however, there has been, both in Japan and in Korea, a clear trend towards consumption of all types of distilled spirits on more and varied occasions, and in different methods of consumption, i.e. in mixed drinks, warm, cold, etc. According to the United States, the expanding methods and venues of consumption have also been aided by greater availability of all types of spirits in all sales channels.

5.138. The complainants further state that, to capitalize on Korean consumer's expanded awareness, the soju market has been creating new categories and brands of soju at a fast pace. Most of the activity has been in the recently established premium soju segment. For example, in Korea, Bohae Brewery first successfully used the strategy of incorporating flavoured additives such as honey to soju in its Kim Sat Gat brand soju. Kim Sat Gat was quickly followed by other premium sojus that also contained honey, or were flavoured by aging in wood.

(c) Consumers' demand for soju has been responsive to the changes in the price of whisky

5.139. The complainants argue that there is statistical evidence indicating that, despite the competitive distortions created by Korea's liquor tax system, demand for soju has been responsive in the past to changes in the prices of the other categories of distilled liquors, and in particular to changes in the price of whisky.

5.140. The complainants further argue that the applicable liquor tax rate on whisky has been progressively lowered from 200% in 1990 to 100% in 1996. According to the complainants, during the same period, the applicable import customs duties were lowered from 70% to 20%. These tax and tariff changes were followed by a reduction of the prices for whisky and a spectacular increase in sales from 11 million litres in 1992 to 27 million litres in 1996.

⁹⁰ See EC Annex 10.

⁹¹ See EC Annex 11 and US Exhibit G.

⁹² See the advertising materials included in EC Annex 12 and US Exhibit G.

5.141. The complainants argue that, the increase in sales of whisky took place, to a significant extent, at the expense of soju. According to the complainants, until last year sales of soju have grown at a lower pace than overall demand for distilled spirits and liqueurs. As a result, the complainants argue, soju lost market share, mainly to the benefit of whisky. Thus, the argument goes, whereas the market share of soju fell from 96.37% in 1992 to 94.39% in 1996, during the same period the share of whisky increased by a similar percentage from 1.53% to 3.14%. The complainants conclude that this transfer of market share from soju to whisky shows that the two liquors are in competition with each other on the Korean market.

5.142. The complainants further explain that this trend may have reversed itself during 1997 as a result of the depreciation of the Korean won, the campaign of boycotts against imported products and the financial crisis of last autumn. According to the complainants, this reversal of market trends constitutes an additional proof of the substitutability between soju and imported western-style liquors.

(d) The Dodwell study shows that there is a significant degree of cross-price elasticity between soju and all other distilled spirits and liqueurs

5.143. The complainants presented a document,⁹³ which purports to contain a copy of a study completed on 17 July 1997 for the Confederation of European Producers Spirits by Dodwell Marketing Consultants Ltd in co-operation with Frank Small and Associates, Korea ("the Dodwell study").

5.144. The complainants argue that the purpose of the Dodwell study was to test the hypothesis that a reduction in the prices of western-style spirits and liqueurs and/or an increase in the prices of soju following a change in the applicable liquor tax rates will lead to a relative increase in the consumption of western-style liquors at the expense of soju.

5.145. According to the complainants, the research method used in the Dodwell study is the same as that followed in the ASI study, which was cited by the Panel on *Japan - Taxes on Alcoholic Beverages II* as one of the reasons for its conclusion that shochu and all other spirits and liqueurs were competitive in the Japanese market.⁹⁴

5.146. The complainants further state that the Dodwell study is based on the responses to questions from a representative sample of 500 Korean spirits drinkers. The complainants also state that the survey-takers showed to each respondent pictures of representative brands of soju, premium soju and three brown spirits (standard scotch, premium scotch and cognac) and a list of prices for each, and asked which type of beverage the respondent would most like to buy given the prices specified.

5.147. The complainants argue that initially, both the proposed price for standard soju and the proposed prices for the other beverages were based on current representative prices on the Korean market ("Level 1" prices). The prices for soju were then successively increased to "Level 2" and to "Level 3". At each of the three price levels for soju, the prices for the other beverages were reduced in two steps ("Level 2" and "Level 3"). Thus, the complainants argue that the respondents were confronted with nine different price combinations. All the prices proposed to the respondents were within the range of the price levels which could reasonably result from the elimination of the existing differences in tax rates. The same research was carried out also with respect to the main types of white spirits (gin, vodka, rum and tequila) and liqueurs.

⁹³ See EC Annex 13.

⁹⁴ See Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, paras 6.29 and 6.32

5.148. The complainants argue that the Dodwell study confirms that there is a significant degree of cross-price elasticity between soju and brown spirits, as allegedly evidenced by the following findings:

- (i) even very small price movements gave rise to significant changes in the preferences of the respondents. For example, if the current representative price of standard soju was increased by just 100 won (10% of the Level 1 price) and the prices for brown liquors remained the same, the share of respondents who would buy brown liquors instead of soju would increase by 8% from 15.2% to 16.4%;
- (ii) the respondents were even more sensitive to an equivalent decrease in the price of the brown spirits. For instance, if the price for a bottle of standard Scotch whisky fell from 11,500 won (Level 1) to 10,150 won (Level 2) and the price of standard soju remained unchanged, the share of standard Scotch whisky would increase from 7.4% to 10% (i.e. by 35%);
- (iii) the switch is most marked when the price for soju increases and, simultaneously, the prices for brown liquors decline. At current representative prices (Level 1), the share of consumers who prefer brown spirits to soju (including premium soju) is 15.2%. If the price of standard soju was increased by 200 won to Level 3 and, at the same time, the prices for brown liquors fell to Level 3, the share of brown spirits would increase to 28.4%, i.e. by as much as 87%.

5.149. The complainants also argue that the Dodwell study shows that cross-price elasticity between soju and white spirits and liqueurs is also significant. Thus, it is alleged that according to the study, if the price of soju was increased by 200 won to Level 3 and, simultaneously, the price for white spirits and liqueurs was reduced to Level 3, the share of consumers who would prefer white spirits and liqueurs to soju (including premium soju) would increase from 13.8% to 23.8% (i.e. by 72 %).

iii) *Soju and other distilled spirits and liqueurs are "not similarly taxed"*

5.150. The complainants note that, as confirmed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages*, for two competitive or substitutable products to be deemed as "not similarly taxed", the difference in taxation must be more than *de minimis*⁹⁵. The complainants further notes that in the same report, the Appellate Body held that whether any particular tax differential is or is not *de minimis* must be determined on a case-by-case basis⁹⁶.

5.151. The complainants presented the following table which purports to show the differences in taxation between each of the sub-categories of soju and the other categories concerned in this dispute. According to the complainants, the table evidences that diluted soju is taxed at the lowest combined rate, whereas distilled soju is taxed at a lower combined rate than any other category with the only exception of "liqueurs".

⁹⁵ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages*, *supra.*, p. 23;

⁹⁶ *Ibid.*

Table 5

**Comparison of the tax rates applied to soju
and other distilled spirits and liqueurs**

	<u>Liquor Tax</u> <u>rate (%)</u>	<u>Education</u> <u>tax rate</u> (% Liquor Tax Base)	<u>Combined</u> <u>tax rate (%)</u>	<u>Discrimination</u> <u>Index</u>
Diluted soju	35	3.5	38.5	1.00
Distilled Soju	50	5	55	1.43/1.00
Whisky	100	30	130	3.38/2.36
Brandy	100	30	130	3.38/2.36
General distilled spirits	80	24	104	2.70/1.89
- (containing whisky or brandy)	100	30	130	3.38/2.36
Liqueurs	50	5	55	1.43/1.00
Other Liquors				
-more than 25% alcohol content	80	24	104	2.70/2.36
-less than 25% alcohol content	70	7	77	2.00/1.40
-containing whisky or brandy	100	30	130	3.38/2.36

5.152. The complainants conclude that table 5 provides evidence that the differences in taxation are in all cases far from being "de minimis" and, therefore, that soju is not "similarly taxed". According to the complainants, the combined tax rate on whisky and brandy, for instance, is 2.36 times higher than the rate on distilled soju and 3.38 times higher than the rate on diluted soju.

iv) *The differences in taxation are applied so as to afford protection to the domestic production of soju*

5.153. The complainants note that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body laid down the following approach for establishing whether dissimilar taxation of directly competitive or substitutable products is applied "so as to afford protection to domestic production":

we believe that an examination in any case of whether dissimilar taxation has been applied so as to afford protection requires a comprehensive and objective analysis of the structure and application of the measure in question on domestic as compared to imported products. We believe it is possible to examine objectively the underlying criteria used in a particular measure, its structure, and its overall application to ascertain whether it is applied in a way that affords protection to domestic products.

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, architecture and revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such protective application, ... Most often, there will other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the circumstances in any given case.⁹⁷

5.154. The complainants argue that in the present case, the following facts and circumstances regarding the "structure of the measures" as well as its "overall application on domestic as compared

⁹⁷ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 29.

to imported products" constitute irrefutable evidence that the Liquor Tax Law and the Education Tax Law are applied "so as to afford protection" to Korea's domestic production of soju. For this proposition, the complainants give the following factors:

- (i) the very magnitude of the tax differentials;
- (ii) the lack of rationality of the product categorisation;
- (iii) the fact that there are virtually no imports of soju;
- (iv) the fact that soju accounts for the vast majority of the Korean production of distilled spirits and liqueurs;
- (v) the fact that almost all whisky and brandy, as well as a significant proportion of the liquors falling within the categories of General Distilled Liquors and Liqueurs are imported; and
- (vi) the existence of a long history of tax discrimination and protectionism.

(a) The magnitude of the tax differentials

5.155. The complainants argue that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body found that the very magnitude of the difference in taxation between shochu and other distilled spirits and liqueurs was sufficient evidence to conclude that the Japanese Liquor Tax Law was applied so as to afford protection to the domestic production of shochu.⁹⁸

5.156. According to the complainants, the situation is similar in the present dispute. It argues that the tax differentials between soju and other distilled spirits and liqueurs are so large that they constitute sufficient evidence in themselves that the Liquor Tax Law and the Education Tax Law are applied so as to afford protection to the domestic production of soju.

5.157. The complainants state that the tax differentials at issue in this dispute appear to be even bigger than those taken into consideration by the Panel and the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.⁹⁹ They add that, it must be recalled that the tax differentials between soju and other distilled spirits and liqueurs would be much larger but for the successive changes introduced by Korea since 1990 in response to pressure from the Community.

(b) The product categorisation is arbitrary

5.158. The complainants are of the view that the Liquor Tax Law defines soju almost exclusively in negative terms, by excluding from a very broad, catch-all formula any type of distilled spirits which happen to be imported in significant quantities. According to the complainants, the lack of specificity of the legal definition of soju is further attested by the overlap between that definition and the legal definitions of other residual categories (e.g. the sub-category defined in Article 3.9 E of the Liquor Tax Law). In the complainants' view, this clearly shows that the application of a lower rate of tax to

⁹⁸ Ibid.

⁹⁹ In *Japan - Taxes on Alcoholic Beverages II*, the taxes in dispute were specific taxes per litre of beverage instead of *ad valorem* taxes. This makes it extremely difficult to compare the tax differentials at issue in the two cases. Nevertheless, it is worth noting that, according to the complainants, in *Japan - Taxes on Alcoholic Beverages II* the differences in specific taxes translated into a difference in tax/price ratios between shochu and whisky of between 10 % and 32 % of their retail sales price (See Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*, at para 4.159). In comparison, in the present case, the tax differential between soju and whisky may represent as much as 91.5 % of the CIF import value of whisky.

soju does not correspond to any distinguishing characteristic of soju, but is merely aimed to afford protection to Korea's domestic production of distilled spirits.

5.159. For instance, the complainants argue that according to their respective legal definitions, the only difference between diluted soju and gin is that the latter has juniper berries and plant flavourings added before distillation¹⁰⁰. However, according to the complainants, this obviously minor difference entails a tax differential equivalent to more than 90% of the import CIF value of a bottle of imported gin. In the complainants' view, this huge tax differential is clearly disproportionate and can only be explained as being aimed at affording protection to the domestic production of soju.

(c) Domestic soju is "isolated" from imports of soju

5.160. The complainants further note that in *Japan - Taxes on Alcoholic Beverages II*, both the Panel and the Appellate Body noted that:

"... the combination of customs duties and internal taxation in Japan has the following impact: on the one hand, it makes it difficult for foreign-produced shochu to penetrate the Japanese market and, on the other, it does not guarantee equality of competitive conditions between shochu and the rest of 'white' and 'brown' spirits. Thus, through a combination of high import duties and differentiated internal taxes, Japan manages to 'isolate' domestically produced shochu from foreign competition, be it foreign produced shochu or any other of the mentioned white and brown spirits".¹⁰¹

5.161. According to the complainants, the situation is similar in the present case. The complainants argue that Korean soju is effectively "isolated" from competition from foreign soju. It is alleged that imports of soju into Korea have always been negligible. It is argued that in 1997 for instance, the imported volume of soju was just 1,625 litres, which allegedly represents barely 0.0002% of the total soju sales in Korea. According to the complainants, therefore, it is indisputable that by favouring soju vis-a-vis other liquors, Korea protects a "domestic production".

5.162. The complainants further argue that Korean soju is even more "isolated" from imports of foreign soju than Japanese shochu was from foreign shochu in *Japan - Taxes on Alcoholic Beverages*. It is argued that in that case, Japan could point to the existence of a significant, even if small in relative terms, flow of shochu imports (between 1-2%). In contrast, it is argued that imports of soju into Korea are virtually non-existent.

5.163. The complainants assert that as in the case of shochu in *Japan - Taxes on Alcoholic Beverages II*, one of the reasons why Korean soju is "isolated" from imports of foreign soju is the high level of the import duties on that product. It is argued that currently, the bound rate on soju is 79% and the applied rate 30%. In comparison, it is alleged that in *Japan - Taxes on Alcoholic Beverages II*, the bound and applied rates on shochu were 26.7% and 17.9%, respectively. It is further argued that the applied import duty rate on soju (30%) is higher than the applied rate on any other category of distilled spirits and liqueurs (15%-20%).

¹⁰⁰ See the legal definitions of diluted soju and gin at Articles 3.1 and 3.9 C of the Liquor Tax Law, respectively.

¹⁰¹ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.35, cited by the Appellate Body Report on the same case, *supra.*, p. 31.

(d) Soju accounts for the vast majority of the Korean production of distilled spirits and liqueurs

5.164. According to the complainants, it may be estimated that soju accounts for more than 95 % of the Korean production of distilled spirits and liqueurs. Thus, by applying a lower tax rate to soju, Korea is affording protection not just to its domestic production of soju but more generally to its entire domestic industry of distilled spirits and liqueurs.

(e) Almost all whisky and brandy sold in Korea is imported

5.165. The complainants argue that whereas imports of soju are almost non-existent, virtually all the sales of whisky and brandy, as well as a significant proportion of the sales of white spirits and liqueurs are imported. In the complainants' view, this makes the Korean liquor tax system even more protective in effect than the tax measures at issue in *Japan - Taxes on Alcoholic Beverages I and II*, where a majority of sales within the more taxed category of "whisky/brandy" was domestically produced.

(f) There is a long history of tax discrimination and protectionism

5.166. The complainants further argue that the Korean soju industry has traditionally benefited from a very high degree of protection against imports. According to this view, until 1989 the Korean market for distilled spirits and liqueurs was almost closed to imports through the combined application of quantitative restrictions and dissuasive import duties. Since then, the argument continues, Korea has been forced to lift the import quotas and to negotiate with the complainants a reduction of the applied customs duties as part of the 1993 Agreement. The complainants assert that in light of Korea's past record of protectionism in this sector, it becomes evident that the measures at issue are but a last ditch attempt by Korea to continue to afford protection to its domestic soju industry against imports of western-style liquors.

5.167. The complainants respectfully request the Panel to find that:

- (i) Korea is in breach of its obligations under GATT Article III:2, first sentence, by applying internal taxes on imported vodka pursuant to the Liquor Tax Law and the Education Tax Law which are in excess of those applied on soju; and
- (ii) Korea is in breach of its obligations under GATT Article III:2, second sentence, by applying higher internal taxes pursuant to the Liquor Tax Law and the Education Tax Law on imported liquors, classified under HS heading 2208, currently falling within the categories of "whisky", "brandy", "general distilled liquors", "liqueurs" and "other liquors" (to the extent that they contain distilled spirits or liqueurs) than on soju, so as to afford protection to its domestic production of soju.

2. Korea

(a) General

5.168. Korea notes that in bringing this case before the Panel, the United States and the European Communities have called into question the validity of the Korean tax regime on alcoholic beverages, claiming that this regime discriminates against some imported spirits, to the benefit of a Korean distilled alcoholic beverage called 'soju', and in violation of Article III:2 of the GATT. Korea concedes, as the complainants point out, that it imposes a different rate of tax on soju than it imposes on certain imported alcoholic beverages. However, in Korea's view, not every difference in rates of tax amounts to a violation of Article III:2.

5.169. Korea asserts that Article III:2 is perhaps the provision of the GATT that treads most heavily upon national sovereignty. In Korea's view, a nation's taxation system is the product of a long and intricate domestic political process. Korea argues that taxes are built up over years, and reflect different and evolving policy goals. No country imposes a single rate of tax on all products. Korea also notes that the GATT contains no requirement that countries harmonise their tax systems. Korea asserts that the fundamental purpose of Art. III:2 is to avoid protectionism.

5.170. Korea further argues that the prohibitions of Art. III:2, while honouring their anti-protectionist purpose, must be strictly interpreted. In Korea's view, before the tax rates of imported and domestic products can be compared, the competitive relationship between these two products must be strong, if not very strong indeed.

5.171. Korea's position is that according to Article III:2, imported products ought not be taxed less favourably than competing domestic products. Korea further argues that where products are perfect substitutes, or 'like', no difference in tax treatment can be tolerated. Where products are not 'like', but are still 'directly competitive or substitutable', the argument continues, there is more room for tax differences, as long as they do not have a protectionist effect.

(b) The Korean Tax System

5.172. Korea proceeds to give an explanation of its internal tax system. It states that it has 32 different types of taxes, which are largely divided into national and local taxes. Korea further states that like other countries, it distinguishes between direct taxes and taxes on goods and services. Unlike some other countries in Korea the share in total tax receipts of indirect taxes is much higher than direct taxes.¹⁰²

5.173. Korea notes that all alcoholic beverages are subject to several taxes, such as value added tax, liquor tax and education tax. The latter two taxes, as applied to certain imported alcoholic beverages, are disputed in this case.

i) *The Liquor Tax*

5.174. Korea notes that the Liquor Tax Law was enacted in 1949, and has been amended more than twenty times since. An important step in the development of the Liquor Tax Law was the change from a specific tax system to an *ad valorem* tax system in 1968.¹⁰³ According to Korea, the reason for this alteration was mainly that the Korean legislature wanted to raise taxes in proportion to the prices of products. It is of some significance, notes Korea, in view of the allegations that Korea's taxes are protectionist, that at the time of enactment of the Liquor Tax Law, and at the time of the change to an *ad valorem* system, Korea had very little imports of liquor.

5.175. Korea notes that the parts of its Liquor Tax Law that are relevant to this case are contained in the general provisions and in the chapter dealing with imposition. In the general provisions, a description is given for each drink in such way that it sets the requirements as to the content of each of the liquors in order to fit into the classification of the Liquor Tax. The section of the law dealing with imposition fixes the rates which apply to each particular group of liquors. The descriptions in the law determine the different applicable rates, thus, Korea concedes imposing a different tax rate on standard soju and whisky.

¹⁰² In 1994, for instance, according to OECD methodology, the share of indirect taxes amounted to 43.4% of total tax revenue in Korea, whereas the comparable figure for the United States was 17.9%. The Korean figure for 1996 (predicted) is 43.7%.

¹⁰³ In this respect, the Korean liquor taxes differ from the liquor taxes at issue in *Japan – Taxes on Alcoholic Beverages II*, which were specific.

5.176. However, Korea argues that the complainants attempt to create the mistaken impression that the law's very structure reveals a protectionist intent.¹⁰⁴ According to Korea, the reality is different. For a long time, soju was the only spirit subject to liquor taxes. Korea notes that though the law's definition was broad, it covered only what was known. Over time, other spirits were marketed, and as they appeared, new tax categories were created.

5.177. Korea notes that the Liquor Tax relates to spirits and beverages containing at least 1% of alcohol. The persons falling under the Liquor Tax are either manufacturers of alcoholic beverages supplying from their factory, or importers. These persons pay taxes on the basis of the price at the time of delivery, when the beverages are delivered from a factory, or, when the liquors are imported, on the basis of the CIF plus duty price.

5.178. Korea further notes that the applicable tax rates on the alcoholic beverages are described in the Liquor Tax Law.¹⁰⁵ The tax system and the applicable rates have evolved over time. The applicable rate does not depend on the origin of the liquor. Korea presents the following rates that purportedly apply to the distilled beverages in dispute:

Drinks	Ad valorem%
Soju: a) standard (or 'diluted') soju b) distilled soju	35% 50%
Liqueurs ¹⁰⁶	50%
General distilled spirits ¹⁰⁷	80%
Whiskies, brandies	100%

5.179. Korea states that being a high-volume, common drink that Koreans usually consume with meals, standard soju is in a class of its own, and so is distilled soju, being an artisanal drink, that is unique to Korea.

5.180. Korea notes that there is also a substantial domestic production of liqueurs, general distilled spirits and, particularly, of whisky, that fall under the higher tax rates.

5.181. According to Korea, the liquor taxes are an important tool for the government of Korea to raise revenue. According to the most recently available figures, liquor taxes amounted to 3.52% of national tax revenues.¹⁰⁸ Their share in indirect taxes represented 9.08%. The largest contributor to the liquor taxes traditionally has been beer, which is mostly domestically produced, which accounts for 69% of the Liquor Tax revenues in 1996.

¹⁰⁴ See EC first submission, at para. 24; US first submission, at para. 24.

¹⁰⁵ Article 19(2).

¹⁰⁶ Examples of 'liqueurs' are Insam (ginseng) ju, Ogapiju, Bailey's, Grand Marnier, and Kahlua.

¹⁰⁷ Examples of 'general distilled alcoholic spirits' are koryangju, rum, gin, and vodka.

¹⁰⁸ This percentage is based on figures from 1996. In the two preceding years the revenue collected from the liquor tax was 3.54% and 3.53%.

ii) *The Education Tax*

5.182. Korea states that in addition to the Liquor Tax, an education tax is levied. According to Korea, Education Tax is an earmarked tax, meaning that the revenues collected through the Education Tax can only be used for the specific purpose of improving the educational system. The Liquor Tax regime is not the only regime that has an Education Tax. Korea asserts that there are ten other regimes to which the Education Tax is attached, such as tobacco consumption tax, property tax and transportation tax. Likewise, taxpayers liable for the payment of liquor taxes are also subject to the education tax. In Korea's calculation, the revenues generated by liquors in the education tax proceeds amount to 12.5%.

5.183. Korea states that the tax basis for the Education Tax, as levied on payers of the liquor tax, is the Liquor Tax corresponding to each kind of drink. The Education Tax applies as follows: alcoholic beverages whose *ad valorem* tax rate is higher than 80% are subject to 30% education tax on the amount of the Liquor Tax, and alcoholic beverages with an *ad valorem* tax below 80% are subject to 10% Education Tax.

5.184. Korea notes that the Education Tax is levied irrespective of the origin of the products. The proceeds of the Education Tax are allocated exclusively to the improvement of Korea's educational system, notably at the mandatory education level from primary to middle school.

(c) *Legal Analysis*

5.185. Korea notes that the complainants argue that because Korea imposes a different rate of tax on 'soju' than the rate which is imposed upon a number of alcoholic beverages, its tax system unfairly burdens imported spirits, to the benefit of the domestic spirit 'soju'.

i) *The purpose of Article III of the GATT is to prevent protectionism, not to harmonise taxes*

5.186. According to Korea, Article III, perhaps more than any other provision of the GATT, steps into a realm which is traditionally the province of national sovereignty -- the domestic tax system.

5.187. Korea notes that as each Member joins the WTO, it brings with it its individual tax system, an intricate web of rules built up over many years reflecting a mixture of government objectives (ranging from social policies to the need to raise revenues).

5.188. Korea further states that no Member of the WTO has the same rate of internal taxation for all products, and the tax differences that have built up throughout the years may not always seem completely coherent. However, the argument continues, it is not the role of the GATT to attempt to render each tax system internally coherent, and nor is it the province of GATT to harmonise the tax systems of its many Members.

5.189. Korea takes note of the 1992 Panel report in *United States - Measures Affecting Alcoholic and Malt Beverages* in which it was stated:

The purpose of Article III is not to harmonise the internal taxes and regulations of contracting parties, which differ from country to country.¹⁰⁹

In Korea's view, tax harmonisation is a sensitive matter even between countries that have achieved a high level of integration, such as the member states of the European Communities.

¹⁰⁹ Panel Report on *United States - Measures Affecting Alcoholic and Malt Beverages*, adopted on 19 June 1992, DS23/R, BISD 39S/206, 276, at para. 5.71 - 5.72.

5.190. Korea further argues that it should be noted that Article III is not intended to encroach upon the powers of WTO Members to pursue their legitimate objectives through their tax systems. In this regard Korea draws attention to a statement by the Appellate Body put in *Japan - Taxes on Alcoholic Beverages*, in which it said:

Members of the WTO are free to pursue their own domestic goals through internal taxation or regulation so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the WTO Agreement.¹¹⁰

5.191. Korea, therefore asserts that Article III of the GATT is only meant to step into this sensitive realm of taxation in certain narrowly circumscribed circumstances, in order to pursue a specific objective. According to Korea, the fundamental purpose of Article III is to avoid protectionism and to oblige the WTO members to provide for equality of competitive conditions for imported products in relation to domestic products. As the Appellate Body put it in *Japan - Taxes on Alcoholic Beverages II*:

The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. Toward this end, Article III obliges Members of the WTO to provide equality of competitive conditions for imported products in relation to domestic products.¹¹¹

ii) *The analysis required under Article III:2*

5.192. Korea states that reconciling the anti-protectionist purpose of Article III:2 with the need to recognise each WTO Member's discretion to maintain and develop its own tax policy has not been an easy exercise.

5.193. Korea further states that the *Malt Beverages* panel construed the so-called 'aims and effects' test. Under that test, as long as the tax system introduced product distinctions for policy purposes that were unrelated to the protection of domestic production, the resulting tax differences could not violate Article III:2.¹¹² According to Korea, this approach did not find favour with the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*. In Korea's view, the Appellate Body (as well as the Panel in the first instance) ruled that the aims and effects test strayed too far from the text of Article III:2, ignoring the distinction made between the two prohibitions contained, respectively, in the first and the second sentence of this provision. The first sentence tolerates no differentiation whatsoever between tax rates that apply to 'like' products. The second sentence imposes constraints on tax differentials that apply to 'directly competitive and substitutable products'.

5.194. Korea further argues that according to the Appellate Body, the wording of the first sentence leaves no room to inquire whether a tax rate differential, which applies to 'like' products, was really introduced with protectionist 'aims and effects'. By this argument, differential tax rates applying to 'like' products violate Article III:2.

5.195. Korea argues, however, that this does not mean that the Appellate Body was insensitive to the concerns of the WTO membership about preserving discretion to develop individual tax policies. Korea notes that in its report, the Appellate Body took great pains to underline 'how narrow the range of "like" products is meant to be'.¹¹³ Korea further notes that the Appellate Body, affirming the

¹¹⁰ See Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 16.

¹¹¹ Appellate Body Report, *supra.*, p.16.

¹¹² Panel Report on *United States - Measures Affecting Alcoholic and Malt Beverages*, *supra.*, para. 5.25.

¹¹³ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 20.

Panel,¹¹⁴ also clarified that 'like' products are a subset of directly competitive and substitutable. In Korea's view, this indicates that Article III:2 only comes into play when the products at issue are in a particularly close relationship (they should be at least "directly competitive or substitutable"). Where there is no relationship, or an insufficiently close relationship between two products, argues Korea, the WTO Members retain the sovereignty to impose taxes according to their own discretion.

5.196. Korea argues that the determination of whether two products are 'like' or directly competitive and substitutable products is based upon an overall appreciation, on a case-by-case basis, of their qualities and their relationship. Korea refers to one general remark regarding both the determination of 'like' products and of directly competitive and substitutable products which was made in *Japan - Taxes on Alcoholic Beverages II*, which allegedly emphasised that a particularly appropriate test to define whether two products are 'like' or 'directly competitive or substitutable products' is the 'marketplace'.¹¹⁵ Korea notes that while noting that there might be other means to identify the broader category of directly competitive and substitutable products, the Appellate Body upheld this reasoning, stating that the: 'GATT 1994 is a commercial agreement, and the WTO is concerned, after all, with markets.'¹¹⁶

5.197. Korea also states that it is useful to make some preliminary comments about the threshold condition of Article III:2: i.e. how does one analyse whether there is a sufficiently close competitive relationship between the Korean sojus and the remaining imported liquors? Korea poses the question, when are products sufficiently competitive for the purposes of comparing their tax rates under Article III.2?

5.198. Korea argues that to answer this threshold question, it is useful to recall first the factors that are relevant to establish a competitive relationship between two products and then analyse the degree of competition that will trigger the application of Article III.2, first and second sentences.

iii) *Relevant factors*

5.199. According to Korea, first, one must determine whether the products at issue are at least roughly comparable. Where potable liquids are concerned, it makes little sense to compare soft drinks with alcoholic beverages for example. Consumers who want a soft drink will not consider alcohol a suitable alternative.

5.200. Korea further states that within the broad category of alcoholic beverages, a further distinction can be made according to product characteristics, such as:

- Raw materials - Are products rice-based, grain-based, potato-based, tapioca-based, etc? Which additives are used? In Korea's view, these elements may influence the taste of the beverage, and the consumer's perception in general.

- Production process - Are the alcoholic drinks based on fermentation only, or on distillation? Are they aged, and if so how, before being sold? According to Korea, these are factors that may influence the final appearance and taste of the drink, but also its image in the marketplace. Ageing in wooden casks, for instance, gives a drink an 'artisanal' image, that may make quite a difference to consumers, even though objectively it is debatable whether more industrial production processes (e.g., mere storage in metal containers) result in inferior products.

¹¹⁴ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, *supra.*, para. 6.22.

¹¹⁵ *Ibid.*

¹¹⁶ See *Japan - Taxes on Alcoholic Beverages II*, Appellate Body Report, *supra.*, p. 25. The Appellate Body reiterated this reasoning in its more recent report in *Canada - Certain Measures Concerning Periodicals*, *supra.*, p. 28.

- Physical characteristics - of the finished products. Are the products similar in terms of their appearance, the degree of alcoholic strength?

Other notable factors determining whether two products compete revolve around price and end use.

- Price - Are the products at issue in the same price range? According to Korea, if prices differ greatly, two seemingly similar products cannot be considered directly competitive. Korea notes that in *Japan - Taxes on Alcoholic Beverages II*, the complainants argued that Japanese shochu and the imported liquors were in the same price range before tax.¹¹⁷ Korea further notes that Japan does not appear to have contested this. Korea asserts that the price differences in Korea between standard soju and the disputed imported liquors are very considerable.

- End uses - Do consumers use these products in the same way? Do they drink a particular drink straight or mixed; with meals, or on other occasions? Korea states that these elements were highlighted in *Japan - Taxes on Alcoholic Beverages I*.¹¹⁸ Korea argues for instance, that depending on the food they usually eat, consumers will show a preference for different alcoholic drinks during meals. In countries with a spicy food tradition, consumers may favour strong alcohol that cleans the palate, when eating meals. In countries where spicy food is not a tradition, consumers will by definition have a different preference for an alcoholic drink that goes best with their national cuisine.

5.201. Korea argues that the existence, or absence, of a competitive relationship can also be gleaned from other factors, such as the places of sale and consumption. According to Korea, one relevant question in this connection is whether the disputed liquors are sold through the same outlets, so that consumers are actually offered a choice between them. If not, this is an indication that they are not, in fact, competing.

iv) *The degree of competition or substitutability*

5.202. Korea poses the question, how strong must competition between two products be, before one can speak of a directly competitive and substitutable, or even a 'like' product relationship within the meaning of Article III:2?

5.203. Korea argues that it is good policy to give a strict reading to the terms of Article III:2. In Korea's view, given that the WTO is an organisation which brings together a large number of diverse countries, and that it has no mandate to harmonise tax policies, the threshold to review taxes under Article III:2 GATT (i.e., the competitive relationship between differently taxed products) is both important and substantial.

5.204. According to Korea, for 'like' products, the competitive relationship must be very strong indeed. Korea cites the Appellate Body report on *Canada - Certain Measures Concerning Periodicals*, in which it was stated that 'like' products are 'perfect substitutes'.¹¹⁹

5.205. Korea argues that in relation to the examination of the legal obligation under Article III:2 second sentence, the existence of competitive relationship is also an essential requirement for the determination of whether products can be determined to be directly competitive and substitutable. In Korea's view, unlike 'like' products, substitution does not have to be perfect between the products. Korea asserts that the texts of Article III:2 second sentence and its Interpretative Note require that the

¹¹⁷ See Panel Report in *Japan - Taxes on Alcoholic Beverages II*, *supra.*, at para. 4.82. See also the more recent *Canada - Certain Measures Concerning Periodicals*, Appellate Body report, at p. 30, where the Appellate Body, in finding a directly competitive and substitutable relationship between certain imported and domestic periodicals, approvingly cited evidence of 'considerable price competition' between the two.

¹¹⁸ See Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.7.

¹¹⁹ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, p. 31.

competitive relationship must still be strong before the products can be considered directly competitive and substitutable. This is why the text refers to "*directly* competing or substitutable products".

5.206. In Korea's view, the complainants have not shown that there is any close relationship between the imported products and soju. Korea therefore, is of the view that they have been unable to show actual competition on the market between the products and are now trying to introduce the argument that the absence of actual competition was due, at least in part, to the tax measures.

5.207. According to Korea, such a loose interpretation of Article III.2 runs counter to the text of the Interpretative Note to Article III.2. This Note adds that 'only where competition was involved' between two 'directly competitive or substitutable' products could a tax differential conceivably amount to a violation of the second sentence of Article III:2. In Korea's view, this language strongly suggests that there must be actual competition between the directly competitive or substitutable products before their tax rates are to be compared.

5.208. Korea further argues that it is clear that in the present case the complainants have neither shown that imported liquors actually compete with the Korean sojus, nor have they shown that these liquors would directly compete with each other in the absence of the tax differential. Korea refers to the argument by the complainants that there is a substantial measure of price elasticity between the Korean sojus and imported liquors. According to Korea, the complainants seek to argue that various product combinations are in competition with each other, on the grounds that relatively small changes in the price of soju will persuade Korean consumers to switch to imported liquors such as whisky. Korea notes that in support of this argument the European Communities submitted a market survey,¹²⁰ which has been endorsed by the United States.

5.209. Korea points out that given the considerable price differences (even pre-tax) and different end uses between these liquors, the complainants' conclusion flies in the face of common sense. Korea adds that another study funded by the European Communities, and conducted by the same organization but not for legal proceedings, found that "soju in particular remains unaffected by imported drinks".¹²¹

5.210. Korea submits that this particular study (the 'Dodwell' study) constitutes poor evidence. Korea puts forward the following reasons for its assertion that the Dodwell study cannot be relied upon as constituting evidence of product substitutability:

v) *Problems in the Dodwell Report*

Internally inconsistent results

5.211. Korea expounds upon the peculiarity and problems, namely flaws in design or oddities in the reported results. Korea mentions as an example that in chart 2, the percentage choosing soju rises when price of soju increases from 1,100 to 1,200 won, even though all other prices are held constant. Korea argues that this seems to imply a positively-sloped demand curve, which is, as the United States noted before the *Japan – Taxes on Alcoholic Beverage II* case, "contrary to one of the fundamental tenets of micro-economic theory."¹²² Moreover, Korea observes, the percentage choosing premium and standard scotch rises as the price of soju rises from 1,000 to 1,100 won but falls as the

¹²⁰ See EC Annex 13.

¹²¹ EC Commission, *Your Guide to Exporting Food Products to Korea, Alcoholic Beverages 1997* (Sofres Report), p.22.

¹²² Panel Report in *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 4.86.

price of soju rises from 1,100 to 1,200 won. Korea notes that such odd findings are frequent: indeed, they appear in every chart.¹²³

5.212. Korea argues that there is no theoretical reason why the quantity demanded of one good should not fall as the price of a related good rises, although the implication that soju and whisky, for example, are complements in consumption, so that a fall in the price of whisky would increase consumption of soju, might seem to many economists implausible. Korea notes that the difficulty with the Dodwell report is that it sometimes shows the quantity of scotch demanded rising as the price of soju rises, and sometimes falling. Korea finds the facts reported, though curious, are less troubling than their lack of internal consistency.

5.213. Korea suggests that consumers in actual markets are unlikely to be so random in their responses to price changes. Korea concludes that the members of the Dodwell sample may have treated the Dodwell question with less gravity than the report's authors might like to believe.

Standard and premium soju

5.214. Korea points to another peculiarity in the treatment of standard and premium soju. Korea observes that in the Dodwell report, the premium soju is offered as a choice side-by-side with western-style spirits in the pairwise choice between white spirits and standard soju and in the pairwise choice between brown spirits and standard soju. Thus, Korea notes, in the Dodwell "brown spirits" test, respondents are offered a choice between scotch, cognac and premium soju on the one hand, and standard soju on the other; and in the white spirits test they are offered a choice between vodka, gin, rum, tequila, liqueur, and premium soju on the one hand, and standard soju on the other.

5.215. Korea argues that grouping soju with western-type spirits rather than with standard soju is eccentric, and suggests a lack of familiarity with these two soju products. According to Korea, standard and premium soju are regarded as close substitutes in Korea. Korea states that premium soju is more expensive than standard soju—the "current price" of premium soju in the Dodwell report is 2,400 won as compared to 1,000 won for standard soju. Korea notes, however, that is hardly a compelling case for putting premium soju in the same group as 20,000 won scotch or 32,000won cognac.¹²⁴

¹²³ In chart 1, the percentage choosing premium scotch falls as the price of soju rises from 1,100 to 1,200 won even through all other prices—including that of premium scotch—are held constant; in chart 3, the percentage choosing premium soju falls as the price of standard soju rises from 1,100 won to 1,200 won; in chart 4, the percentages choosing gin and tequila both fall as the price of soju rises from 1,000 won to 1,100 won; in chart 5, the percentage choosing tequila falls as the price of soju rises from 1,000 to 1,100 won, and the percentages choosing vodka, gin and premium soju all fall as the price of soju rises from 1,100 to 1,200 won; and in chart 6, the percentages choosing liqueur and premium soju both fall as the price of soju rises from 1,000 to 1,100 won, and the percentages choosing vodka and gin both fall as the price of soju rises from 1,100 to 1,200 won.

¹²⁴ According to Korea, taxation of premium soju is identical to that of standard soju, and the natural division between soju on the one hand, and western-style spirits on the other would on its face have given clearer results. Rejection of the natural division seems to be a major flaw in the design of the Dodwell study, and it would be interesting to know how it came about and why it was maintained.

Korea claims that, as it is, the outcome of the study is blurred by interactions between standard and premium soju, which account for much of the change reported. The first Dodwell results, for example, are based on holding at current levels the price of brown and white spirits (and premium soju) while the price of standard soju is hypothetically raised from 1000 to 1200 won. The reported result is that standard soju loses 5.2 percentage points to "brown spirits." Three of these points, however, are gained by premium soju. Against white spirits, standard soju loses 5 percentage points, but 4 are gained by premium soju.

According to Korea, if these results are treated seriously, as presumably they were by the authors of the report, they strongly suggest that standard and premium soju are close substitutes in consumption. That finding

Problems

5.216. Korea states that studies of the Dodwell type must be carefully designed if they are not to fall foul of bias. Korea points out that the Dodwell report clearly has not managed this. Korea discusses two sources of bias and claims that either is sufficient to eliminate the credibility of the Dodwell Report.

Choice of respondents

5.217. Korea points out that no reason is given for the exclusion of males above the age of 49 or of the rural population when the Dodwell report states “It was decided to select as respondents for the research 500 Korean men in 3 Korean cities aged between 20 and 49 who have purchased soju in the last month.”¹²⁵

5.218. Korea states that no information is provided on how and where the same was selected, or on how its members were induced to spend their time answering the survey questions. Korea notes that no information is given on the drinking habits of respondents—for example, where they typically purchase alcohol, or how much they consume (although questions 5-13 deal with these matters). Korea further notes that no information is provided on the actual characteristics of the sample—for example, average age, occupation, income—that would permit a check on whether the sample is even representative of “Korean males aged between 20 and 49 who have purchased soju in the last month.”

5.219. Korea argues that the restriction and exclusion of the rural population are not the only ones placed on the sample. Korea indicates that p. 3 of the report announces that “additional criteria for the respondents were whisky purchase in the last 3 months.” Korea notes that no reason is given for rejecting persons who have not purchased whisky in the last three months. Korea conjectures that, possibly, the results of the study in the absence of this condition were disappointing. Korea notes that it is certainly true that a good way to obtain a strong response to a fall in the price of whisky and a rise in the price of soju is to select a sample of persons that drink both soju and whisky (and, of course, a whisky purchase in the last three months and a soju purchase in the last month is consistent with a purchase of both in the last week, day or hour).

5.220. Korea states that the effects of selection bias are evident, regardless of the motivation for the additional restriction,. Korea points out that in the Dodwell sample, at current prices, 72 per cent of respondents select soju when asked to choose between brown spirits and soju; and 72 per cent select soju when asked to choose between white spirits and soju (Korea refers to the Dodwell study, p. 6). Korea notes, however, that the actual share of soju in consumption of distilled spirits in Korea, however, is about 95 per cent.

5.221. Korea asserts that the discrepancy between those who prefer soju at current prices in the Dodwell study and the true figure is very large¹²⁶ Korea nevertheless states that the difference

might have been expected to lead the authors of the Dodwell report to use the natural division. It is curious that it apparently did not have that effect.

¹²⁵ The Dodwell Report at p. 2.

¹²⁶ The figure of 72 per cent is used by the authors of the Dodwell report (p. 6). According to Korea, an alternative would have been to take the percentage of the sample choosing either standard or premium soju at current prices: 84.8 per cent then choose soju and 15.2 per cent brown spirits proper when offered that pair, and 86.2 per cent choose soju and 13.8 per cent western-type white spirits of that pair. This reduces one discrepancy between the Dodwell sample and actual market shares—the Dodwell percentage choosing brown spirits proper fall to only five times actual market share. But it also highlights other discrepancies. In the Dodwell sample 14.85 per cent of those choosing soju opt for premium soju: in fact, premium soju takes about 4 to 5 per cent of total soju sales. In the Dodwell sample, 13.8 per cent choose western-type white spirits, which have an actual market share of 1.8 per cent.

between 72 per cent of the sample and 95 per cent that choose soju in reality is likely to seriously understate how unrepresentative the sample is. Korea attributes the discrepancy to the fact that respondents were given a pairwise choice between soju and brown spirits, and then a pairwise choice between soju and white spirits. They were not offered a three-way choice between soju or brown spirits or white spirits.

5.222. Korea acknowledges that some respondents may choose brown spirits rather than soju from that pair, but soju rather than white spirits when offered that pair; while others might select white spirits rather than soju in that pairwise offering, but soju rather than brown spirits. Offered a three-way choice, all of those who reject soju in the pairwise choice will continue to reject soju. Korea, however, emphasizes that those who chose white spirits when offered a choice between soju and white spirits need not be the same as those who chose brown spirits when offered a choice between soju and brown spirits. Korea states that it follows that the figure of 72 per cent choosing soju rather than brown spirits in the Dodwell sample, and the similar percentage selecting soju rather than white spirits, gives the highest possible percentage of those in the sample who would have chosen soju had they been offered a three-way choice.

5.223. Korea points out that the actual percentage choosing soju in a three-way choice would be 72 per cent only if all those who prefer white spirits to soju also prefer brown spirits to soju and vice versa. Korea notes that at the opposite extreme, though, if all of those choosing whisky over soju prefer soju to white spirits; and if all of those choosing white spirits rather than soju prefer brown spirits, the percentage opting for soju in a three-way choice would be 44 per cent—28 per cent would reject soju in favour of brown spirits, and 28 per cent would reject soju for white spirits. Korea states that only 72 per cent of Dodwell respondents choose soju at current prices indicates the unrepresentative nature of the Dodwell sample: that a lower figure is avoided only by the failure to offer a three-way choice; and that in such a choice, the number choosing soju might fall as low as 44 per cent, puts the Dodwell report into a world entirely different from that of Korean reality.

5.224. Korea argues that the Dodwell study is based upon a sample of persons who are strongly biased towards western-type spirits, relative to the Korean population as a whole. Korea asserts that the Dodwell sample is not a credible sample. Korea states that, even leaving aside other grounds for doubt, the response to hypothetical price changes of a group so unrepresentative cannot be taken to reflect anything of the responses of the Korean population as a whole to real price changes.

The single choice drink

5.225. Korea indicates that the Dodwell study respondents are confronted with an either-or choice. Korea notes that according to the Dodwell script, interviewers say: “As you can see, there are five types of spirits and photos of typical brands of these types. Which spirit would you choose at these prices?”

5.226. Korea states that reliable information about how different prices might change drinking habits—that is, whether a person who is a regular soju drinker might switch to becoming a regular whisky drinker were the price of soju higher and the price of whisky lower—might be relevant in this

According to Korea, these discrepancies strongly suggest sample bias. The Dodwell report, though, does not provide enough information to translate percentages of Dodwell respondents into a figure directly comparable with actual market shares, so that it does not allow calculation of whether the comparisons above understate or overstate the degree of bias. One problem is that Dodwell respondents are asked to choose a single bottle: in fact, drinkers are likely to consume different drinks at different times. Another problem is that those choosing soju in the Dodwell sample, for example, might on average consume more soju than those choosing whisky consume whisky. The implied market share of soju would then be more than 72 per cent. To approach actual market shares, Dodwell soju choosers, if they drank nothing but soju, would have to consume a volume of soju about 13 times greater than Dodwell whisky drinkers, if they drank nothing but whisky.

case. However, Korea argues, that is not what the Dodwell interviewers ask about. Korea notes that they ask which bottle a respondent would choose at the different prices. Korea points out in the Lexecon/Hindley Report that respondents might perfectly naturally interpret the Dodwell questions asking: “If you saw these prices the next time you bought a bottle of spirits, which bottle would you choose?” Korea notes that such questions opens the possibility that some respondents interpreted the hypothetical prices as a one-time offer: “If you saw these prices the next time you bought a bottle of spirits, but knew that usual prices would be back in force the time after that, which bottle would you buy?” Korea emphasizes that some Dodwell respondents may simply be saying that they would try a bottle of high-price cognac were it temporarily on offer at such a low price.

5.227. Korea argues that respondents interpreting the question as asking “would you try a bottle of cognac if it was offered at this price?” are almost certainly more likely to answer affirmatively than those interpreting the question as asking “would these prices cause you to change your drinking habits?”. Accordingly, Korea concludes, the ambiguity in the question almost certainly increases the number saying they would buy a bottle of brown or white spirits at a lower price.

5.228. Korea emphasizes that there is absolutely no reason to suppose that respondents are speaking about a change in their drinking habits—that their answers imply that if soju rose in price from 1,000 won to 1,200 won, they would switch their regular drink, during meals for instance, from soju to cognac at 32,000 won or scotch at 20,000 won.

5.229. Korea argues that market surveys, carried out specifically for the purposes of legal proceedings at the request of an interested party, are, of course, to be treated with caution. The analysis must be rigorous, and bias must be avoided at all cost. According to Korea, the Dodwell study does not meet these standards. Korea sums up what it perceives to be the most glaring defects of this study:

- (i) It is not at all clear whether the sample of Korean consumers used for the analysis was representative.
- (ii) The questions posed were, in Korea's view, ambiguous. Korea argues that the question ‘which spirit would you choose at this different price?’ for example, might have been interpreted by respondents as asking whether they would change their habit of drinking soju with meals and switch instead to a western-type spirit; *or* as the different question of whether, at the hypothetical lower price, they would buy an experimental bottle of a western-type drink.
- (iii) Korea argues that the conclusions drawn from this study by the complainants are fanciful. According to Korea, it does not rebut the common sense presumption that, given the enormous price differences (even before tax) between standard soju and western-type liquors and their different end uses, no appreciable number of Korean consumers consider them to be substitutes.¹²⁷

5.230. Korea further argues that in contrast, more credence can be given to a study, which was not prepared specifically for regulatory purposes, but which tries to explain in objective terms to exporters the situation on the Korean market. Korea refers to a recent report initiated by the European Commission recently, which stated:

Soju is consumed widely, from the young to the old, and is the most popular traditional drink in Korea. Soju in particular remains unaffected by imported alcoholic drinks. Furthermore

¹²⁷ See Attachment 2 of Korea, which is a critique by Lexecon Ltd and Dr. Brian Hindley (London School of Economics) of the Dodwell Study.

Soju, is insulated from economic downturns and maintains a loyal following of steady consumers.¹²⁸

5.231. Korea asserts that the constant and independent demand for soju is not the result of any protective government policies. Korea refers to the same EC study which notes that:

"The Korean alcohol market is no longer a market protected by the government with market shares contested by local producers. In fact, it is becoming a truly global market where multinational companies convene to compete with one another for the lucrative and promising Korean market".¹²⁹

(d) Product-by Product Analysis

5.232. Korea submits that as competitive relationships differ from product to product and from market to market, the United States and the European Communities bear the burden of proving for each individual product combination that a 'like' or 'directly competitive and substitutable' relationship exists in the Korean market before they can put the applicable tax rates into question.

5.233. Korea states that, without assuming the complainants' burden of proof, it will demonstrate the failure of the complainants to discharge this burden in the following way:

- (i) that the complainants have confused various products that are called soju.
- (ii) Korean soju is a different product from Japanese shochu.
- (iii) Korean standard soju is unlike distilled soju. Korea argues that these are different products in terms of *inter alia* their raw materials, production process, taste, price, place of consumption, end use, and their marketing. Korea also submits that they are subject to different tax rates: 35% for standard soju and 50% for distilled soju.

5.234. Korea, therefore argues that both diluted soju and distilled soju must be compared individually to each of the imported liquors in question. Further, it states that although premium soju is a variation of diluted soju, Premium's price is somewhat higher, though still far below the price of the imported liquors. Premium soju represents only a small volume of diluted soju sales (currently, around 5%). In the discussion below of diluted soju due account is taken, where necessary, of any of premium's special features.¹³⁰

5.235. Korea notes that the only products that the United States and the European Communities have alleged are 'like' are standard soju and distilled soju and vodka. Korea states that it will therefore only make representations about the lack of a 'like product' relationship as far as vodka is concerned. In its view, it goes without saying that Korea does not accept that any 'like product' relationships exist in this case.¹³¹

5.236. Korea also seeks to point out the very considerable price differences that exist between the imported liquors and diluted soju. According to Korea, the complainants recognize these differences

¹²⁸Sofres Report, p.22

¹²⁹Ibid., p. 12.

¹³⁰ For instance, in giving average prices of standard soju, the higher price of premium is taken into account.

¹³¹ Korea is mindful of the fact that in the most recent Japanese liquor taxes case, a 'like' product relationship was found to exist between one product pair: Japanese shochu and vodka. However, given the differences between Japanese shochu and the Korean sojus, as well as the differences between the Korean and the Japanese markets, this holding is inapplicable to the case at hand, according to Korea.

at actual market prices.¹³² However, Korea argues that these price differences remain considerable, even when the disputed taxes are eliminated. Korea points out that this is shown by the complainants' own expert study, the Dodwell Study.¹³³ Korea's position is that although it contests the results of the Dodwell Study, the raw price data provided in that study appear to be generally correct. Korea feels that these data are so compelling that it has not felt it necessary to go beyond the data set forth by the complainants. In its view, the one exception is whisky, where, given its importance to this case, Korea has supplemented the Dodwell data with its own figures.

5.237. In short, Korea is seeking to show that an inexpensive local meal drink such as diluted soju is not in direct competition with expensive western-type liquors. In the alternative, Korea is seeking to show why the complainants have not shown that Korea's tax system meets the other criteria of Article III:2, assuming that the Panel would still find a competitive relationship between some products,

5.238. Korea states that contrary to what the complainants are alleging, the so-called soju based cocktails are not soju. According to Korea, these are sweetened mixtures, with a low alcohol percentage (10-15%), that were introduced in 1994. They are not comparable to either standard or distilled soju. Korea adds that to make the distinction, manufacturers never use the word 'soju' in the brand names for these products. They are classified differently, like liqueurs, according to the liquor tax law. Korea points out this classification also covers such imported liqueurs as Bailey's, Grand Marnier, Kahlua, etc. Liqueurs are subject to a tax rate of 50%. It is unclear to Korea what, if any, complaint the European Communities and the United States are formulating in this respect.

5.239. Korea also argues that contrary to EC assertions, sales of soju-based cocktails did not increase by 1250% in 1995. According to Korea, the taxed volume of soju-based cocktails increased by 419% in 1995, from 1,583 kl (1994) to 8,218 kl (1995), and that in 1996 sales decreased by 8% (to 7,562); in 1997 by 22% (to 5,893 kl).¹³⁴

i) *Diluted soju*

Diluted soju and Whisky

5.240. Korea argues that diluted soju and whisky are entirely different products, regardless of the perspective from which one looks at them. Korea points out that, firstly, the physical difference between these two products is immediately obvious to the eye and to the palate. Even more striking, according to Korea, are the market differences between the way that diluted soju and whisky are sold and consumed in Korea. Korea states that the primary differences boil down to this: in Korea, diluted soju is the drink one finds on the dinner table, the drink that is consumed with meals. As such, it is an inexpensive beverage. According to Korea, diluted soju is not drunk in bars or clubs. Whisky, by contrast, is an expensive drink that is primarily consumed in high-class bars and clubs -- hardly ever with meals.

5.241. According to Korea, these factors show that there is no actual competitive relationship between diluted soju and whisky, and a removal of the tax differential would not create direct competition between those two drinks either.

5.242. Korea argues that at first glance, one can see that diluted soju is a 'white' spirit, transparent and colourless, while whisky is a 'brown' spirit, of a translucent golden-brown colour (an element

¹³² Sofres Report, at p. 53 (1997), reproduced in Attachment 3.

¹³³ Pre-tax prices are provided in the Dodwell Study on page 20, in the column marked 'NET'. See Attachment 4.

¹³⁴ Source: National Tax Administration.

much prized by consumers). Korea adds that, diluted soju has an alcoholic strength of 25% by volume, while the alcoholic strength of whisky is at least 40% by volume.

5.243. As to their organoleptic qualities, Korea states that the most important types of whisky - Scotch, Irish, Bourbon and Canadian - have in common a very typical flavour and smell. It states that the elements that are often mentioned in connection with whisky are that it has a warm, smooth and smoky flavour. According to Korea, one of the objectives in the production process is, as with wine, to develop the taste and aroma imparted to the beverage as a result of the raw materials used for its production (maize, barley, rye or malt) and its ageing in wooden casks.

5.244. Korea further argues that, on the other hand, diluted soju has quite a 'rough' flavour and tends to leave a stinging sensation in the mouth and throat. Korea submits that this is a function of the raw materials of which standard soju is made and its production process. In Korea's view, the emphasis in the production process of diluted soju is on making the product as cheaply as possible, not, as with whisky, on ageing and adding value and subtle flavours. That is why, according to Korea, standard soju tends to have a 'cold' mouth feel that makes the drink suitable for consumption with the typically spicy Korean cuisine for which whisky is not suited. Hence, Korea concludes, as a matter of taste, Korean consumers do not consider whisky and diluted soju as substitutes for each other.

5.245. Korea further states that diluted soju is the alcoholic beverage that Koreans prefer with their meals. It is an effective foil for the hot and spicy food Koreans prefer, and Koreans consider that it is important to have some food when consuming diluted soju, in order to protect the stomach from the drink's harshness.

5.246. Korea concedes that it may seem unusual that Koreans prefer a distilled alcoholic beverage with their meals. Korea points out that in many cultures, particularly western ones, the alcoholic beverage found at the table is usually a fermented beverage with a lower alcohol content, such as wine or beer. It is in fact a western notion that distilled alcoholic beverages are not drunk with meals, but as straight drinks or cocktails. However, Korea points out that not all cultures share this trait, and gives as an example the Chinese, who allegedly also enjoy distilled alcoholic beverages with their meals. Finally, Korea notes that as in most countries, whisky is not consumed with meals in Korea.

5.247. Korea argues that these differences have follow-on effects. In conjunction with meals, standard soju is often consumed at home, while whisky is not. Whisky is instead consumed primarily in high-class hotel bars, night clubs, room saloons, and karaoke bars. Diluted soju not only not consumed in those places, it is not even on offer. Korea adds that when diluted soju is drunk away from home, it is mainly in Korean restaurants (including barbecue houses), mobile street vendors and inexpensive Chinese restaurants, where whisky is not normally available.

5.248. Korea therefore states that the Hankook Study introduced by the European Communities¹³⁵ begs the question. It allegedly shows that whisky is available in shops, hotels, danlanjulum (karaoke bars), Japanese restaurants, cafés, bars, night-clubs and discos. According to Korea, however, it does not show that soju is available in all of these outlets. Furthermore, argues Korea, it omits to mention the outlets in which diluted soju is drunk, but whisky is not available, such as the outlets where Koreans typically eat (Korean restaurants, including barbecue houses, mobile street vendors and inexpensive Chinese restaurants).

5.249. Korea states that in addition to the fact that diluted soju is a 'meal drink' while whisky is not, another element which shows in a most definitive way that diluted soju and whisky are not directly competitive and substitutable is their large difference in price. According to Korea, whisky is not nearly in the same price range as standard soju.

¹³⁵ EC Annex 10.

5.250. Korea asserts that in order to exclude any possible distortive effect from the disputed taxes, it will only compare pre-tax prices.¹³⁶ At this level, in Korea's analysis, striking price differences emerge from the Dodwell Study. According to Korea, Premium Scotch whisky is 12 times the price of diluted soju. North American whiskies are 10.8 times the price of diluted soju, and standard Scotch whisky is 7.2 times the price of diluted soju. Even the cheapest whisky, bottled in Korea, is cited as 6.3 times the price of standard soju.¹³⁷ In Korea's view, these figures show that diluted soju and whisky are far from being in the same price range.

5.251. To further support that point already made through the Dodwell data, Korea provides in the following table, average pre-tax prices for the past three years using its own figures. Korea explains that because these figures are calculated by dividing the total taxed value by the total taxed volume, they show the weighted average (pre-tax) prices of whisky and diluted soju (including premium soju) in Korea. In Korea's view, the results¹³⁸ show more pronounced price differences:

(in Korean won, pre-tax)	1995	1996	1997
Standard soju (360 ml)	289.94	305.11	322.46
Whisky (360 ml)	3401.27	3582.09	4111.50
Factor of:	11.73	11.74	12.75

5.252. Korea submits that these price differences are maintained even if taxes are harmonised, either down to the diluted soju level, or up to the whisky level. According to Korea, this is a compelling indication that whisky and diluted soju would not be in direct competition, even if the tax differential were eliminated.

5.253. Korea points out that this is not to say that whisky sales would not rise if the tax on whisky were reduced. It concedes that this might well be the case, just as in the past tax rate reductions on whisky have led to increased whisky sales. Korea points out, however, that whisky would still not be in direct competition with diluted soju. According to Korea, their price and other differences would remain too important and diluted soju sales would continue to develop largely independently.¹³⁹

5.254. Korea states that this observation was also made by the recent European Commission study already cited:

¹³⁶ Pre-tax prices are provided in the Dodwell Study on page 20, in the column marked 'NET'. See Attachment 4 Korea.

¹³⁷ According to Korea, it is to be noted that this is not a representative price for domestic whisky. For some reason, the Dodwell Study has split up the domestic brands (BIK stands for 'bottled in Korea') and has listed some of them among Premium Scotch Whisky as well. An example is the leading domestic brand (Imperial Classic), which is an expensive brand.

¹³⁸ The underlying data are set out in Attachment 5 of Korea.

¹³⁹ Korea states that the complainants' allegation that in recent years diluted soju sales have been eroded by growing sales of imported liquors is improbable. See EC first submission, at para. 51. The only thing they show is a slight (2%) reduction in the market share of diluted soju on the total spirits market from 1992 to 1996 (EC first submission, at Annex 6). In absolute terms, however, diluted soju sales rose by almost 13% (EC first submission, at Annex 5). During those five years, the spirits market increased in size (more than 15%); and diluted soju sales grew somewhat more slowly than sales of imported liquors. Increased income, the relative maturity of the market for diluted soju, etc., are more likely explanations to explain the difference in growth rate than any competition between whisky and diluted soju.

Soju in particular remains unaffected by imported alcoholic drinks. Furthermore Soju, is insulated from economic downturns and maintains a loyal following of steady consumers.¹⁴⁰

5.255. Korea also notes that the complainants have also not taken into account external factors such as currency fluctuations that also have an impact on sales of imported whisky.

5.256. Accordingly, Korea concludes that it is not under any legal obligation, by virtue of Article III.2 GATT, to reduce taxes on whisky to diluted soju levels (or, for that matter, to increase taxes on standard soju to whisky levels). In Korea's view, these two products are simply not sufficiently related on the Korean market for a tax differential to raise GATT concerns.

5.257. Korea submits that there are also other factors that contribute to the conclusion that diluted soju and whisky are not directly competitive and substitutable. Korea cites for instance, the marketing strategies for both drinks follow from the distinct consumption patterns and the price aspects described above. According to Korea, the target consumer is clearly different for both drinks and the producers and importers market the drinks accordingly. According to Korea, diluted soju is marketed as an everyday drink, consumed during meals, barbecues -- not in luxurious surroundings. It is contended that these advertisements typically show Korean citizens in day-to-day clothes having diluted soju while eating. In contrast, according to Korea, whisky is positioned as a high class luxury drink that is meant for special occasions. The advertising is allegedly meant to appeal to consumers who are prepared to pay a considerable price for this privilege.¹⁴¹

5.258. Korea also argues that each product has its own branding strategy. Korea contends that no trademark for whisky is used for sales of diluted soju, neither is a soju trademark used for sales of whisky. Korea states for example, that the Jinro company sells its domestic whisky under the 'Imperial Classic' brand, whereas its diluted soju is sold as 'Jinro Gold'. In Korea's view, this is yet another indication demonstrating that both products do not compete, and are not substitutable on the Korean market.

Diluted soju and Brandy/Cognac

5.259. Korea argues that there are a myriad of differences between diluted soju and brandy/cognac. Some of these differences are apparent at first glance. Korea contends that in their packaging, brandies/cognacs are presented in an elegant fashion in keeping with their distinguished character. This makes these drinks very suitable for gifts. The same cannot be said about diluted soju, bottled in common plastic or glass bottles and geared toward frequent consumption, rather than to occasional consumption.

5.260. Korea further argues that another striking difference is in the appearance of the alcohol itself: brandy/cognac is generally a deep golden brown colour and has substantial body, while standard soju is a white clear spirit, with little body. Brandies/cognacs have an alcohol content of at least 40%, as opposed to diluted soju's 25%. Further, the flavour and aroma of brandy has been much celebrated, and described as 'velvety' and full-bodied, with a powerful and pleasant bouquet. Part of the typical flavour of brandies/cognacs can be attributed to the fact that they are derived from fermented fruit. Korea also points out that in addition, brandies/cognacs undergo an important ageing process in oak casks (e.g., in order to bear the name 'cognac', this special brandy must be aged for at least 6 years in

¹⁴⁰ Sofres Report, at p. 22 (1997). See Attachment 3 of Korea.

¹⁴¹ See Attachment 6 of Korea for typical Korean advertisements for diluted soju and whisky. According to Korea, the advertisements submitted by the complainants are misleading in this regard. Many of them are directed not to the Korean market but to foreigners (see US, Exhibit D, which is a 'Sky Shop' duty free advertisement offered to international airline passengers; Exhibit F, which is an advertisement in English published in an international industry journal; or Exhibits H and I, which are advertisements in the Japanese language for the Japanese market).

wooden casks). It is contended that diluted soju on the other hand is most often made of tapioca, and has a much more industrial production process with no ageing. Suffice it to say that the resulting diluted soju has none of the refined characteristics of brandies/cognacs.

5.261. Korea further states that the price of brandy/cognac compared to diluted soju clearly spells out that competition between these products is improbable: pre-tax, brandy is 19.2 times as expensive as diluted soju.¹⁴² In Korea's view, this is certainly not 'within a relatively short range' of prices.

5.262. Korea submits that consumers perceive brandies/cognac and diluted soju as completely different products and use them in completely different ways. According to Korea, brandies are very expensive luxury drinks, and are consumed in places in keeping with their stature: room saloons, clubs, hotel bars, and other luxurious premises where standard soju is not on offer. Korea adds that brandy/cognac would not be consumed with a meal while diluted soju is the traditional cheap Korean drink essentially drunk during meals. It is contended that it is drunk (often in rather large quantities) by ordinary folks in less illustrious settings than brandy, such as with a meal at home or in a family restaurant. Korea states that a request for a glass of cognac such as Rémy Martin in these settings would likely be met with incredulity.

5.263. According to Korea, these differences are further reflected in the fact that the marketing strategies of diluted soju and brandies are essentially different. Korea states that of all the drinks concerned by this dispute, brandy probably has the most luxurious image, and is marketed as such, in its packaging, advertising, the target consumer class, and of course, its price range. The marketing of diluted soju, is, as stated before, concentrated on meal consumption and is the 'common' man's drink.

Diluted Soju and Vodka

5.264. Korea states that vodka is the only product for which the United States and the European Communities have claimed a 'like' relationship with diluted soju. Korea raises doubts as to the evidence brought by the complainants for alleging 'likeness' of diluted soju and vodka. According to Korea, out of six physical characteristics of vodka and diluted soju which the United States compared, only two corroborate their point of view. Korea notes that the Panel in the *Japan - Taxes on Alcoholic Beverages II* stated that "'like products' need not be identical in all respects". However, Korea further notes that this statement was immediately followed by an insistence that "the term 'like product' should be construed narrowly...."¹⁴³

5.265. Korea states that as far as the alleged 'likeness' is concerned, it should be noted that vodka and diluted soju do not fall under the same tariff classification. Vodka is allegedly classified under HS Classification 2208.60.00, while diluted soju falls under HS Classification 2208.90.40. Korea also mentions that there are other differences that suggest that there is no direct competitive relationship between these two products. Korea states that even though the difference between standard soju and vodka is not as striking as the differences between diluted soju and whisky, brandy, and cognac, described above, diluted soju and vodka are not like. However, Korea points out that both diluted soju and vodka also resemble tap water and paint thinner-- a sign, according to Korea, that appearances can be deceptive.

5.266. Firstly, Korea states that consumers are unlikely to treat vodka and diluted soju as substitutes for each other in light of the price differences between them. Even the comparison of the pre-tax prices of diluted soju and vodka shows that vodka is 5.7 times the price of diluted soju.¹⁴⁴ According

¹⁴² According to the Dodwell Study submitted by the complainants, page 20.

¹⁴³ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.21.

¹⁴⁴ According to the Dodwell Study, at p.20.

to Korea, if these products were truly as 'like', in competition, or substitutable for each other, it would be difficult to understand how such a vast price discrepancy could exist.

5.267. Korea further argues that vodka and diluted soju are not consumed in the same ways or in the same places. In Korea's view, this follows, not only from the price difference, but also from the difference in alcohol percentage (vodka: 40%; standard soju: 25%). Korea contends that vodka is primarily a 'mixing' drink, and that there are even recipe books dedicated to cocktails one can make with vodka. According to Korea vodka is mostly consumed, though at considerably lower volumes than whisky, in room saloons, hotel bars, night clubs, karaoke bars, in short, places where meals, and standard soju, are not offered.

5.268. Korea also states that diluted soju is drunk straight in a typical small glass and is decidedly not a mixer. Korea contends that the outlets for diluted soju are generally eating establishments, and they are more 'ordinary' than those at which vodka is offered. It is contended that one can buy soju in places like barbecue houses, restaurants, mobile street vendors and Chinese restaurants, while one cannot generally buy vodka there.

5.269. Korea further states that diluted soju is a volume drink, which vodka is not. According to Korea, the small volumes of vodka sold in Korea are not attributable to the tax differential. Whisky, with a higher tax than vodka, sells at considerably larger volumes in Korea. In Korea's view, the more likely explanation for vodka's small sales volume is simply that Korean consumers have no particular taste for it.

5.270. According to Korea, in light of all these differences, vodka and diluted soju are certainly not 'like' products, and they are also not directly competitive and substitutable.

Diluted Soju and Gin

5.271. Korea states that even though diluted soju and gin look alike, there is more to these products than meets the eye. Firstly, Korea states that gin is usually 40% alcohol while diluted soju is only 25% alcohol. Secondly, gin is derived from maize and flavoured with certain aromatics and spices, in particular juniper berries, which impart to gin a unique flavour and aroma, reminiscent of spices -- a taste which is not comparable to any other liquor. By contrast, diluted soju is made with tapioca or potatoes, and has a more harsh and neutral flavour. Korea argues that, accordingly, a consumer desiring the specific taste of gin will not settle for soju. Conversely, a Korean consumer interested in soju will not turn to gin with its typical, even overbearing, taste.

5.272. Korea further states that another reason why consumers would not substitute gin for diluted soju is the fact that gin is a product which is significantly more expensive than diluted soju. According to Korea, even without taking into account the disputed taxes levied on both drinks, the price differential between the average price of diluted soju and gin amounts to a factor of five.¹⁴⁵ Korea maintains that at harmonised tax rates this large price difference would remain.

5.273. Korea argues that the fact that consumers do not consider gin and diluted soju to be substitutable for each other is borne out in the patterns of consumption and places of sale. According to Korea, the vast majority of diluted soju is drunk straight, with meals. Gin on the other hand is served as a long drink, not straight, and is not drunk during meals. Korea contends that gin is an 'occasional' drink in Korea, only rarely purchased on the Korean market even compared to whisky. Compared to diluted soju consumption volumes, gin is a mere drop in the bucket, showing that in terms of demand, gin is not a substitute for diluted soju.

¹⁴⁵ According to the Dodwell Study submitted by the complainants, p. 20 (see Attachment 4 of Korea).

Diluted Soju and Rum

5.274. Korea states that rum comes in two varieties, light and dark, and while light rum looks like diluted soju, dark rum does not. However, Korea states that both varieties of rum are very different from standard soju. Firstly, Korea argues that diluted soju has an alcoholic strength of 25% by volume, while rum is at least 38% alcohol by volume. Secondly, Korea argues that rum is distilled at less than 96% by volume from the juice of cane sugar or molasses, specifically so that the distillate retains the specific organoleptic characteristics imparted to it from those raw materials. Thirdly, rum is aged. According to Korea, the result is a sweetness and a caramel flavour and smell that is smooth and appealing. Korea notes that, on the other hand, diluted soju is made from more neutral raw materials (tapioca, potatoes, corn), and is not aged. It has a 'rough' flavour and tends to leave a burning sensation in the mouth and throat. According to Korea, therefore, due to this difference in taste, a consumer would not be willing to accept rum when he wants diluted soju, or vice versa.

5.275. Korea further argues that like with the other liquors, consumers are even less likely to consider these two products as substitutes for each other in light of the difference in price between them. Korea states that pre-tax, rum is already 6.2 times more expensive than diluted soju.¹⁴⁶

5.276. Korea states that in addition to, and likely because of, the physical and price differences, diluted soju and rum are consumed in very different fashions. Rum is allegedly usually mixed as a cocktail and sold at bars and night clubs, where diluted soju is not even available while diluted soju is almost exclusively drunk neat and is normally served as an accompaniment to food.

5.277. Korea argues that these differences are borne out in the marketing of both products: rum is presented as a special and exotic beverage, intended for consumption in elegant establishments such as those mentioned above. Diluted soju on the other hand, is the commoner's drink, and is marketed as such.

5.278. Korea therefore concludes that, as with gin, the disparity in the volumes of rum sold and the volumes of diluted soju sold should be kept in mind. In other words, diluted soju is a commodity, while rum is a special, 'niche' drink.

5.279. Korea submits that it has presented a product-by-product analysis of the relationship of diluted soju and the imported liquors at issue. Korea considers that the conclusion of this analysis is that none of these products is in a directly competitive and substitutable relationship with any other (and, of course, that vodka, and for that matter, none, of the imported beverages is 'like' diluted soju).

5.280. Korea further submits that even if the Panel considers that any one of the imported products is directly competitive and substitutable for standard soju, there is still no violation of Article III. That is because the complainants have failed to prove, as is required under Article III:1, that the tax differential at issue in this case is 'so as to afford protection to domestic production.'

5.281. Korea argues that, firstly, it should be recalled that in *Japan - Taxes on Alcoholic Beverages II*, a protectionist effect was found in the combination of customs duties and the tax differentials, which 'isolated' Japanese shochu from competition. Korea contends that this combination does not exist in Korea. Korea submits that although it levies a (GATT-compatible) customs duty, its market for soju is not 'isolated' at all. Korea recalls once more the recent report published by the European Commission:

The Korean alcohol market is no longer a market protected by the government with market shares contested by local producers. In fact, it is becoming a truly global market where

¹⁴⁶ Ibid.

multinational companies convene to compete with one another for the lucrative and promising Korean market.¹⁴⁷

5.282. Korea further argues that making diluted soju basically involves mixing joojung with water, and in Korea the vast majority (approximately 70%) of the joojung used to make diluted soju is imported in a semi-finished state. Korea adds that when joojung is locally produced it is primarily made from imported ingredients (notably tapioca). According to Korea, therefore, even if the Panel concludes that standard soju is 'protected' by the difference in tax, one could only say that Korea protects one imported product at the expense of another.

5.283. Korea argues that on the other hand, if Korea's diluted soju production is nevertheless considered substantial enough to amount to domestic production, then it must also be considered that Korea has a domestic whisky industry as well. According to Korea, the production of whisky in Korea is in fact similar to the production of diluted soju, in that concentrated whisky is imported, then mixed with water and caramel, and then bottled. Korea states that this process, though it can be described in these simple terms, does add a substantial amount in value.¹⁴⁸ From this perspective, therefore, by imposing a higher tax on whisky, Korea has in fact been penalising its own domestic whisky industry.

5.284. Korea also argues that the fact that there are few imports of soju (e.g., from Japan) can be explained by commercial realities, rather than regulation: Japanese shochu sells at prices that are much closer to western-type liquors in Japan.

ii) Distilled Soju

5.285. Korea argues that if one could speak of a 'soju market', diluted soju would represent more than 99.8% of that market, and distilled soju, 0.2%.

5.286. Korea points out that the small volume of sales of distilled soju is indicative of the fact that distilled soju is a special artisanal product. Korea states that it is in fact difficult to compare a product that is mass-marketed around the world such as the imported liquors at issue in this case to such a tiny niche product, sold only in Korea. According to Korea, distilled soju is not in the same league as these world-wide players.

5.287. Korea further states that because distilled soju is prepared with great care and in small quantities, it is an expensive product in the price range of top-range whiskies and brandy/cognac. This is in contrast to diluted soju which is far less expensive than the imported products, and falls completely on the other end of the scale.

5.288. Korea also states that distilled soju comes in an expensive ceramic bottle and is most often offered as a gift to friends or colleagues, to be taken home and consumed there. It is marketed as such.

Distilled Soju and Whisky

5.289. Korea argues that the differences in the appearance of distilled soju and whisky are obvious. Distilled soju is a 'white' spirit, while whisky is a brown spirit. As regards taste, whisky has a typical flavour, described as smooth, smoky and warm. Korea adds that one can detect the taste and aroma imparted to the beverage as a result of its raw materials (maize, barley, rye) and its mandatory ageing in wooden casks for at least 3 years. Distilled soju has a full-bodied liquor with a clean aftertaste.

¹⁴⁷ See Attachment 3 of Korea.

¹⁴⁸ Korea understands that the cost of raw materials as a proportion of pre-tax prices can be comparable for standard soju and domestic whisky production.

This flavour is achieved by using mainly rice or grain as a raw material. Korea states that distilled soju can be, but need not be, aged (for a maximum of 2 years) in order to refine its flavour.

5.290. Korea also argues that distilled soju and whisky are used for very different consumer needs. Korea states that the most common way to drink whisky in Korea is as a cocktail, on the rocks, diluted with water or another mixer while distilled soju is almost exclusively drunk neat, that is, not diluted or mixed.

5.291. Korea states that most whisky is sold in Korea through channels as bars, hotels, room saloons, night clubs, karaoke bars and restaurants while distilled soju is a typical artisanal 'gift' item and as such is mostly sold through retail shops (and, recall, in very small quantities). Korea further states that distilled soju offered as a gift is then consumed at home, rather than in trendy bars like whisky.

5.292. Korea argues that consistent with these different patterns of consumption is a different type of marketing: whisky, a chic drink to be sipped in swanky venues; distilled soju, a traditional product to be offered as a gift.

Distilled Soju and Brandy/Cognac

5.293. Korea argues that as with whisky, the differences between distilled soju and brandy/cognac are apparent at first glance. Brandies/cognacs are brown spirits, contrary to distilled soju which is a clear white spirit. In addition, Korea states that brandies have more body as they are aged for a longer period than distilled soju. As to their taste, brandies/cognacs have a warm and fruity taste, while the taste of distilled soju is full-bodied with a clean aftertaste.

5.294. According to Korea, the difference in raw materials and production processes is the origin of this difference in taste and appearance. Brandies/cognacs are derived from fermented grapes, then aged in wooden casks, generally from 3 to 12 years. Distilled soju is usually made with rice and grain, and can only be aged for 2 years.

5.295. Korea argues that brandy/cognac is usually consumed neat in a high-brow restaurant as a digestif. Distilled soju, as mentioned above, is generally received as a gift, and therefore is consumed at home. Further, the marketing of distilled soju is specifically geared at offering the product as a gift, whereas brandy/cognac is more often consumed by the glass in restaurants or high class drinking establishments.

Distilled Soju and Vodka

5.296. Korea states that there are similarities between distilled soju and vodka. They are both white spirits, and they have similar degrees of alcoholic strength. However, Korea argues that, in light of other, more important differences in price, places of sale and consumption, end uses and marketing, distilled soju and vodka cannot be considered as 'like products' or as directly competitive or substitutable products.

5.297. Korea argues that distilled soju is a very special product that has a different flavour from vodka. Vodka approaches 'flavourlessness', while the taste of distilled soju is linked to its raw material. Vodka and distilled soju are also not consumed in the same fashion or in the same places. Due to its absence of flavour, vodka is particularly suitable for use in mixed drinks and is most often consumed as long drink in Korea. In so far as vodka is consumed in Korea, it is mostly sold through bars, discos, and room saloons. By contrast, distilled soju is only consumed straight. In general, distilled soju is sold through shops as it is a typical artisanal gift item. When received as a gift, distilled soju is subsequently consumed by the recipient at his home.

5.298. According to Korea, the above differences are reflected in the marketing of these products. Distilled soju is marketed as a traditional beverage and an appropriate gift, while vodka is marketed as a drink suitable for cocktails to be consumed while out on the town in the evening.

Distilled Soju and Gin

5.299. Korea states that one of the most important differences between distilled soju and gin is their tastes. Gin allegedly has an immediately recognisable flavour, which is unique and distinct, due in particular to one of its raw materials: juniper berries. Distilled soju is usually made of rice or grain and is not produced with such distinctive added flavours.

5.300. Korea also states that consumers do not consume gin and distilled soju in the same way or in the same places. The special flavour of gin is generally only appreciated as a long drink, not straight, and is most often consumed in up-scale locations, such as bars, room saloons and comparable places. Distilled soju, on the other hand, is always consumed straight and never mixed. Korea states that distilled soju is a typical gift, and subsequent to receipt is usually consumed at home, rather than out in bars and clubs.

5.301. Korea also states that distilled soju is marketed as a traditional Korean gift. Gin, on the other hand, is marketed as a drink suitable for cocktails to be drunk out on the town.

Distilled Soju and Rum

5.302. Korea states that rum and distilled soju differ in price, physical characteristics, organoleptic qualities, and are used by consumers to fill different needs. For these and other reasons distilled soju and rum are not directly competitive and substitutable.

5.303. Korea states that rum comes in both light and dark varieties. The light rum is a clear white spirit, and therefore could be said to resemble distilled soju. Dark rum however is a brown spirit, and does not resemble distilled soju.

5.304. Korea states that both types of rum have a very different flavour from distilled soju. Rum is distilled from the juice of cane sugar or molasses in such a way that the distillate has discernible organoleptic characteristics deriving from those raw materials; the result is a mildness and a caramel flavour that is smooth and appealing. Unlike rum, distilled soju is usually made of rice and is a dry alcohol which does not have the same mild caramel flavour.

5.305. According to Korea, as a result of these differences, distilled soju and rum are consumed in very different fashions. First of all, in so far as rum is consumed in Korea, the most common way to drink rum is as a cocktail in places such as bars, hotels, and room saloons. By contrast, distilled soju is almost exclusively drunk neat, that is, not diluted or mixed with other liquids. Korea also argues that distilled soju is most often presented as a gift, which is bought by the giver in a shop, and consequently drunk by the recipient at home.

Analysis of the "so as to afford protection" requirement

5.306. According to Korea, the marketing strategies of rum and standard soju reflect the different geographical origins of the drinks. Rum is marketed as an exotic drink, which is ideally used as a cocktail during night-time occasions. The marketing of distilled soju, on the other hand, reflects the traditional Korean life-style (illustrated by its presentation in special Korean ceramic bottles, often as a set with ceramic cups).

5.307. Korea states that, as with diluted soju, Korea has presented an explanation, product-by-product, of why distilled soju is not 'like' vodka or directly competitive and substitutable for any of the imported liquors involved in this case.

5.308. Korea states that even if the Panel disagrees with Korea's point of view, the complainants have still failed to make out a violation of Article III. In Korea's view, in order to prove a violation, the complainants must show that the tax differential at issue is 'so as to afford protection to domestic production.'

5.309. Korea states that distilled soju is a traditional, artisanal product. It is not a mass-marketed, international product such as the imported beverages concerned. In other words, the demand for a product like distilled soju is specific and static -- it would be difficult to affect it a great deal in either direction by altering the price, especially not to the degree at issue in this case. Indeed, despite the lower tax applied to distilled soju, its sales are still minuscule.

5.310. Korea wants the Panel to imagine, *quod non*, that it found that whisky and distilled soju were directly competitive and substitutable products, and that the other conditions of Article III were met. Korea would then be forced to harmonise the tax rates on these two products. Korea submits that it could not lower the tax rate on whisky for distilled soju, as the impact on its revenues would be too great. Instead, it would have to raise the tax rate on distilled soju, crippling a tiny artisanal product which is part of its heritage, with no benefit to the imported beverages.¹⁴⁹

5.311. According to Korea, the result of this analysis is that even if the Panel disagrees with Korea's arguments that distilled soju is not directly competitive and substitutable to any of the imported beverages concerned, the requirement of Article III:1 has still not been met: the complainants have not proved that the different tax applies 'so as to afford protection' to distilled soju.

¹⁴⁹ According to Korea, in this regard, it could even be said that the special position of distilled soju for Korea merits an exception under Article XX(f) of the GATT.

VI. REBUTTAL ARGUMENTS

A. EUROPEAN COMMUNITIES

1. Shochu and soju

6.1. The European Communities notes that according to Korea, the only difference between shochu and soju is that shochu contains two additives only (sugar and citric acid) whereas soju contains four to five more additives. However, according to the European Communities, it is still unclear whether there is a legal requirement to use any of those additional four to five additives or whether it is simply a characteristic of certain brands.

6.2. The European Communities argues that all the extra additives except one (mineral salt) supposedly found in soju but not in shochu are sweeteners. Thus, the EC view is that the alleged difference between soju and shochu appears to be nothing other than the fact that soju is somewhat "sweeter" than shochu. The European Communities adds that Korea does not specify how much "sweeter" soju must be. According to the European Communities, there appears to be no legal requirement in Korea regarding the minimum sugar content of soju. The analytical tests conducted by the Scotch Whisky Research Institute have allegedly revealed no trace of this supposed difference in "sweetness" alleged by Korea.¹⁵⁰

6.3. The European Communities further argues that at any rate, the difference alleged by Korea is a very minor one. The European Communities asserts that Coca Cola, for example, also is slightly sweeter in some countries than in others, so as to match different local tastes. Significantly, Korea does not even allude to this supposed characteristic of soju when it attempts to distinguish it from vodka and other distilled spirits.

6.4. The EC view is also that Korea also implies that, unlike soju, the majority of shochu A is frequently aged and brown coloured. According to the European Communities, over 99% of shochu is white¹⁵¹ and non aged.¹⁵²

6.5. The European Communities also notes Korea's contention that, unlike soju expressly manufactured for the Japanese market, "true" soju consumed by the Korean minority in Japan is not treated as shochu by the Japanese authorities for customs and tax purposes. According to the European Communities, this claim seems to be at odds with the statements made by Japan before the 1996 Panel on *Japan - Taxes on Alcoholic Beverages II*.¹⁵³ The EC view is that even if Korea's claims were correct, they would only go to show that Japan applied its Liquor Tax Law so as to afford protection to its domestic production of shochu not only vis-à-vis imports of western spirits but also vis-à-vis imports of soju.

2. The Japanese market and the Korean market

6.6. The European Communities argues that according to Korea, the main difference between the Korean market and the Japanese market would be that in Japan the prices of shochu and of imported liquors are "within a relatively short range", whereas in Korea soju is much less expensive than imported liquors.

¹⁵⁰ See EC Annex 8. The EC states that although Korea attempts to discredit that research by describing it as a "partisan report", it offers no evidence to dispute the findings of that report.

¹⁵¹ The optical density of shochu, measured by the light of 430 nanometer wavelength is, at the maximum, 0.08. The usual optical density of Scotch whisky is between 0.45 and 0.70.

¹⁵² See Panel Report on, *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 4.54.

¹⁵³ *Ibid.*, para. 6.35.

6.7. According to the European Communities, Korea does not provide any evidence to support its allegations regarding the Japanese market, but instead makes a misleading reference to an argument made by the European Communities in the *Japan - Taxes on Alcoholic Beverages II* case.

6.8. The European Communities argues that the prices of shochu on the Japanese market vary considerably. At one extreme, there is inexpensive standard shochu sold in bulky plastic bottles of 1.8 to 4 litres or even in paper packages. At the other extreme, there are premium brands sold in 0.7 litre bottles which are generally three to four times more expensive than standard shochu.¹⁵⁴ According to the European Communities, standard shochu still accounts for the majority of sales, like in Korea, even though sales of premium shochu are growing rapidly. The price range for western-style spirits is allegedly even wider than that of shochu, especially in the case of whisky and brandy.

6.9. The European Communities explains that when it argued that in Japan the pre-tax prices for shochu and western spirits were within a relatively close range, it based itself on a comparison of the prices for premium shochu brands, on the one hand, and standard brands of western spirits, on the other hand¹⁵⁵. According to the European Communities, even on that basis, the pre-tax prices for standard imported whisky were sometimes as much as twice the price for shochu. It was never disputed by the EC that the prices of premium whisky or premium brandy in the Japanese market could be many times higher than the prices of standard shochu.

6.10. The European Communities notes that like Korea in this dispute, Japan submitted to the Panel a comparison of pre-tax weighted average prices. According to that comparison, the pre-tax price for brandy and whisky were 13 times and 5 times higher, respectively, than the pre-tax price for shochu A.¹⁵⁶

6.11. The European Communities also notes Korea's claim that another important difference is that in Japan shochu A and shochu B are sold in comparable volumes and at similar prices. The EC view is that this is correct but irrelevant. The European Communities fails to see how this difference can be conducive to stronger competition between shochu and western spirits, as compared to soju.

6.12. Finally, the European Communities notes that Korea invokes differences in drinking styles. According to Korea, soju is always drunk "straight", whereas shochu is drunk in other styles in addition to "straight", such as diluted with warm water and mixed in cocktails. According to the European Communities, this is inaccurate as far as soju is concerned. The EC view is that soju is not always drunk straight, and in particular, it is also drunk as cocktail, as attested by the growing sales of pre-mixes. As to the fact that shochu is drunk with warm water (i.e. in a style which is not characteristic of any western spirit) the European Communities fails to see how this may have had the paradoxical result of making shochu more competitive with western spirits than soju.

3. All types of soju are one and the same product

(a) Distilled and diluted soju

6.13. The European Communities notes that Korea attempts to create an artificial distinction between the two basic types of soju: distilled soju and diluted soju¹⁵⁷, with an obvious strategy: many of the alleged differences which, according to Korea, make soju "unlike" or "not directly competitive

¹⁵⁴ See EC Annex 1.

¹⁵⁵ See EC Annex 2.

¹⁵⁶ See EC Annex 3.

¹⁵⁷ The EC argues that "diluted soju" is a term used in the Liquor Tax Law and other official Korean sources and not one created by the complainants, as Korea seems to imply. See, for example, the decision of the Fair Trade Commission in Attachment 1 to Korea's First Submission and the 1997 Korean Taxation Guide published by the Ministry of Finance in Annex 4 to this submission.

or substitutable" with western-style liquors (including in particular the differences in pricing) cannot be substantiated when those liquors are compared to distilled soju.

6.14. According to the European Communities, Korea seems to be ready to "sacrifice" distilled soju in order to spare diluted soju. In the EC view, that sacrifice would be more apparent than real, in view of Korea's statement that under certain conditions the producers of distilled soju may be designated as possessors of an "intangible cultural asset". The European Communities retorts that Korea carefully omits to say that this may entail an exemption from the Liquor Tax and the Education Tax.¹⁵⁸

6.15. According to the European Communities, the reality, however, is that distilled soju and diluted soju are but two varieties of the same product, as it should be obvious already from the fact that the two bear the same name. The European Communities notes that many other spirits are also produced in different types or varieties. In the case of whisky, for instance, it is possible to distinguish between malt Scotch, grain Scotch, blended Scotch, Canadian, Irish, Bourbon, Rye, etc. According to the European Communities, in relative terms distilled soju is no more different from diluted soju than, for example, malt Scotch from grain Scotch.

6.16. The European Communities argues that the distinction between distilled soju and diluted soju was not introduced in the Liquor Tax Law until 1991.¹⁵⁹ In the EC view, it was a distinction created exclusively for tax purposes as no similar distinction is found in Korea's tariff schedule, where all soju is classified within a single heading with the description "soju".¹⁶⁰

6.17. The European Communities notes that until the 1960s, most soju sold in Korea was produced according to the method described in the legal definition of "distilled soju". The origins of what the Liquor Tax Law calls "diluted soju" go back to 1962, when, in order to cope with a severe shortage of grains, the Korean Government adopted a series of measures to encourage the use of ethyl alcohol. By the mid seventies, the European Communities further argues, distilled soju had given way to diluted soju. According to the European Communities, such swift transition was possible only because, in the eyes of Korean consumers, the two varieties of soju are the same product.

6.18. The European Communities asserts that the differences between distilled soju and diluted soju are aptly described by a decision of Korea's Fair Trade Commission.¹⁶¹ According to the first "Established Fact" of that Decision,

"Distilled soju is made from a mix of additives and water blended into an alcohol solution extracted by a method of 'single-step' distillation. On the other hand, 'diluted' soju refers to soju made from a mix of additives, water and grain solution (or distilled soju solution - the Liquor Tax act classifies soju as being diluted soju where the ratio of the grain solution or the distilled soju solution amounts to 20 % or less of the total volume of alcohol) blended into an alcohol solution extracted by a method of 'continuous' distillation'. Thus, the basic difference between those two types of soju lies in whether the alcohol was extracted by means of single-step distillation or continuous distillation."

6.19. The European Communities notes that other spirits such as whisky and brandy can also be obtained either by single-step distillation (also referred to as "pot still" or "discontinuous") or by

¹⁵⁸ See the 1997 Korean Taxation Guide published by Korea's Ministry of Finance in EC Annex 4.

¹⁵⁹ The distinction was introduced in response to pressure from the EC to eliminate the tax differentials between soju and the other distilled spirits. The creation of the category of distilled soju was but a fig leave, which allowed Korea to claim that "expensive" soju was no less taxed than "some" imported liquors (namely the category of "liqueurs").

¹⁶⁰ See EC Annex 5.

¹⁶¹ See Attachment 1 to First Submission of Korea.

continuous distillation. It further notes for instance, that malt Scotch whisky is produced by pot-still distillation, while grain Scotch whisky is obtained by continuous distillation.

6.20. The European Communities argues that the close similarity of the two types of soju is attested by the fact that distilled soju and diluted soju can be and are often blended with each other. When distilled soju represents more than 20% of the total alcohol content, the admixture is taxed as distilled soju and not as diluted soju. Again, a parallelism can be drawn to whisky. The most common type of Scotch whisky is blended whisky, which is produced by mixing malt Scotch and grain Scotch.

6.21. The European Communities further argues that the other differences between diluted soju and distilled soju alleged by Korea are either exaggerated or irrelevant because:

- (a) there is no legal requirement to use only rice or grains for making distilled soju. In accordance with the legal definition of distilled soju, other raw materials containing starch can be used as well. On the other hand, diluted soju can also be produced from grains;¹⁶²
- (b) although diluted soju cannot be aged by law, it is perfectly legal to blend previously aged distilled soju and neutral spirits in order to make diluted soju;
- (c) as stressed by Korea at another point of its submission where it seeks to distinguish distilled soju from whisky, "distilled soju can be, but need not be, aged";
- (d) the price difference between distilled soju and diluted soju are no larger than, for example, the prices differences between certain types of whisky;
- (e) there are also appreciable differences in taste between Premium diluted soju and Standard diluted soju or, for example, between Scotch Whisky and Bourbon;
- (f) many other spirits are produced both artisanally and industrially;
- (g) there is no legal requirement regarding the minimum alcohol content of either distilled or diluted soju.

(b) Premium and standard diluted soju

6.22. The European Communities reiterates that, a new segment of so-called "premium soju" brands is emerging rapidly within the category of diluted soju. Premium soju is characterised by a milder taste, the use of flavourings and/or ageing and more sophisticated packaging.¹⁶³ All this makes premium diluted soju even more similar to western-style spirits than standard diluted soju.

6.23. The European Communities argues that Korea cannot deny that premium diluted soju is the same product as standard diluted soju, since this is not a distinction which is reflected in Korea's regulations. Instead, Korea allegedly attempts to minimise the importance of premium soju by presenting it as an exception of minor importance and then ignores it in the remainder of its submission.

¹⁶² For instance, according to the Sofres Report, the Premium Soju brand Kim Sat Gat uses rice or barley. See the Sofres Report, p. 23.

¹⁶³ See the Sofres Report, at pp. 23-24

6.24. The European Communities notes, however, that this "exception" accounts for a volume of sales which exceeds the combined sales volume of all imported spirits. The EC claimed that premium diluted soju may have accounted for as much as 10 percent of soju sales in 1997.¹⁶⁴

4. Soju and vodka are like products

The standard for the interpretation of "like products"

6.25. The European Communities argues that Korea seems to consider that it is sufficient to point to the existence of any difference, however minor, between two liquors, such as for instance a vaguely defined difference in taste, in order to exclude a finding of "likeness" for the purposes of GATT Article III:2, first sentence.

6.26. According to the European Communities, as clarified by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, in Article III:2, first sentence, the notion of "like" product must be construed "narrowly".¹⁶⁵ Nevertheless, the EC view is that it is also a well established principle that in order to be "like" two products need not be "equal" or "identical" in all respects.¹⁶⁶ The European Communities notes that according to *Japan - Taxes on Alcoholic Beverages I*:

[m]inor differences in taste, colour and other properties (including differences in alcohol contents) do not prevent products from qualifying as like products.¹⁶⁷

6.27. According to the European Communities, Korea's position appears to be based on the mistaken notion that in order to be "like" two products must be "perfectly substitutable". The European Communities argues that contrary to Korea's allegations, the Appellate Body has never taken such an extreme view, and that Korea's reasoning is a classical *non sequitur*. The European Communities further argues that in *Canada - Certain Measures Concerning Periodicals*,¹⁶⁸ the Panel noted that a case of perfect substitutability would fall within Article III:2, first sentence, in order to reject an argument by the defendant to the effect that between the products concerned there was "imperfect substitutability" only. According to the European Communities, the Appellate Body, however, did not thereby imply that two products must always be "perfectly substitutable" in order to be "like". Indeed, such an interpretation would make Article III:2, first sentence, inapplicable except in cases of overt origin based discrimination between identical products.

6.28. The European Communities asserts that, in order to escape the implications of the two Panel reports on *Japan - Taxes on Alcoholic Beverages*, Korea over-emphasises the importance of the

¹⁶⁴ According to footnote No 30 of Korea's First Submission, in 1996 the total taxed volume of premium soju was 35,108 kl. In comparison, the total volume of imports of whisky, cognac, rum, gin and vodka during the first eleven months of 1996 was 22,286 kl (see EC's First Submission, Annex 7).

Also according to footnote No 30 of Korea's First Submission, in 1997 total taxed volume of premium soju was 43.878 kl. During the same year, the total taxed volume of "whisky" was 24.530 kl (see Attachment 5 to Korea's First Submission,).

There is no legal definition of "premium soju". The discrepancy between the market share of premium soju estimated by the EC in its First Submission (at para. 54) and the share mentioned by Korea may be explained by the fact that Korea uses a narrower definition of premium soju.

¹⁶⁵ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, pp. 19-20

¹⁶⁶ See Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.21. See also the Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, at par. 5.5, referring to the Panel Report on *United States - Taxes on Petroleum and certain Imported Substances*, *supra* at para. 5.1.1, where the Panel found that some of the imported and domestic products, albeit not identical, were like products since they served substantially the same uses.

¹⁶⁷ *Ibid.*, para. 5.9.

¹⁶⁸ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, p.28

"consumers' tastes and habits" as one of the relevant criteria for a "like" product determination. According to the European Communities, that criterion was indeed mentioned by the Working Party on *Border Tax Adjustments*,¹⁶⁹ which has been cited with approval by the Appellate Body in *Japan - Taxes on Alcoholic Beverages*¹⁷⁰ and *Canada - Certain Measures concerning Periodicals*.¹⁷¹

6.29. The European Communities argues however, that in practice, past panels have given little weight to "consumers' tastes and habits" when making "like product" determinations. Instead, they have focused on objective factors such as the physical characteristics of the products and their end uses. According to the European Communities, the reason for that approach is that "consumers' tastes and habits", unlike the physical characteristics of products and their objective end uses, are influenced by prices and, consequently, also by taxes. Alleged differences in "consumers' tastes and habits" may have been created, or at least "fossilised", through discriminatory internal taxes and cannot, therefore, constitute a valid justification for continuing to apply those discriminatory taxes.

6.30. According to the European Communities, an example of this approach is provided by the Panel report in *Japan - Taxes on Alcoholic Beverages II*:

[E]ven 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 use by consumers) the Panel agreed with arguments submitted to it [...] 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 [...] 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 crystallise consumer preferences for traditional domestic products, the Panel found that the traditional Japanese habits with regard to shochu provided no reason for not considering vodka to be a "like" product.¹⁷²

6.31. The European Communities asserts that Korea invokes the fact that vodka is allegedly more expensive than soju as one of the reasons that make those two spirits "unlike". According to the European Communities, the differences in prices between diluted soju and vodka have been grossly overstated by Korea, whereas distilled soju may, in fact, be more expensive than vodka.

6.32. The EC view is also that prices are not relevant for a "like" product determination. According to the European Communities, prices are not one of the criteria mentioned in the Working Party on *Border Tax Adjustments*. Nor are they mentioned as a relevant criterion by the Appellate Body in *Japan - Taxes on Alcoholic Beverages* or *Canada - Certain Measures affecting Periodicals*. The EC view is that it is not aware of any single case in which prices have been taken into account for a "like" product determination, whether for the purposes of Article III:2, or of any of the other GATT provisions incorporating that notion.

6.33. In fact, notes the European Communities, in *Japan - Taxes on Alcoholic Beverages II*, the Panel rejected in categorical terms an argument by Japan to the effect that local spirits were not "like" imported ones because they were less expensive:

[T]he Panel was of the view that "like" products do not become "unlike" merely because of differences in prices, which were often influenced by external government measures (e.g.

¹⁶⁹ Report of the Working Party on *Border Tax Adjustments*, BISD 18S/97, para. 18.

¹⁷⁰ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 20.

¹⁷¹ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, p.21.

¹⁷² Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 5.7.

customs duties) and market conditions (e.g. supply and demand, sales margins). The Panel was convinced that such an interpretation would run counter to the objective of Article III:2 to avoid that discriminatory or protective internal taxation of imported products would distort price competition with domestic like or directly competitive products, for instance by creating price and consumer categories and hardening consumer preferences for traditional home products.¹⁷³

6.34. The European Communities also argues that there are two additional reasons for disregarding prices when making a "like" product determination. The first reason is that Article III:2, first sentence, purports to establish a hard-and-fast rule. Once it is determined that two products are sufficiently similar to be "like", it is irrefutably presumed that any difference in taxation between them will afford protection to the domestic production and, therefore, must be condemned. The European Communities continues that implicit in this presumption, there is also the assumption that products which are sufficiently similar to be "like" must of necessity be "directly competitive or substitutable". According to the EC view, Korea's interpretation would undermine that assumption and require complainants to prove that products which are sufficiently similar to be "like" are also "directly competitive and substitutable" in terms of price. The European Communities argues that if a such view was upheld, the presumption established in the first sentence of Article III:2 would lose much of its effectiveness and the clear textual distinction between the first and the second sentences of Article III:2 would become blurred.

6.35. The European Communities argues that the second reason is that Korea's reliance upon price differences for justifying a different tax treatment is fraught with dangerous implications for the world trade system. According to the European Communities, the present dispute is concerned with a situation where imported products tend to be more expensive than the local products. Yet, if prices were deemed relevant for a "like" product determination, it would be open for developed country Members to claim that cheap imports from low cost developing country Members are too inexpensive to be on the same market with identical local products and to impose higher taxes on those imports. In the EC view, the mere possibility for a developing country Member to demonstrate before a Panel, in respect of each single category of products, that its exports do compete in terms of price with identical products of the importing country is likely to be an ineffective deterrent against this kind of abuses.

(a) Vodka and diluted soju

6.36. The European Communities also argues that Korea is able to identify only one single difference between vodka and diluted soju, namely that vodka has a higher alcohol content than diluted soju. According to the European Communities, whereas diluted soju is usually bottled at an alcoholic strength of 25%, vodka has between 37% and 40% alcohol content by volume¹⁷⁴.

6.37. The European Communities further notes that the two Panel Reports on *Japan - Taxes on Alcoholic Beverages* have established that differences in alcoholic content do not suffice to make two liquors "unlike". In particular, *Japan - Taxes on Alcoholic Beverages II* concluded in unequivocal terms that:

¹⁷³ Ibid., para. 5.9 (b)

¹⁷⁴ This difference is not reflected in the Liquor Tax Law, which sets no minimum alcohol content for either diluted soju or vodka.

[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.¹⁷⁵

6.38. According to the European Communities, this conclusion was not based on the observation of the specific "tastes and habits" of the Japanese consumers but purported to have a general validity on all markets.

6.39. The European Communities also notes that Korea, while admitting implicitly that vodka and diluted soju are virtually identical, denies that they are "like" by pointing to differences in customs classification, end-uses and pricing.

6.40. In the EC view, the alleged differences regarding end uses are the same as those invoked by Korea with respect to other spirits. They are allegedly either overstated or irrelevant.

6.41. The European Communities argues that the difference in customs classification is totally irrelevant. The European Communities notes that Korea's tariff is based on the 1996 version of the Harmonised System (HS). Under the previous version of the HS, vodka was allegedly classified into the same basket heading as soju (HS 2208.90, "other"). In the 1996 HS classification, it was allegedly decided to create a separate position for vodka (HS 2208.60) simply because that spirit had become one of the most internationally traded spirits and not because in the meantime it had developed new physical characteristics or end uses which made it "unlike" soju and all the other liquors falling within HS 2208.90.

6.42. According to the European Communities, for these reasons, the alleged differences in prices are also irrelevant. The EC view is that in any event, Korea grossly overstates the actual differences. The pre-tax prices for soju shown in the Dodwell Study, on which Korea bases its comparison, are prices for standard diluted soju. The pre-tax prices for premium diluted soju are between two and three times higher.¹⁷⁶ If an adjustment is made to take into account differences in alcohol content, the pre-tax price for a bottle of imported vodka is two to three times higher than the pre-tax price for a bottle of premium soju.¹⁷⁷ In the EC view, in relative terms the difference in prices between premium diluted soju and vodka is the same as the difference between standard and premium diluted soju and much less than the difference between either premium or standard diluted soju and distilled soju.

(b) Vodka and distilled soju

6.43. The European Communities asserts that it has identified two differences between distilled soju and vodka:

- (a) unlike vodka, distilled soju cannot be filtered through white birch charcoal, although it can be filtered through any other materials; and
- (b) distilled soju must be obtained through non-continuous distillation.

6.44. The European Communities asserts that Korea does not even mention these two differences in its argument. The EC view is that this confirms that, as claimed by the EC, those differences in manufacturing process have little impact on the final characteristics of the products and do not prevent vodka and distilled soju from being "like" products.

¹⁷⁵ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.23.

¹⁷⁶ See EC Annex 6.

¹⁷⁷ See EC Annex 7.

6.45. The European Communities notes that in Korea's submission, the main difference between distilled soju and vodka would be a difference in taste: "Vodka approaches 'flavourlessness', while the taste of distilled soju is linked to its raw material".

6.46. According to the European Communities, this difference, however, is clearly minor and cannot preclude a finding of "likeness". Once again, it is necessary to recall that according to *Japan - Taxes on Alcoholic Beverages I*: "[M]inor differences in taste, colour and other properties (including differences in alcohol contents) do not prevent products from qualifying as like products."¹⁷⁸

6.47. The European Communities argues that in terms of flavour, distilled soju is no more different from vodka than, for example, Japanese shochu B, which is also obtained by non-continuous distillation of, *inter alia*, grains.

6.48. The European Communities further argues that in order to compensate for the absence of any significant difference in physical characteristics between distilled soju and vodka, Korea invokes differences in end uses and marketing.

5. Soju and the other distilled spirits are directly competitive and substitutable products

(a) Standard for the interpretation of "directly competitive and substitutable"

6.49. The European Communities notes that at several points of its submission, Korea argues that the notion of "directly competitive and substitutable products" must be applied "strictly".

6.50. According to the European Communities, the restrictive interpretation of the terms "directly competitive or substitutable" advocated by Korea finds no support in the text of Article III, and that it is refuted by the drafting history of GATT 1947 as well as by prior panel reports.

6.51. According to the European Communities, during the discussions within the Geneva Preparatory Committee and subsequently at the Havana Conference, the delegates discussed a number of examples of "directly competitive or substitutable products" which indicate clearly that the drafters had in mind a rather broad interpretation of those terms. Those examples included apples and oranges;¹⁷⁹ linseed oil and tung oil;¹⁸⁰ synthetic rubber and natural rubber;¹⁸¹ coal and fuel oil;¹⁸² and tramways and buses.¹⁸³

6.52. The European Communities argues that past panels which have interpreted the notion of "directly competitive or substitutable products" have also refrained from taking the narrow approach advocated by Korea. The European Communities also argues that the two Panel reports on *Japan - Taxes on Alcoholic Beverages* reached the conclusion that all distilled spirits were directly competitive or substitutable products. Another example, according to the European Communities, is provided by the Panel report on *EEC - Measures on Animal Feed Proteins*, which concluded that vegetable proteins and skimmed milk powder were "directly competitive or substitutable" products for the purposes of applying the second sentence of Article III:5.¹⁸⁴

¹⁷⁸ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.9.

¹⁷⁹ EPCT/A/PV.9, at 7.

¹⁸⁰ E/CONF.2/C.3/SR.11 p. 1 and Corr.2.

¹⁸¹ *Ibid.*, p.3

¹⁸² E/CONF.2/C.3/SR40, at 2.

¹⁸³ *Ibid.*

¹⁸⁴ Panel Report on *EEC - Measures on Animal Feed Proteins*, *supra.*, para. 4.3.

6.53. The European Communities also notes that Korea, in order to justify its restrictive interpretation of "directly competitive or substitutable", argues that the purpose of Article III:2 is not to harmonise tax policies but to avoid protectionism.

6.54. The EC view is that it would agree that the purpose of Article III:2 is to avoid protectionism, but nevertheless takes issue with Korea's contention that this purpose commands a "strict" reading of the notion of "directly competitive and substitutable" product.

6.55. The European Communities notes that in *Japan - Taxes on Alcoholic Beverages II*, first the Panel and then the Appellate Body concluded that the notion of "like product" must be construed "narrowly" in the first sentence of Article III:2. According to the European Communities, this interpretation was deemed necessary in view of the fact that, as put by one of the complainants in that dispute, Article III:2, first sentence, is like a "guillotine": once it has been established that two products are like, any tax differential between them is deemed prohibited, without it being necessary to ascertain whether the tax differential is applied "so as to afford protection".¹⁸⁵

6.56. The European Communities notes further that in contrast, there is no indication in *Japan - Taxes on Alcoholic Beverages II* that the notion of "directly competitive or substitutable" product must also be construed "narrowly" or "strictly". According to the European Communities, this reflects the different wording and structure of the second sentence of Article III:2. Unlike the first sentence of Article III:2, the second sentence makes express reference to the first paragraph of Article III. This means, in the EC view, that in order to establish a violation of Article III:2, second sentence, it must be determined first, as one of three separate requirements, that the tax differential is "applied so as to afford protection to domestic production". According to the European Communities, therefore, a "strict" or "narrow" reading of the terms "directly competitive or substitutable" is not warranted in order to ensure that only protectionist measures are condemned.

6.57. The European Communities notes that in the same vein, Korea also argues that Article III:2 second sentence applies only where there is "actual" competition, as opposed to "potential" competition. According to Korea, this interpretation is "strongly suggested" by the Interpretative Note to Article III:2 and, in particular, by the terms ".... where competition was involved". According to the European Communities, those terms, however, refer to "competition" only, without requiring that it must be "actual" competition. "Potential" competition is already "competition" within the meaning of the Note.

6.58. According to the European Communities, the use in the Interpretative Note of the terms "competitive" (and not "competing") and substitutable (instead of "substitute") is a further indication that the GATT drafters envisaged the application of Article III:2 not just in instances of "actual" competition but also where there is "potential" competition. This is allegedly even clearer in the equally authentic French and Spanish versions which refer to ".... *un produit directement concurrent ou un produit qui peut lui être directement substitué..* ." and "... *un producto directamente competidor o que puede substituirlo directamente...*", respectively.

6.59. The European Communities argues that Korea's interpretation is also refuted by prior Appellate Body and Panel reports which have recognised the relevance of "potential" competition for the purposes of Article III:2.

¹⁸⁵ The European Communities states that 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 domestic products.

6.60. The European Communities recalls that *Japan - Taxes on Alcoholic Beverages I* stressed that internal tax measures should not be used to "crystallise" consumer preferences for domestic products.¹⁸⁶

6.61. The same view was reiterated in *Japan - Taxes on Alcoholic Beverages II*:

[t]he responsiveness of consumers to the various products offered in the market] may vary from country to country, but should not be influenced or determined by internal taxation. The Panel noted the conclusions in the 1987 Panel Report 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.¹⁸⁷

6.62. The European Communities also notes that the relevance of potential competition has also been recognised by the Appellate Body in *Canada - Certain Measures Affecting Periodicals*:

[W]e are not impressed either by Canada's argument that the market share of imported and domestic magazines has remained remarkably constant over the last 30-plus years, and that one would have expected some variation if competitive forces had been in play to the degree necessary to meet the standard of "directly competitive" goods. This argument would have weight only if Canada had not protected the domestic production of Canadian periodicals through, among other measures, the import prohibition of Tariff Code 9958 and the excise tax of Part V.1 of the Excise Act.¹⁸⁸

6.63. According to the European Communities, the relevance of potential competition for the application of Article III:2, second sentence, flows from the well established principle that Article III does not protect export volumes but expectations on the competitive relationship between imported and domestic products.¹⁸⁹ Those expectations may exist even if there is no "actual" competition yet between imported and domestic products due to protective tax measures.

6.64. The European Communities further argues that, Korea's position would have the absurd result of actually rewarding those Members who apply the most protectionist tax measures. If a Member applies a tax in such a way as to completely exclude imports of a competitive product, it would never be possible for other Members to show that there is "actual" competition between that product and the protected domestic product and, therefore, that such measures violate Article III:2. Meanwhile, a Member applying a less protectionist tax measure which restricts but does not pre-empt "actual" competition between domestic and imported goods would be found to violate Article III:2.

6.65. The European Communities notes that Korea, in support of its peculiar interpretation of Article III:2, emphasises that this provision is perhaps the GATT provision "that treads most heavily

¹⁸⁶ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, para. 5.7. At the same paragraph, the Panel added that:

"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."

¹⁸⁷ Panel Report on *Japan - Taxes on Alcoholic Beverages*, para. 6.28

¹⁸⁸ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, at 28.

¹⁸⁹ See e.g. Working Party on "Brazilian Internal Taxes", adopted 30 June 1949, II/181, 185, at para. 16; Panel Reports on *United States - Taxes on Petroleum and Certain Imported Substances*, *supra.*, para. 5.1.9, *United States - Measures Affecting Alcoholic and Malt Beverages*, *supra.*, 271; and *United States - Measures affecting the Importation, Sale and use of Tobacco*, adopted on 4 October 1994, DS44/R, paras. 99-100.

upon national sovereignty." Korea implies that since taxation is at the core of the Members' sovereignty, Panels should adopt a deferential standard whenever taxes are concerned.

6.66. According to the European Communities, this argument is totally misguided. In the EC view, it is instructive to compare the wording of Articles III:2 and III:4 of GATT. Article III:4, the general national treatment provision, is concerned only with discrimination between "like products". In contrast, Article III:2 is concerned with discriminatory taxation not only between "like products" but also between the larger category of "directly competitive and substitutable" products. In the EC view, this shows that the GATT drafters were well aware that discriminatory taxation may be one of the most pernicious forms of protectionism and, for that reason, aimed to provide stricter rules with respect to internal tax measures than with respect to other internal regulations, rather than the opposite.

(b) Physical characteristics

6.67. The European Communities notes that Korea's submission lingers upon the differences in physical characteristics between soju and other spirits. Korea implies that those differences are sufficient to conclude that soju and other spirits are not "directly competitive or substitutable" with each other.

6.68. The European Communities states that it is necessary to recall that two products do not have to be similar in terms of physical characteristics in order to be "directly substitutable and competitive". As noted in *Japan - Taxes on Alcoholic Beverages II*,

"competition can and does exist among the products that do not necessarily share the same physical characteristics. In the Panel's view, the decisive criterion is whether they have common end uses..."¹⁹⁰

6.69. The European Communities argues that it is obvious that if two products have similar physical characteristics, this constitutes a strong indication that they are "directly competitive or substitutable". According to the European Communities, in the present case, the similarity between soju and the other distilled spirits is such that it is a sufficient reason for the Panel to conclude that all of them are "directly competitive or substitutable".

6.70. The European Communities does not deny the existence of differences in physical characteristics between soju and other spirits. According to the EC view, if there were no such differences, it would have claimed that soju and the other distilled spirits are "like" and not simply "competitive or substitutable".

6.71. According to the European Communities, the differences invoked by Korea are, in essence, the same shown in EC Annex 9. In the EC view therefore, there seems to be no disagreement with Korea as to the nature of the differences, only as to their significance.

6.72. In the EC view, those differences are relatively minor and do not prevent soju from being "directly competitive or substitutable" with other distilled spirits. Indeed, according to the European Communities, many of the differences invoked by Korea, such as differences in alcohol content, colour or flavour, would not be sufficient even to exclude a finding of "likeness".¹⁹¹

6.73. The EC claims its position is supported by the two Panels on *Japan - Taxes on Alcoholic Beverages*, which allegedly concluded that all distilled spirits were "directly competitive or

¹⁹⁰ Panel report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.22.

¹⁹¹ *Ibid.*, para. 5.9.

substitutable" on the Japanese market, notwithstanding their different physical characteristics. Even if, as claimed by Korea, Japanese shochu was not "like" Korean soju, it remains that the differences between Korean soju and the other types of distilled spirits alleged by Korea are the same as the differences between Japanese shochu and those spirits.

(c) End uses

6.74. The European Communities notes Korea's argument that soju and the other spirits are not used in the same way by Korean consumers and, for that reason, are not "directly competitive or substitutable." Korea also points to differences in drinking style, drinking occasion and place of consumption.

6.75. According to the European Communities, firstly, Korea seems to rely on the mistaken premise that in order to be "directly competitive or substitutable" two products must compete or substitute each other in respect of all possible economic uses. According to the European Communities, that narrow view has been rejected by the Appellate Body in *Canada - Certain Measures Concerning Periodicals*.¹⁹² In that case, Canada argued that US magazines were not "directly competitive or substitutable" with Canadian magazines because, while they provided a reasonable substitute as an advertising medium, they were poor substitutes as an entertainment and communication medium. Thus, according to Canada, US and Canadian magazines were only "imperfect substitutes". The Appellate Body dismissed this argument by pointing that a case of "perfect substitutability" would fall within Article III:2, first sentence and ruled that all the magazines concerned were directly competitive or substitutable.

6.76. The European Communities further argues that similarly, in *Japan - Taxes on Alcoholic Beverages I*, the Panel based its conclusion that Japan's Liquor Tax Law violated Article III:2, second sentence, on the finding that there existed direct competition or substitutability among the liquors concerned, "even if not necessarily in respect of all the economic uses to which the product may be put"¹⁹³

6.77. According to the European Communities, these two reports make it very clear that in order to establish that two products are "directly competitive or substitutable", it may be sufficient to show that they are "directly competitive or substitutable" in respect of certain uses.

6.78. Secondly, according to the European Communities, the consumption patterns of soju and the other spirits concerned in this dispute are much more diverse and flexible than Korea's simplistic presentation would suggest. According to the European Communities, Korea would have the Panel believe that soju is always drunk straight and with meals and only at certain types of outlets, whereas western spirits are always drunk in styles other than straight, before or after meals and at different types of outlets. In the EC view, the reality is much more complex than this black-and-white picture. According to the European Communities, although the consumption patterns of soju and western spirits are not identical, there is a substantial degree of overlapping and, therefore, competition between the two categories.

6.79. The European Communities further argues that Korea's submission focuses exclusively on the most traditional consumption patterns and disregards the rapid emergence of a new drinking

¹⁹² Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, supra, p.28.

¹⁹³ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, supra, para. 5.7.

culture which is increasingly comparable to that of other developed countries, especially among young consumers.¹⁹⁴

6.80. Thirdly, in the EC view, consumption patterns are affected by prices, which in turn are affected by tax differentials. It is certainly not a coincidence if in the present case the less taxed product is consumed more often with meals¹⁹⁵ or if the more taxed products are more often found at expensive outlets than at less expensive ones. According to the European Communities, it is necessary to discern those differences which may reflect the genuine "tastes and habits" of the Korean consumers from those which have been created or, at least, "fossilised" by discriminatory taxation.

6.81. Finally, the EC view is that Korea's sweeping and categorical statements regarding the end uses of the different types of spirits are not supported by any evidence whatsoever, even though Korea is in possession of the necessary market surveys. According to the European Communities, the Panel should draw appropriate inferences from Korea's refusal to disclose those surveys.

(d) Drinking styles

6.82. The first difference alleged by Korea is that soju is always drunk straight. The EC view is that this is simply not true. The most frequent style for drinking soju is straight. But soju is also consumed in other styles, including mixed with other non-alcoholic beverages, especially by young consumers. This is attested by the growing sales in recent years of soju-based pre-mixes, of which some samples have been provided to the Panel. For tax purposes, soju-based pre-mixes are not considered as soju but as liqueurs. Nonetheless, the success of those pre-mixes proves that Korean consumers enjoy drinking soju mixed with other beverages.¹⁹⁶

6.83. Furthermore, western-style spirits also are consumed straight. In particular, straight is the most frequent drinking style of brandy. Similarly, whisky is most often consumed alone, diluted with water or on the rocks, all of which are effectively "straight".

(e) Drinking occasion

6.84. The European Communities notes that, according to Korea, soju is consumed always with meals. In the EC view, this is an over-simplification. Soju is often, but not always, consumed with meals. For instance, according to the European Communities, *sojubangs* are one of the most typical places for drinking soju. Yet *sojubangs* are bars and not restaurants. In addition, it is the EC view that

¹⁹⁴ See the Sofres Study, pp 3-7. According to the Sofres Report (at p. 4), the main changes in the Korean drinking culture are:

- Consumers prefer premium drinks for their taste and aroma,
- Consumers (young generation) prefer western style atmosphere
- A drinking culture where 3 to 4 people, instead of a large group, gather to drink in moderate amounts,
- A drinking culture where people drink lightly at home with family members.

¹⁹⁵ The EC claims that Korea defies economic logic when it states that "In Korea, standard soju is the drink one finds on the dinner table, the drink that is consumed with meals. As such it is an inexpensive beverage" (Korea's First Submission, para. 130)

According to the European Communities, it seems more logical that soju has acquired the status of "every-day meal drink" because it is inexpensive, rather than the opposite. If soju had been subjected to import quotas and then to dissuasive import duties and very high discriminatory internal taxes, it could have never achieved that status.

¹⁹⁶ The Sofres Report describes this development in the following terms, at p.24:

"Also the sale of other liquors in the form of soju cocktail (lemon flavoured soju, cherry flavoured soju, etc.) have been introduced since 1994, targeting the young generation. The sale of soju cocktails have exploded and in July 1995, sales were up 12.5 times compared to the same period of the previous year. This is proof of the changing consumption patterns of Korean consumers."

soju-based cocktails are rarely consumed with meals. On the other hand, other spirits can be and sometimes are drunk with meals, even if admittedly less frequently than soju.

6.85. The European Communities further notes that according to Korea, the reason why Korean consumers drink soju and no other spirit with their meals is because soju has a unique "harsh" (or "rough") flavour that goes well with Korean hot and spicy food.

6.86. According to the European Communities, this "culinary exception" argument, however, is far from convincing. In the EC view, the traditional tastes and habits of Korean consumers alone are not sufficient to explain why soju is consumed more often with meals. Koreans do not eat hot and spicy food all the time. Nor does all soju respond to the "harsh/rough" description, as allegedly evidenced by the advertisement for the soju brand Jinro Bisun which praises itself on being "mild".¹⁹⁷ In the EC view, there are other spirits which may go just as well with hot and spicy food, such as vodka or, as pointed out by Mexico in its oral intervention before the Panel, tequila. Finally, the European Communities states that the peculiarities of Korean cuisine would not explain why, according to Korea, soju predominates in "inexpensive Chinese restaurants" but not in the rather more expensive Japanese restaurants.

6.87. According to the European Communities, one of the main reasons why soju is more often consumed with every-day meals than western-style spirits is simply because western-style spirits are more expensive, to a large extent as a result of protective taxation. In the EC view, if western-style spirits were taxed as soju, they would be less expensive and Korean consumers could afford to drink them with meals more often.

6.88. The European Communities also notes that Korea does not claim that distilled soju is consumed with meals, yet until the 1960s most soju was distilled soju. The European Communities asks whether this means that Koreans' allegedly traditional habit of drinking soju with meals did not start until the 1960s? or rather, as it seems more plausible, that most Koreans cannot afford to drink their every-day meals with the now rather expensive distilled soju and instead tend to keep it for special occasions and drink it in smaller doses than required to accompany a meal, just like they do with western-style spirits?

(f) Place of consumption

6.89. The European Communities refers to Korea's claim that soju is typically drunk in places where western-style spirits are not available yet, such as "Korean restaurants, mobile street vendors and inexpensive Chinese restaurants".

6.90. The EC view is that it is true that western-style spirits still have little presence in certain types of outlets, but that cannot be explained, as Korea pretends, simply as the result of "consumers' tastes and habits." In the EC view, it is surely not coincidental that those outlets where the penetration of western spirits remains the lowest are also the least expensive.

6.91. According to the European Communities, Korea's submission totally disregards the existence of a clear trend towards wider availability of western-style spirits. The EC position is that only a few years ago, western-style spirits could be found only in upmarket restaurants and entertainment establishments. Since then, as shown by the Hankook survey included in the EC First Submission, western style-spirits have gained considerable distribution penetration and are now available at a wide range of outlets. According to the European Communities, the continued application by Korea of protective internal taxes stands as an obstacle to that trend.

¹⁹⁷ Attachment 6 to Korea's First Submission.

6.92. The European Communities states that in this regard, it is instructive to compare the Korean and Japanese markets. According to the European Communities, only a decade ago, Japanese *izakayas* (the equivalent of traditional Korean restaurants) used to serve only shochu, sake and beer, whereas western-style *snack bars* would serve western drinks but not shochu. Today, shochu and western style spirits are allegedly usually available at both *izakayas* and *snack bars*.

6.93. The European Communities further argues that it is important to note that a considerable and growing proportion of both soju and western-style spirits is purchased for consumption at home. In the EC view, this is totally ignored in Korea's submission. Specifically, the EC industry estimates that between 30 % and 35 % of western spirits and more than 20 % of soju are consumed at home.

6.94. According to the European Communities, as evidenced by the Hankook survey, western-style spirits are sold for home consumption through the full range of retail channels, where they compete head-on with soju.¹⁹⁸ The European Communities further claims that as shown by the photographs attached to its First Submission, retail establishments of different types often display soju and other distilled spirits side-by-side on the same shelves.

(g) Gift giving

6.95. The European Communities notes that in the case of distilled soju, Korea advances the additional argument that its main use is for gift giving. The EC view is that although this may be so, western-style spirits, and in particular whisky and brandy, are also often offered as a gift. The advertisements for Robbie Dhu and Johnny Walker Gift Set includes two advertisements promoting specifically the purchase of whisky for gift-giving.¹⁹⁹ According to the European Communities, Korea incurs in an even more embarrassing contradiction when, in comparing diluted soju and cognac, it states that the latter is "very suitable for gifts."

(h) Pricing

6.96. The European Communities also notes that Korea contends that the pre-tax prices of soju are much lower than the pre-tax prices of western style spirits. Korea alleges that, because of that price difference, there cannot be competition between soju and western-style spirits.

6.97. The European Communities takes issue with Korea's contention that it is sufficient to compare pre-tax prices in order to exclude "any possible distortive effect from the disputed taxes."

6.98. The European Communities states for example, that tax differentials may affect the relative importance of the different price segments within each tax category. The European Communities refers to the Panel Report in *Japan - Taxes on Alcoholic Beverages II*, in which it was stated that one of the consequences of a protective system of internal taxes may be to make it more difficult for the cheaper brands of the more heavily taxed products to enter the market.²⁰⁰ The EC view is that in Korea, this effect is attested by the fact that premium brands account for a disproportionate share of imports,²⁰¹ whereas the cheapest brands of western spirits are virtually absent. On the other hand, lower taxes have given to soju producers an advantage to target in particular the low end of the market.

¹⁹⁸ Ibid.

¹⁹⁹ Attachment 6 to Korea's First Submission.

²⁰⁰ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.33 (d).

²⁰¹ See the Sofres Report, at p. 26.

6.99. The European Communities also argues that protective taxes limit the sales growth of the more heavily taxed imported categories and, as a result, keep their unit costs at an artificially high level, as compared with less taxed domestic products which are sold in much greater volumes.

6.100. In any event, according to the European Communities, absolute price differences are not of themselves determinative of whether two products are "directly competitive or substitutable." In the EC view, what really matters is the consumers' response to changes in relative prices. The Dodwell study allegedly provides evidence of that type of response. The European Communities notes that Korea has criticised the supposed methodological flaws of the Dodwell study, but it has not put forward any contrary evidence showing that there is no significant degree of cross-price elasticity between soju and western spirits.

6.101. According to the European Communities, in the present case, absolute price differences are even less determinative in view of the nature of the products concerned. The European Communities adds that spirits are not like cars, which are purchased by most consumers in developed countries only once every four or five years. Spirits are consumable products, which can be purchased many times over a relatively short period of time. According to the European Communities, Korea's argument assumes that each Korean consumer drinks always the same type of spirit. In practice, however, most consumers, even if they prefer a certain type of spirit, may drink also other spirits depending not only on the occasion but also on the prevailing prices for each of them.

6.102. In the EC view, the above reasons explain why the two Panels on *Japan - Taxes on Alcoholic Beverages* did not take into account absolute prices differences, even though such differences were also substantial in the Japanese market.²⁰²

6.103. The European Communities further argues that at any rate, the comparisons made by Korea grossly overstate the actual price differences. The pre-tax prices for diluted soju shown in the Dodwell study, on which Korea has based its price comparisons, are prices for standard diluted soju. The pre-tax price for premium soju is between two and three times higher.²⁰³ In the EC view, if an adjustment is made to take into account the differences in alcohol content, the pre-tax price for a bottle of standard whisky is about two to three times higher than the pre-tax price for a bottle of premium soju²⁰⁴.

6.104. The European Communities also argues that the differences between the pre-tax prices for distilled soju and standard diluted soju are even larger than the differences between the pre-tax prices for standard whisky and standard diluted soju.²⁰⁵

6.105. The European Communities notes that as additional evidence, Korea submits a comparison of the "weighted average prices" for whisky and soju. According to the European Communities, that comparison, however, is meaningless. The prices for whisky vary enormously. Even if one considers only mainstream brands, the prices for standard blended whisky may be as much as ten times less than the prices for de luxe and single malt whiskies. The EC view is that although to a lesser extent, the prices for soju also vary. The pre-tax prices of premium diluted soju may be two to three times higher than the prices for standard diluted soju. According to Korea, premium soju accounts for 5 % of the

²⁰² According to the European Communities, in *Japan - Taxes on Alcoholic Beverages I, supra.*, the Panel ruled that price differences were irrelevant for a like product determination. Prices are not mentioned in the Panel's analysis under the second sentence of Article III:2. In *Japan - Taxes on Alcoholic Beverages II, supra.*, differences in prices were examined by the Panel only in connection with Japan's argument that, because tax/price ratios were "roughly the same", the products were not taxed "similarly" (paras. 6.33-6.34) but not for the purposes of determining whether the products were "directly competitive or substitutable" (paras. 6.28-6.32)

²⁰³ See EC Annex 6.

²⁰⁴ See EC Annex 7.

²⁰⁵ See EC Annex 6.

total sales of diluted soju. According to the European Communities, therefore, as a result, the weighted average price for all diluted soju calculated by Korea is virtually the same as the average price for standard diluted soju.

i) Other alleged differences

6.106. The European Communities refers to Korea's claim that the advertising for soju is targeted at the "common man" whereas the advertising for western-style spirits targets the up-market consumer. In the EC view, the soju advertisements included in Attachment 6 to Korea's submission fail to support those allegations. They do not show farmers or labourers but rather business men in shirts and ties. According to the European Communities, Korea has carefully omitted to include in Attachment 6 to its submission any example of recent soju advertising for premium brands, which is even more clearly targeted to the up-market Korean consumer.²⁰⁶

6.107. The European Communities contends that Korea's allegations regarding the differences in advertising imply that while soju is the poor man's drink, whisky and other imported spirits are a luxury drink for the most affluent classes. In the EC view, this is totally misleading, as both soju and whisky are now widely consumed across social boundaries.²⁰⁷

6.108. The European Communities also notes that Korea makes the argument that the fact that some Korean companies which sell both whisky and soju do so under different trademarks is an indication that the two products do not compete in the same market, yet some of those companies use also different brands for premium diluted soju and standard diluted soju.

6.109. According to the European Communities, even less convincing is Korea's argument that diluted soju does not compete with vodka, gin and rum because the latter are sold in small volumes whereas soju is a mass volume product. In the EC view this is because only a few pages later Korea reverses this argument without any apparent embarrassment in order to claim that distilled soju is a "tiny niche product."

6. The Dodwell study

6.110. According to the European Communities, until the early 1990s, western spirits were virtually excluded from the Korean market by a combination of trade barriers. In the EC view, too few sales figures are available to allow an econometric analysis of the substitution relationship between soju and Western style spirits. This leaves a survey such as the Dodwell study as the only method. In the EC view, Korea does not appear to question the rationale for the survey. However, as Korea has presented a number of criticisms to the Dodwell report, the European Communities responds to those criticism as follows-

²⁰⁶ EC Annex 12.

²⁰⁷ The Sofres Report describes as follows the profile of the whisky drinkers (at p. 25):

Whisky, an expensive drink perceived as the drink of the upper class, was used mainly for gift purposes and sold in upmarket restaurants and entertainment establishments. However, whisky is widely becoming more of a drink of choice among various age groups. With market liberalisation and overseas travel liberalisation, many Koreans have ready access to whisky and it is becoming well accepted by the general public. In reflection to this trend, whisky consumption is increasing at a rapid pace".

According also to the Sofres Report (at p.23), in the Korean alcohol market, Soju is a very popular product drunk by all classes.

(a) Alleged "inconsistency" of results

6.111. The European Communities notes that Korea points to the fact that there are a number of anomalies in the study. Notably, on a few charts there appears anomalous behaviour in terms of slightly higher soju purchases when prices for the soju increase. According to the European Communities, these anomalies are far less troublesome than Korea is suggesting:

- (a) Despite some unexpected sign reversals the results show very clearly and consistently that:
 - (i) more people choose western spirits when the price of soju increases; and
 - (ii) less people choose soju when the price of other spirits decreases.
- (b) Anomalies are in practice limited to switching between western spirits. The moving away from soju when its price increases is very robust.
- (c) The anomalies affect only some 15 percent of the observed changes in quantities. Moreover, if one were to compare only the selection at the 1000 Won price level with the selection at the 1200 Won price level only 5 (small) anomalies arise out of 48 possibilities.

In the EC view, this is far from being a bad result for a survey because, as Korea pointed out, it has to be kept in mind that the survey deals with fallible human beings. A perfectly consistent result from interviewing five hundred people cannot be expected, and would actually be highly suspicious. The anomalies also run counter to the implicit insinuation that the survey results are biased by the patron of the study.

(b) Standard vs. premium soju

6.112. The European Communities notes that the inclusion of premium diluted soju as an object of choice biases the results upwards. According to the European Communities, this is not the case because:

- (a) Premium diluted soju is a close substitute for standard diluted soju, as Korea has acknowledged. Therefore, the inclusion of premium soju in the sample provides an extremely useful benchmark with which it can be compared the price reaction of the other spirits. The survey clearly establishes that the pattern of consumer choices of premium soju and other spirits is the same. In both cases higher prices for standard soju lead to higher consumption of alternative drinks (whether premium soju or others), even if the changes for western spirits are less pronounced. Therefore, the inclusion of premium soju in the sample allows to demonstrate strongly that the other liquors in the sample are soju substitutes.
- (b) The study shows quite clearly the choices made by the surveyed persons. The fact that many people move to premium soju does not distract from the fact that many also switch to western-style drinks.
- (c) Lower prices for western drinks increase their consumption, even if the price for premium soju is lowered at the same time.
- (d) The elimination of premium soju from the choices would probably make more people pick any of the other spirits.

(c) Choice of respondents

6.113. According to the European Communities, the criticisms made by Korea with respect to the choice of respondents are also unfounded because:

- (a) The survey does not intend to estimate a cross-price elasticity. It is much less ambitious. Its purpose is solely to establish that soju and other liquors are in competition.
- (b) There is no direct link between the percentage of soju volume consumed by the Korean population and the number of people that prefer soju as a drink. It is very conceivable that the average soju drinker consumes larger quantities of soju than the average whisky drinker consumes whisky. Therefore the differences in percentage figures should not be over-dramatised.
- (c) Even if the percentage figures for western style drinks were too high, Korea claims nowhere that this would change the direction of change in consumer behaviour. In fact, the criticism of the "inconsistencies" of the study implicitly acknowledges that consumers should move away from soju as soju becomes relatively more expensive. This relationship is exactly what the survey attempts to show, and Korea's acceptance of this basic tenet should be welcome.
- (d) The survey cannot show that in all markets and under all conditions people react to prices. However, it does show that at least in the (important!) market of male Korean city dwellers between 20 and 49, the issue of price differences is important. It is a simple question of survey economy to concentrate on those interviewees that are most likely to give an informed answer. Furthermore, it is unquestionable that the surveyed population group is an important market segment for spirits. It is reasonable to assume that the established relationship also holds in other market segments.

(d) Pair-wise choices

6.114. The European Communities reiterates that the fact that the survey sample might have a higher preference for drinking western beverages than the Korean sales volume figures suggest is of no consequence to the validity of the results. In the EC view, what matters is that a cross-price relationship is established.

6.115. The European Communities also states that it should be mentioned in this context that the separate paring of brown and white liquors actually biases the reaction to price increases downwards rather than upwards. The European Communities refers to Korea's explanation that a preference for white liquor does not imply a preference for brown liquor over soju. A person with a preference for brown liquor might therefore not be impressed by the rising soju prices to drink white liquor, and vice versa. In the EC view, this means the price reaction of the survey will be underestimated.

(e) Single drink choice

6.116. The European Communities notes that Korea claims that the phrasing of the survey question may be ambiguous. In particular, Korea presumes that the question could be interpreted as a unique and non-repeated sales offer.

6.117. In the EC view, it is difficult to see why this should be the case, in particular since the phrasing of the question belongs to the standard repertoire of market surveys. However, even if it were interpreted thus, it is quite clear that people react to price changes and choose more imported

liquors, at the expense of soju. This means clearly that the consumer interprets the liquors for choice as substitutes.

6.118. According to the European Communities, Korea would have preferred a phrasing "would these prices cause you to change your drinking habits?" In the EC view, this question would produce lower figures (which is actually why it is proposed). The reason for this is simply that people are less able to make a statement about permanent behavioural change. The European Communities add that the proposal of Korea also sits oddly with a remark earlier on the internal consistency of the results.

6.119. In the EC view, the conclusions of the survey are quite clear: consumers are sensitive to the relative prices of soju and other drinks and change their behaviour accordingly. This indicates very strongly that the consumers view Western liquors and soju as substitutes. According to the European Communities, Korea's critique does not affect these conclusions.

(f) Overall

6.120. The European Communities also argued that the spirits markets have two defining characteristics. First, spirits consumption is habitual behaviour in that people tend to order the same drink they ordered on a previous given occasion. Thus, behaviour changes only gradually. Second, spirits are experience goods in that they must be purchased and consumed to be evaluated by consumers. Descriptions do not suffice. Market penetration increases slowly as it is necessary to get consumers actually to try the products first. Market surveys such as the Dodwell study must be evaluated in light of these factors.

7. The Sofres report

6.121. The European Communities notes that Korea, while disparaging the Dodwell study, places considerable reliance on another document commissioned by the European Communities and prepared by the same market research organisation as the Dodwell study: the document entitled "Your Guide to Exporting Food Products to Korea - Alcoholic Beverages" (the "Sofres Report").

6.122. In the EC view, although it is obvious that Korea has perused the Sofres Report for "quotable" passages, the results of that search are rather meagre: just two short passages of two sentences each.

6.123. According to the European Communities, the Sofres report is a generic report intended to provide a description of the current market situation, which may serve as a guide to the EC exporters. The Sofres report did not even attempt to address the question tackled by the Dodwell study, namely whether a connection can be established between the price of western-style spirits and the sales of soju and vice-versa.

6.124. The European Communities further argues that the Sofres Report relies on the assumption that, not just soju and western-style spirits, but all alcoholic beverages are part of the same market. For instance, market shares are calculated with respect to the entire alcoholic beverages market, which would have been meaningless if the authors of the report had considered that soju and other spirits do not compete on the same market.

6.125. The European Communities also argues that when the Sofres report states that "soju remains virtually unaffected by imported alcoholic drinks" it means simply that, despite the considerable increase in imports of whisky and other western-style liquors, soju continues to account for the vast majority of sales of spirits. At the same time, the use of the term "virtually" before "unaffected" shows that the authors considered that there was actual, even if limited in terms of the volumes concerned, competition between soju and other western-style spirits. In the EC view, the term "remains" clearly indicates that the authors of the report did not regard the current predominance of

soju as a fixed and permanent feature of the Korean market but as a temporary situation which could change in the future as a result of increased sales of western-style spirits.

8. The Trendscape survey

6.126. The Trendscape survey addresses two questions, the first of which was – "in which of the following places have you drunk whisky/soju during the last six months."

6.127. According to the European Communities, the response to this question confirms that although soju is still consumed more often at traditional Korean venues and whisky at western-style or entertainment outlets, there is no rigid segregation between the two.

6.128. The European Communities further argues, that the survey shows that, contrary to Korea's allegations, there is already a significant degree of overlap. Firstly, the European Communities alleges that soju is also consumed in places where whisky has already established a presence. The EC view is that 8% of respondents declared to have drunk soju at Karaoke bars, which are still the main places for drinking whisky. Furthermore, the European Communities states that the Trendscape survey shows that whisky is also drunk in places where soju has traditionally been the predominant spirit, such as Korean restaurants and bars.

6.129. The European Communities also argues that the survey confirms that home consumption at home is one of the main end-uses for both whisky and soju. According to the European Communities, as much as 34% of respondents declared to have drunk whisky at home whereas the percentage of respondents who had drunk soju at home was 43%.

6.130. The second question asked to the respondents was whether they had the habit of drinking whisky/soju with meals or without meals. According to the European Communities, the response to this question confirms that whisky is also drunk with meals, even if less often than soju. The European Communities claims that 7% of the respondents answered that they had the habit of drinking whisky with meals.

6.131. The European Communities further argues the survey also shows that, contrary to the claims repeatedly made by Korea, soju is by no means always consumed with meals. It is the EC view that the respondents who declared to have the habit of drinking soju with meals was just 36%.

6.132. As a complement to the second question, the respondents were also asked whether they had the habit of drinking whisky/soju with or without food. According to the European Communities, the response to this question was very similar in both cases: whereas the percentage of respondents who declared to have consumed whisky with food was 86%, the percentage of respondent who declared to have drunk soju with food was 97%.

6.133. The European Communities concludes that both the Nielsen study and Trendscape survey show that despite the fact that western spirits have been virtually excluded from the Korean market until very recently, and that western spirits remain subject to much higher taxes than soju, there is already a significant degree of overlap as regards their end-uses. In the EC view, the extent of that overlap could only increase if the tax differentials between soju and western spirits were eliminated.

9. The measures are applied "so as to afford protection to domestic production"

6.134. The European Communities argues that Korea has not presented any meaningful argument in order to refute the claim that the measures at issue afford protection to its domestic production.

6.135. According to the European Communities, Korea's main defence is that whisky bottled in Korea from imported concentrated whisky should be considered as a domestic production. In the alternative, Korea claims that soju produced in Korea from imported neutral spirits should be considered as imported.

6.136. In the EC view, there is an obvious difference between those two situations. Concentrated whisky has already all the essential characteristics of whisky and can be used only to bottle whisky. It is imported under the same tariff heading as bottled whisky (HS 2208.30) and is subject to the same import duties.

6.137. The European Communities further argues that in contrast, neutral spirits are a raw material which can be used to produce a variety of alcoholic beverages, including for example vodka and gin, as well as other products, such as heating fuel or pharmaceutical products. Neutral spirits are imported under a different tariff heading and are subject to much lower import duty than soju. In the EC view, if Korea takes the view that soju is the same product as neutral spirits, it should explain why it does not apply the same taxes to all liquors made from neutral spirits.

6.138. The European Communities further argues that at any rate, even if Scotch whisky bottled in Korea had to be considered as a domestic product, soju would still account for almost all of Korea's domestic production of spirits. It is thus beyond question that by protecting soju, Korea protects its domestic production of spirits.

6.139. The European Communities asserts that in this regard, it is worth recalling that the existence of a substantial production of genuine domestic whisky in Japan did not prevent the two Panels on *Japan - Taxes on Alcoholic Beverages* from concluding that Japan's Liquor Tax Law infringed Article III:2, second sentence.²⁰⁸ Further, according to the European Communities, it is also worth noting that almost all Japanese shochu A is made from imported neutral spirits. Yet, the two Panels on *Japan - Taxes on Alcoholic Beverages* had no hesitation to consider shochu A as a domestic production.

6.140. The European Communities argues, therefore, that Korea's allegation that soju is isolated from imports by "commercial realities", rather than regulatory action has not been substantiated and is in any event totally irrelevant. What matters is that imports of soju are and have always been negligible and, therefore, that by favouring soju the Korean Government can be assured that it protects a domestic production, and a domestic production alone.

6.141. According to the European Communities, Korea's argument that the tax differentials cannot be protective because the pre-tax price differentials are too large is logically flawed. If the Panel found that the products concerned are "directly competitive or substitutable" despite the pre-tax price differentials, it would follow necessarily that those price differentials are not large enough to exclude, of themselves, the possibility that the tax differentials may afford protection to domestic production.

6.142. The European Communities also notes that Korea denies emphatically that the Liquor Tax Law's very structure and design reveals a protectionist purpose, but fails to offer a minimally reasonable explanation for the Liquor Tax Law's many apparent inconsistencies.

²⁰⁸ According to the European Communities, in *Japan - Taxes on Alcoholic Beverage I*, *supra.*, Japan argued that the Liquor Tax Law did not afford protection to domestic production because imports of special grade whisky accounted for merely 14.6 % of total sales of that product. This argument was disregarded by the Panel which only took into account the fact that the less taxed product (Shochu) was produced almost exclusively in Japan. Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, paras. 3.10 (f) and 5.11.

6.143. The European Communities states for instance, that Korea attempts to explain the Liquor Tax Law's product categorisation by saying that, originally, soju was the only product subject to the Liquor Tax Law and new tax categories were created only as other spirits appeared on the market. In the EC view, this does not explain why it was considered necessary to add to the definition of soju a series of exceptions, so as to exclude the most important categories of imported spirits, nor does it explain why it was necessary to apply much higher rates on the newly created categories.

6.144. According to the European Communities, the closest that Korea comes to giving a coherent explanation for the Liquor Tax Law's apparent lack of rationality is when it states that "as tax rules are developed, they must accommodate varying levels of taxpayer resistance" and that "in sum, taxes are a delicate balancing act for any government." In the EC view, this means that if soju is subject to lower taxes it is simply because soju producers have more political weight than importers of whisky.

6.145. With respect to distilled soju, the European Communities notes that Korea advances the argument that equalising the taxes for distilled soju and whisky would "cripple" the distilled soju industry with no benefit to the imported beverages industry. According to the European Communities, this argument, is totally irrelevant in order to determine whether the current system "affords protection to domestic production." It is also allegedly at odds with Korea's previous allegation that demand for distilled soju is "specific and static" and that, for that reason, "it would be difficult to affect it a great deal in either direction by altering its price".

B. UNITED STATES

1. General: Violation of Article III:2

6.146. The United States notes that in its first submission, it showed that Korea's application of preferential tax rates to soju discriminates against vodka, a "like" product and against all other distilled spirits, which are directly competitive or substitutable, in violation of Article III:2. According to the United States, in response, Korea has principally argued that soju is a unique product in a unique market, and that a violation of Article III cannot be alleged in light of the differences it cites between soju and other distilled spirits.

6.147. The United States notes that Korea, in an attempt to assist its attempt to distinguish western distilled spirits from soju, characterizes distilled soju as a product distinct from diluted soju in an apparent willingness to sacrifice the tax preference for this "special" artisanal product that makes up 0.2% of its total soju sales. The United States argues that the effort is to downplay the characteristics of distilled soju that are identical to those of western distilled spirits, such as its alcohol content and use of aging. According to the United States, however, the different types of soju, however, are the same or "like" product for all practical purposes.²⁰⁹

6.148. The United States asserts that in the first instance, the two varieties have the same name. Both standard and distilled are clear in appearance and filtered similarly, and unlike vodka, which is taxed at 30 percent, the Education Tax rate of distilled and standard soju is 10 percent. The United States adds that although distilled soju is made from discontinuous (pot still) distillation, the distinction has minimal tangible effect on the product. Products such as whisky and brandy can be manufactured by either continuous distillation or pot still (discontinuous) distillation. The United States further argues that both types of soju are derived from the same raw materials, and Korean law

²⁰⁹ The United States argues that it is not necessary, for purposes of Article III:2, to determine whether a product is the same product or simply "like." The drafters obviously avoided limiting the application of the national treatment disciplines to the "same" products for fear of definitional disagreements on the basis of minor variations in products.

apparently does not require the use of any particular starch source such as rice; any starch source can be used. Finally, the United States notes that, as to their packaging, whether a product is marketed as "artisanal" or not is a reflection of the manufacturer's marketing savvy, rather than a fundamental departure from the nature of the product.

6.149. The United States argues that a better perspective on Korea's emphasis on differences between standard and distilled soju (namely price, taste, and marketing) may be seen by comparing with another category of alcoholic beverage such as wine. According to the United States, wines cover a broad range of prices and qualities, yet it would be difficult to argue that a \$10 table wine and a \$100 bottle of Bordeaux wine are not "like." The price difference between inexpensive and expensive wine can vary by a factor of ten or more. The United States continues that, similar to distilled soju, expensive wines are marketed in small volumes with distinctive advertising and packaging in order to emphasize uniqueness, and might, in the opinion of some, possess more complex bouquet and aroma than inexpensive wines.

6.150. According to the United States, therefore, variations in price, taste and marketing of products with similar end uses simply offer consumers alternative choices and do not mean they are not the same or "like" products.

2. Violation of Article III:2, First Sentence

6.151. The United States considers that vodka is "like" soju and that, under Article III:2 first sentence, Korea must eliminate any tax on vodka that exceeds the tax on soju. The US view is that Korea wrongly suggests that the absence of "perfect substitutability," the presence of minor differences in physical characteristics and production processes, differences in price, and differences in the end-uses in a particular market prevent two products from being "like."

6.152. The United States argues that Korea's argument that "like" products include only those that are "perfectly substitutable," has no basis in the text of Article III:2 or in Appellate Body reports, because if products were perfectly substitutable, they would likely be identical. The United States notes that in *Canada - Certain Measures Concerning Periodicals*, the Appellate Body noted that perfectly substitutable products would "fall within" the scope of "like" products,²¹⁰ but that does not mean that only perfectly substitutable products can be considered "like" products. According to the United States, the text of Article III:2 that refers to "like" products (in French, *produits similaires*) avoids the obvious tax discrimination that could result between similar products that do not share every single characteristic and accordingly are not "perfectly substitutable."

6.153. The United States further argues that, although the Appellate Body has clarified that the term "like" in Article III:2 must be narrowly construed, it is well established in GATT practice that products do not have to be identical to be considered "like" products.²¹¹ Korea's insistence that minor differences such as alcohol content and additives prevent two distilled spirits from being "like," runs directly counter to findings such as that in *United States - Measures Affecting Alcoholic and Malt Beverages*, in which the panel considered a low-quality style of Mississippi wine made from a special "scuppernong" kind of grape to be "like" all other kinds of wine.²¹² The United States further notes that in *Japan - Taxes on Alcoholic Beverages I*, taxes on alcoholic beverages, vodka and shochu were considered "like" products even though vodka was filtered differently. The US view is that Korea's

²¹⁰ Appellate Body Report, p. 28.

²¹¹ *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.6 "minor differences do not prevent products [from] qualifying as "like"; *U.S. - Taxes on Petroleum and Certain Imported Substances*, *supra.* (liquid hydrocarbon products although not identical were "like" crude oil and natural gas because they served substantially same end uses).

²¹² BISD 39S/206, 276-77.

argument that in a few instances vodka might be made of different raw materials than soju is not relevant if it does not affect aspects of the product identifiable to the consumer. According to the United States, whatever the original starch source, it is ethyl alcohol from various sources that is used in the production of US vodka, Korean soju and Japanese shochu. The production process allegedly varies only by filtration methods and level of dilution with water, resulting in minimal differences in the products produced.

6.154. The United States also argues that Korea's attempts to distinguish vodka from soju exaggerate the importance of the attribute. With respect to diluted soju, Korea has identified alcohol content as an important physical difference. According to the United States, the alcohol content of diluted soju is bottled at about 25%, while vodka is bottled at about 40%. But the United States notes that the WTO Japan panel conclusively rejected the notion that a difference in alcoholic strength of two products precluded a finding of likeness, on the basis of the simple observation that "alcoholic beverages are often drunk in diluted form."²¹³

6.155. According to the United States, such a difference in alcohol content does not even exist with respect to distilled soju. The United States notes that Korea, with respect to distilled soju, emphasizes the taste. In the US view, any such difference in flavour is probably linked to the distillation process rather than raw material, since vodka and soju are often derived from the same raw materials. In this regard, soju is no more different from vodka than Japanese shochu B, which is also obtained through a non-continuous (pot-still) distillation process.

6.156. The United States also argues that the fact that vodka has now been placed in its own tariff heading in Korea's schedules (2208.60) is also irrelevant. According to the United States, it was previously in the same basket category as soju (2208.90), but was broken into a separate heading to correspond to changes in the 1996 Harmonized System, which created a separate category to reflect the vast international trade in the product.

6.157. The United States further argues that Korea's emphasis on consumer tastes and habits as a dispositive factor in determining whether two products are "like" is also misplaced. According to the United States, the original identification of this factor derives from the Report of the Working Party on *Border Tax Adjustments*.²¹⁴ However, the United States notes that the report emphasized that the interpretation of "like" or "similar" products "should be examined on a case-by-case basis," which "would allow a fair assessment in each case of the different elements that constitute a 'similar' product."

6.158. According to the United States, *Japan - Alcoholic Beverages I* and *II* did not consider consumer tastes and habits to be significant in determining likeness where the market was previously restricted. The United States further argues that although the 1987 GATT panel agreed that in theory both objective factors and "the more subjective consumers' viewpoint" should be considered, it chose to disregard the "subjective" factor of "traditional Japanese habits" on the following basis:

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.²¹⁵

²¹³ Panel Report on *Japan - Taxes Alcoholic Beverages II*, *supra.*, para. 6.23.

²¹⁴ BISD 18S/97, 102.

²¹⁵ *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.7.

6.159. The United States asserts that for the same reasons, the same panel also disregarded Japan's argument that differences in prices between local shochu and imported distilled spirits could prevent a finding of "like." According to the United States, the panel "was of the view that 'like' products do not become 'unlike' merely because of differences . . . in their prices, which were often influenced by external government measures (e.g. customs duties) and market conditions (e.g. supply and demand, sales margins)." Further, according to the United States, under the circumstances presented in the Japan dispute (a long history of protection, as in Korea), the panel considered that giving any weight to factors such as consumer traditions in a country or differences in price would run counter to the objective of Article III:2, by "creating different prices and consumer categories and hardening consumer preferences for traditional home products."²¹⁶ In the US view, such reasoning is equally compelling in this dispute.

6.160. With respect to vodka, the United States argues that Korea's attempt to draw a stark distinction between vodka and soju does not correspond to the very similar physical attributes and manufacturing processes of these products. Vodka is often made from the same grain-based neutral spirits as soju. Although a little costlier, white birch charcoal filtration produces virtually the same results as using other types of charcoal filtration -- and accordingly this difference did not prevent the *Japan – Taxes on Alcoholic Beverages II* panel from finding that vodka and shochu are "like" products. The United States also claimed that it is also wrong to emphasize alcoholic strength as a dispositive factor in selecting a distilled spirit. Once they are prepared, many mixed drinks, such as vodka cocktails have a lower alcohol content than straight soju. As determined by the panel in the *Japan* case, a difference in the alcoholic strength of two products "did not preclude a finding of likeness, especially since alcoholic beverages are often drunk in diluted form.

6.161. The United States argues that, with respect to the taste and sensation of the products, it is not the raw materials that are responsible for the so-called "stinging sensation" supposedly imparted by soju. If this were true, then all spirits could and can claim a "stinging sensation in the mouth and throat", since the raw materials are similar in many other spirits. For example, Archer Daniels Midland Company's grain neutral spirits are used for both soju and Smirnoff vodka (produced in the United States). The claimed unique "cold" mouth feel may come from the fact that soju, like vodka, is usually refrigerated before consumption. Moreover, although Korea cites to "harshness" as a unique desirable characteristic of standard soju compared to the smoothness or mildness of Western-style spirits, as the representative from the European Community pointed out, the advertisement in its submission for Jinro Bisun, produced by Korea's largest producer of soju (Attachment 6), boasts how it is a "mild" one, the same way Western-style spirits are marketed.

6.162. The United States also argued that as a factual matter, the characterization of Korean soju as unique is also at odds with the view of even the top Korean soju producer Jinro. On its Internet home page, Jinro sets out the following question: "What is Soju?" It provides the following response: "Jinro Soju, a sort of *vodka-like spirits* which began life in the 13th century, is the traditional Korean liquor. . ." (US Exhibit Q.) Similarly, an Internet search reveals the description of soju by an apparently French Canadian food critic as "la vodka coreene" (Korean vodka). (US Exhibit R.)

3. Violation of Article III:2, Second Sentence

6.163. The United States reiterates that Korea's taxes on imported distilled spirits in addition to vodka are applied so as to afford protection to domestic production of soju, in violation of Article III:2, second sentence. The United States notes that as set out by the Appellate Body in the *Japan* case, a violation of the second sentence requires three elements to be shown. First, the products must be directly competitive or substitutable; second, the products must be taxed in a way that is not "similar"; and third, the measure must be applied so as to afford protection to domestic production.

²¹⁶ Ibid., at para. 5.9.

According to the United States, Korea's attempted defence has focused accordingly on the first element, substitutability, and the vast majority of the Panel's questions also pertain to this element.

(a) The Text

6.164. The United States argues that Korea, in attempting to show that soju does not compete with imported distilled spirits, mainly relies on the argument that in order for products to be considered "directly competitive or substitutable," the complaining parties must show that "actual competition" between soju and all distilled spirits is occurring on the Korean market for all end uses. In the US view, although the complaining parties have shown actual competition and common end uses for most of the products in question, it is also potential competition with imported distilled spirits that is at issue in this dispute. The United States adds that Korea's legal interpretation is belied by an examination of the ordinary meaning of the relevant provisions, taken in their context, and in light of their object and purpose, as required under principles of international treaty interpretation.²¹⁷

6.165. The United States argues that the overriding purpose in Article III:2, second sentence is the incorporation as an obligation of the objective stated in Article III:1, that taxes should not be applied so as to afford protection to domestic production. The interpretive note to the second sentence, that it applies only "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" must be read in light of this overall purpose.

6.166. According to the United States, Korea's argument that competition must be actual runs counter to the text of the interpretive note and the purpose of the central obligation. The phrase "competition was involved" is more likely to mean the situation where competition is presented, rather than where competition is "currently occurring for every use," as suggested by Korea. Further, in the US view, this interpretation is more consistent with other terms in Article III:2, because in addition to proscribing protective taxation between directly competitive products, the interpretive note applies to "directly substitutable" products.²¹⁸ The United States further argues that the word "substitutable" is one that clearly shows the application of the second sentence to potential substitution -- i.e. it means able to be substituted; it does not require a test of whether and how many products are currently being substituted. The French text, in the US view, underscores the application of the obligation to potentially competitive products even more clearly: "un produit qui peut lui être directement substitué" (a product that can be directly substituted for the taxed product).

6.167. The United States further argues that the scope of the obligation to include potential competition is also consistent with the obligation in Article III:4, which requires national treatment for "like" domestic and imported products. According to the United States, the Article III:4 obligation has long been understood to apply to regulations that "might adversely modify the conditions of competition" between imported and domestic products, regardless of current trade.²¹⁹

6.168. The United States refers to the *United States -- Section 337 of the Tariff Act of 1930* case, wherein it was noted that the Article III:4 obligation "calls for effective equality of opportunities" for imported products, rather than particular export volumes.²²⁰ The United States further notes that the 1949 Working Party Report on *Brazilian Internal Taxes* takes the view that Article III:2, first sentence

²¹⁷ See Article 31 of the Vienna Convention on the Law of Treaties.

²¹⁸ According to the United States, although the English text of the interpretative note is ambiguous on the point, the French translation appears to suggest that the word "directly" also applies to the word "substitutable." Either way, it does not have implications for this dispute.

²¹⁹ *Italian Discrimination Against Imported Agricultural Machinery*, adopted on 23 October, 1958, BISD 7S/60, 64.

²²⁰ BISD 36S/345, 386-87.

applies, "whether imports from other contracting parties were substantial, small, or non-existent," and stresses their "potentialities as exporters."²²¹ Similarly, concerning Article III:2 second sentence, unless "directly competitive or substitutable" is interpreted as applying to potential competition, its scope will be much narrower and permit the perpetuation of unfair competitive conditions that result from protected markets.²²²

6.169. The United States argues further that the application of Article III:2 to potential competition is also confirmed by GATT and WTO cases that have emphasized the distorting effect of past restrictions in the market. *Japan -- Taxes on Alcoholic Beverages I* disregarded traditional Japanese habits in determining that vodka and shochu were "like," emphasizing that they resulted from past protection.²²³ *Japan -- Taxes on Alcoholic Beverages II* similarly noted that "consumer surveys in a country with . . . a [discriminatory] tax system would likely understate the degree of potential competitiveness between substitutable products."²²⁴ The United States also notes that the Appellate Body in *Canada -- Certain Measures Concerning Periodicals* had a similar response to Canada's arguments that static market shares over 30 years showed a lack of "direct competition." It noted, "this argument would have weight only if Canada had not protected the domestic production of Canadian periodicals through, among other measures, the import prohibition of Tariff Code 9958 and the excise tax of Part V.1 of the Excise Act."²²⁵

6.170. The United States argues that Korea is also wrong to insist that in order to be substitutable, products must be substitutable for all economic uses, such as consumption in restaurants or as an accompaniment with Korean food. According to the United States, although the GATT and WTO panels and the Appellate Body in the Japan case praised the concept of examining uses in a given market, as a practical matter they did not provide much weight to consumer tastes and habits. In the US view, the GATT Japan panel specifically noted that there was direct competition and substitutability as between all the liquors in dispute "even if not necessarily in respect of all the economic uses to which the products may be put."²²⁶ More recently, in *Canada - Measures Concerning Periodicals*, the Appellate Body specifically found that the products in question were directly competitive or substitutable even if they were poor substitutes for certain purposes.²²⁷ According to the United States, such an approach is consistent with other GATT panel findings, such as the application of Article III:2 in *EEC - Measures on Animal Feed Proteins* to products that were substitutable only "under certain conditions."²²⁸ In the US view, the products involved -- skim-milk powder on the one hand, and oilseeds, cakes and meals, dehydrated fodder and corn gluten feed, on the other -- confirm the appropriate broad scope of the term "directly competitive or substitutable."

(b) Drafting History

6.171. The United States argues that the drafting history of the GATT 1947 supports the broad textual interpretation of the scope of "directly competitive or substitutable." According to the United States, prior to the Geneva drafting session, the text of what became the second sentence of Article III:2 was not in the nature of an obligation and referred only to competitive products. At the Geneva session, according to the United States, delegates discussed the scope of the language that eventually provided the basis for the present obligation. Concerning which products would be compared, some

²²¹ GATT/CP.3/42, adopted 30 June, 1949, II/181, 185.

²²² The United States believes that this interpretation is all the more compelling because the second sentence is meant to compensate for the narrow interpretation required of the term "like" in Article III:2, first sentence, as acknowledged by the panel and Appellate Body in the Japan - Alcoholic Beverages case.

²²³ *Japan - Taxes Alcoholic Beverages I*, supra, para. 5.7.

²²⁴ Panel. Report on *Japan - Taxes on Alcoholic Beverages II*, supra, para. 6.28.

²²⁵ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, supra, p. 28.

²²⁶ *Japan - Taxes on Alcoholic Beverages I*, supra, para. 5.7.

²²⁷ Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, supra, p. 28.

²²⁸ BISD 25S/49, 63-64, adopted on 14 March, 1978.

country delegates cited examples of domestic and imported products that could be "competitive" and trigger the application of the legal obligation. These included quite broad categories of products, such as domestic apples and imported oranges;²²⁹ domestic linseed oil and imported tung oil;²³⁰ and domestic synthetic rubber and imported natural rubber.²³¹

6.172. The United States further notes that the record discloses that no disagreement was expressed by delegates with the breadth of these specific examples of "competitive" products, including the reference to apples and oranges. In Havana, when the text of the legal obligation on national treatment was approved, the Chairman of the Sub-committee reported "only one important change in substance" from the Geneva text. Provisions for a negotiated elimination of discriminatory internal taxes in the previous draft evolved into to their outright elimination.²³²

6.173. According to the United States, at that point, the term "directly competitive or substitutable" was added in the text. After adoption of the present text and interpretive note, one additional question was raised concerning examples of what might be considered "directly competitive or substitutable products" for purposes of the interpretive note to Paragraph 2. One delegate allegedly asked if "coal vs. fuel oil" and "tramways vs. busses" could be considered directly competitive or substitutable. Another delegate allegedly noted the need for actual cases in order to interpret the provision, but opined that such products were not substitutable. A third delegate, however, allegedly stated that decisions could not be made except in relation to a particular factual situation, but that a tax on coal in a particular case might be designed to protect the fuel oil industry.²³³ In the US view, this comports with the Appellate Body's finding in *Japan-Taxes on Alcoholic Beverages II* that determinations are to be made on the basis of "all relevant facts," when examining each of the "number of means" for identifying the "broader category of products that might be described as 'directly competitive or substitutable.'"²³⁴

6.174. The United States concludes that the examples discussed in the drafting history show that the comparison of internal taxes on domestically produced soju, on the one hand, and imported distilled spirits, on the other, is well within the scope contemplated by the drafters. The emphasis was obviously not on particular attributes of the products such as physical characteristics, production processes, or quality, but on the ability of the products to be used in the same manner, and the extent to which a government acted to protect a domestic product to prevent such substitution in its market.

(c) Directly competitive or substitutable

Physical characteristics

6.175. According to the United States, Korea's submissions argue that some differences in production processes and physical characteristics prove that soju and imported distilled spirits are not in fact "like," "substitutable" or "competitive" products. The United States argues that from a basic economic perspective, however, differences in production or physical characteristics are not *a priori* determinative of whether two products are substitutable or directly competitive. For example, cane sugar and artificial sweeteners are totally different in terms of production process and chemical composition, yet they clearly compete directly in coffee houses and restaurants. In order to determine substitutability, the Panel should consider whether the products in question compete for consumer spending on a category of goods. In this case, all spirits should be considered as in competition

²²⁹ E/PC/T/A/PV/9, p. 7.

²³⁰ E/CONF.2/C.3/SR.11, p. 1 and Corr.2.

²³¹ E/CONF.2/C.3/SR.11, p. 3.

²³² E/Conf.2/C.3/SR.40, p.1.

²³³ E/Conf.2/C.3/SR.40, p. 2.

²³⁴ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

because they compete for consumers' spending on various products within the category of alcoholic spirits. Similar production processes, physical characteristics, and end uses are indicative of "like" products, but some differences in these factors do not establish that two products are not substitutable. Another factor in determining substitutability is the extent to which consumers respond to relative price increases in one product by increasing purchases of another. These products are likely to be substitutes. Thus, Korea's reliance on minor differences in the production and physical characteristics as dispositive evidence of non-substitutability is misplaced. Furthermore, Korea greatly exaggerates the differences between soju and imported spirits.

6.176. The United States argues that it is unlikely that two identical products would not, to some degree, be substitutable, though they may not be perfectly substitutable. Even physically identical products might be packaged differently, marketed differently, or ultimately targeted at different consumer groups, but they would nonetheless remain "able" to be substituted. For example, two identical bottles of aspirin (with the same contents, price and packaging) are perfectly substitutable, whereas two bottles of aspirin with a different package size, branding, or price, but containing aspirin of the same chemical composition are not *perfectly* substitutable but remain substitutable, with demand for one being influenced by the price of the other.

6.177. According to the United States, with respect to other Western distilled spirits, the Korean submission stresses difference in color as between whisky and soju as a factor that rules out competition between these products. However, the United States argues that color may not only differ as between types of spirits, but also within spirit categories. For instance rum, tequila and shochu all have clear and amber versions, yet they do not become different non-competing products because of it.

6.178. According to the United States, it is also wrong to emphasize alcoholic strength as a dispositive factor in selecting a distilled spirit. Once they are prepared, many mixed drinks, such as vodka cocktails have a lower alcohol content than straight soju. As determined by the panel in *Japan – Taxes on Alcoholic Beverages II*, a difference in the alcoholic strength of two products "did not preclude a finding of likeness, especially since alcoholic beverages are often drunk in diluted form."

6.179. The United States agrees that flavour and aroma are important factors in selecting a distilled spirit, but again argues that a different flavor hardly precludes substitutability between classes of distilled spirits such as whisky, soju, vodka and rum. Indeed, the range of flavours and aromas *within* a class of spirit have as much of an impact on consumer choice as does the range of flavours and aromas *between* classes of spirits. In fact, soju itself is available in different flavorings, such as honey and wood. Under Korea's theory, different flavours of soft drinks such as Coke and Fanta do not compete, but it is doubtful that anyone familiar with the market would agree.

6.180. The United States further argued that Korea's invocation of so-called distinguishing physical characteristics for other Western distilled spirits is entirely arbitrary. The United States argues that Korea's citation of physical characteristics to distinguish soju from other Western distilled spirits are the same characteristics that happen to distinguish various kinds of Korean soju from each other. For example, Jinro's promotional material for its premium soju brands on its Internet home page cites factors such as a "rich smooth taste" and oak flavoring, the same factors Korea relied on in its first submission to distinguish soju from whiskey.²³⁵ According to the United States, Jinro's descriptions in fact confirm the competitive relationship between soju and Western spirits.

6.181. The United States further argues that, with respect to the taste and sensation of the products, it is not the raw materials that are responsible for the so-called "stinging sensation" supposedly imparted by soju. If this were true, then all spirits could and can claim a "stinging sensation in the mouth and

²³⁵ US Exhibit Q.

throat", since the raw materials are similar in many other spirits. For example, Archer Daniels Midland Company's grain neutral spirits are used for both soju and Smirnoff vodka (produced in the United States). The claimed unique "cold" mouth feel may come from the fact that soju, like vodka, is usually refrigerated before consumption. Moreover, although Korea cites to "harshness" as a unique desirable characteristic of standard soju compared to the smoothness or mildness of Western-style spirits, as the representative from the European Community pointed out, the advertisement in its submission for Jinro Bisun, produced by Korea's largest producer of soju, boasts how it is a "mild" one, the same way Western-style spirits are marketed.

6.182. The United States also challenges the Korean claim that soju is uniquely suited to spicy food and unlike Western spirits, is consumed exclusively during meals in Korean restaurants or at home. According to the United States, that does not mean that Western-style spirits are not equally suitable for such use. Other countries also have hot and spicy food, and consume distilled spirits other than soju. For instance, in the United States, when consuming hot and spicy Mexican food, it is common to consume tequila in the form of a Margarita. In Poland, vodka is drunk with herring. Consumers' habits are not fixed, and can change with the introduction of alternative products. Indeed, in Korea a considerable proportion of imported Western-style distilled spirits is not consumed in bars and posh hotels, but at home, similar to soju. The United States says it understands that after dinner at home, both soju and Western-style spirits are an option.

6.183. The United States argues that, as the GATT drafting history demonstrates, in order to be directly competitive or substitutable, products need not share a majority of physical characteristics, and a basic commonality of physical properties is sufficient. The basic physical properties of soju and Western distilled spirit categories are essentially the same: all are concentrated forms of alcohol that are produced through distillation and used for human consumption. Their variations -- distillation method, appearance, taste, alcoholic content, and raw material inputs -- do not create any particular product not substitutable for the other. The 1987 *Japan* liquor panel did not consider the minor variations in distilled spirits important, instead stressing the flexibility of use: "Alcoholic drinks might be drunk straight, with water, or as mixes. . . . [T]he flexibility in the use of alcoholic drinks and their common characteristics often offered an alternative choice for consumers leading to a competitive relationship."²³⁶ According to the United States, this approach, consistent with the consideration by the drafters that oranges and apples are competitive, confirms that it is most appropriate to consider a broad commonality of physical characteristics.

End Uses

6.184. According to the United States, in examining the current uses of distilled spirits in the Korean market, it should be recalled that already both soju and Western-style distilled spirits are sold and advertised side by side. In the Korean Air duty free magazine²³⁷ (US Exhibit D), presumably catering to both Korean and foreign travellers, Johnnie Walker Blue Label, Johnnie Walker Gold Label and Moon Bae-Sool soju are advertised on the same page. Moreover, as shown in the pictures in U.S. Exhibit G, soju and Western-style spirits are sold together in a range of retail establishments. In the first picture, Cherry 15 is next to Seagram Extra Dry Gin, and Alexander vodka is next to Korean premium soju (aged in oak) in a convenience store. In the fourth picture, Something Special Scotch whisky is next to Kim Sat Gat premium soju in a Seoul supermarket. The fact that these products are sold through the same retail channels is important evidence of direct competition in the market place.

6.185. The United States argues that Korea has implied that soju, because it is less expensive, is marketed to an entirely different group of consumers than Western spirits and therefore is not directly competitive with Western spirits. The United States disagrees with that implication. In fact,

²³⁶ See panel Report on *Japan – Taxes on Alcoholic Beverages I*, *supra.*, at para. 5.7.

²³⁷ US Exhibit D.

according to the United States, given the greater degree of availability of Western spirits, it is more likely that many Koreans will consume both soju and Western spirits, differentiating the timing, degree and occasion of their consumption mix based on personal preferences and the relative prices of the two products. Moreover, The United States agrees with the representative of the European Communities that, as shown in Attachment 6 of the Korean submission, soju is also aimed at businessmen in shirts and ties, and not farmers or factory workers. This is exactly the same group of people Western spirits companies are targeting -- Korea's middle and upper class professionals.

6.186. The United States also claims that Korea's narrow approach to end uses looks at whether a distilled spirit is consumed before, during or after a meal; as a mixed drink, with ice, or straight; and what type of food is served at a restaurant. In fact, Korea attempts to draw strict categories where none exists in the Korean market or any place else US manufacturers are familiar with. Before addressing the issue of mealtime consumption, the United States recalls that Korea says little regarding other sub-categories of usage in which even Korea admits Western distilled spirits compete, such as consumption in bars, after meals, and in the home, or providing as a gift. Korea, does, however, concede in its answer to U.S. question 3, that some standard soju will also be consumed at home without a meal, as are western spirits.

6.187. According to the United States, Korea's narrow approach to end use is also undermined by the GATT drafting history citing to apples and oranges as directly competitive products. As stated by Korea, "A member of a group of products that are related in consumption need not be a substitute for all other members of the group -- just for *some* other members of the group." In its second submission Korea refers to the U.S. citation of differing end uses for apples and oranges as evidence that such products may not be competitive or substitutable. Although it is unlikely that oranges would be substituted as filling for apple pies, this does not preclude their substitutability for several other end uses, such as fruit juices, fruit jellies and jams, and overall fresh fruit consumption. Differences in product end uses may vary, but they do not erect a wall preventing substitution between differing types products within the same category.

6.188. The United States also argues that Korea's focus on differences in consumption within the on-premise and off-premise market segments is not appropriate for purposes of Article III:2. On-premise consumption covers a broad range of establishments that must be considered together for purposes of substitutability, particularly since the availability of Western spirits has continually expanded. In addition, in the on-premise consumption segment, serving particular distilled spirits is up to the discretion of the owner of the particular establishment. In general, establishments such as inexpensive Korean restaurants that appeal to low-income patrons are less likely to serve expensive high-end distilled spirits, and vice versa. However, with all of the variability in types of restaurants, bars and night clubs in Korea, it is not realistic to assume distinct rigid categories with respect to marketing and distribution of distilled spirits, and Korea has shown no support for such allegations.

6.189. The United States further argues that in the off-premise sector, making generalizations about particular kinds of stores would be equally incorrect. In Korea's retail sector, virtually all types of spirits are available in all types of establishments, yet in different proportions. For instance, a small family-owned shop will have cases of soju available and a few bottles of premium Scotch whisky on the shelves. Conversely, upscale department stores, such as Lotte and Shinsegae in downtown Seoul, will carry a preponderance of imported spirits, and may only have a small display for domestically-produced soju. The wide range of availability of imported spirits is clearly established in the Hankook study submitted by the EC as well as photographs of a range of retail establishments in which soju and Western spirits share the same store shelves submitted by the United States. Korea's argument that such placement is unimportant because in one photograph submitted by the United States, Gillette shaving foam is also apparent, overlooks the fact that the shaving foam is on a neighbouring set of shelves, not in the same group with the distilled spirits.

6.190. The United States notes that Korea's market for imported distilled spirits has been open for less than a decade, and is not a mature market with respect to consumer's awareness of, and receptivity toward, different types of spirits, their uses and places of consumption. Even though there are some differences in the methods of consumption compared to other countries, such as consumption of soju with Korean meals, it is wrong to assume, that end use must be identical for all uses under Article III:2. Given the fact that the spirits industry has been barred from the Korean market until recently, the industry has not had the opportunity to address and capitalize on every possible usage of its products in Korea. However, since all distilled spirits are fundamentally interchangeable, as Western spirit products become more familiar to Korean consumers, it is expected that methods of consumption will continue to expand.

6.191. The United States claims that with respect to on-premise consumption, Korea has also implausibly maintained that there is no overlap between the types of restaurants or bars that serve soju, and those that serve imported spirits. In fact, in its answers to U.S. question 4, Korea has already conceded at least some potential overlap between distilled soju and Western spirits when it recognizes that soju is offered in so-called "very expensive and traditional Korean and Japanese restaurants." Given its earlier statement that Western spirits are sold in Japanese restaurants, Korea minimally acknowledges substitutability in such restaurants.

Price

6.192. With respect to Korea's arguments on the different prices of the various products, the United States claims that although Korea glosses over the concept of substitutability, it does not go so far as to claim that the existence of large pre-tax price differentials precludes two products from being substitutable. In fact, Korea acknowledges such substitutability when it states that standard soju and premium soju, two products with a typical price differential of more than 100%, are considered "close substitutes" in Korea.

6.193. The United States notes that the substitutability of alcoholic beverages in a wide price range is not uncommon. Moreover, a range of prices exists within several product types. For example, whisky prices can range from ten to a hundred dollars for a bottle. The Korean submission frequently cites whisky as 11 times higher in price than soju, ignoring the price ranges within the whisky product category. For example, pre-tax imported whisky prices (for 375 ml bottles) range from over 5,000 won for premium scotch whisky to over 3,000 won for standard scotch whisky. Thus, at the extremes, imported scotch whisky pre-tax prices are 7.2 to 12 times higher than standard soju, not including domestic bottled whisky which is 6.3 times higher. Notably, imported standard scotch whisky pre-tax prices are only 3.6 times higher than premium soju.

6.194. The United States further argues that price differences are not of themselves evidence of a lack of actual or potential competition. Changes in consumer purchase behaviour are dependent on relative price changes, not absolute prices between competing products. Constructing a price demarcation where products with relative prices exceeding a specific threshold are considered not directly competitive or substitutable ignores the reality that these products are arrayed along a price continuum available to consumers in the marketplace. The availability of products across a spectrum of prices in the Korean market attests to a commensurate range of differing consumer tastes and preferences for distilled spirits, as well as the desire of individual consumers to vary their individual consumption choice on the basis of occasion, place of consumption and other factors. Moreover, purchases of distilled spirits, unlike purchases of items such as automobiles or homes, occur on numerous occasions over a relatively short time frame. Consequently, at the margin, changes in relative prices between spirits, such as soju and Western spirits, may alter *some* individual consumption decisions, but not *all*.

6.195. Furthermore, the United States notes that Korea's price analysis devotes substantial attention to comparisons of standard soju and the more upscale whisky products, giving limited attention to the variability of prices within spirit categories such as whisky and soju. For example, the pre-tax price of premium soju is two to three times higher than standard soju, and in some instances distilled soju pre-tax prices exceed those of Western spirits. In comparing soju and whisky weighted average prices, the United States claims that Korea's analysis failed to account for the variation of prices among differing whisky products. Furthermore, when adjustments are made for alcoholic content, pre-tax price differences between standard soju and Western spirits range from 3 to 6 times higher and for premium soju, 2 to 3 times higher.

Broader substitutability of distilled spirits

6.196. The United States argues that there is evidence that Korean Consumers are not substantially different from other consumers around the world in the ways that they form tastes for alcoholic beverages. According to the United States, the US, EC and Korean submissions show that the advertising for the products is similar and aimed at similar audiences. In fact, the advertisements would not be out of place in Western magazines except for the Korean print. In addition, in Korea, as in the rest of the world, distilled spirits are sold in stores, bars and restaurants, among other locations. In Korea, soju and Western spirits are purchased from the same shelves in different retail outlets. Thus, there is market evidence supporting the US statements that all spirits should be considered as in competition because they compete for consumers' spending on various products within the category of alcoholic spirits.

6.197. The United States argues that Korea's implication that all distilled spirits are not a recognized category of competing goods is contradicted by both international and Korean practices. There is a reason that the international convention on the Harmonized System, to which Korea is a party, has grouped all distilled spirits, including soju, under the same customs heading. This classification reflects the fact that on the international scene, distilled spirits are considered a distinct product group that includes soju. One need only look at a recent issue of an industry trade journal, *Drinks International*²³⁸ which puts out a list of the top spirits brands in the world each year, to see that soju is considered a competitor to all other distilled spirits in HS heading 2208. On page 35 of the March 1998 edition, one sees that Jinro Soju is ranked the number one spirits brand in the world.

6.198. The United States notes that Korean government itself groups imports of soju with other distilled spirits in its implementation of the Harmonized System, and groups all alcoholic beverages together -- soju, beer, vodka, whiskey, sake etc. -- in a single liquor tax law. In its responses to our questions, Korea admits that sake and beer compete with soju. It is self-serving to insist that the other products in its liquor law (such as imported distilled spirits) do not compete, despite their being grouped together in Korea's own laws.

6.199. According to the United States, several other factors support what should be the obvious conclusion that Korean consumers can be presumed to recognize the similarity of soju and imported spirits. Western spirits and Korean soju are sold alongside each other in retail outlets, and their advertisements are aimed at a similar clientele with similar sales pitches. The development, by Korea's own soju producers, of bottling operations for imported whiskey is also significant. These producers have obviously recognized that the products compete and are taking advantage of the distribution channels already developed for traditional soju brands.

6.200. The United States argues further that Korean manufacturers have advertised soju in the same international media as Western distilled spirits and seek to take advantage of characteristics of soju that are similar to those of Western distilled spirits. The United States refers again to a recent edition

²³⁸ US Exhibit P.

of *Drinks International*. Page 14 of the March 1998 issue contains an advertisement for Jinro Soju, which asks potential purchasers to “experience its unique smooth taste” and boasts of its “incomparable versatility for cocktails.” It even shows soju in a glass “on the rocks” with a lemon slice and a maraschino cherry. Obviously, Korea’s top soju producer, Jinro, considers soju substitutable for Western distilled spirits and eminently suitable for a variety of their uses -- like Western spirits, not only drunk straight in a shot glass, but also “on the rocks” or mixed with other products to make cocktails.

6.201. The United States argues that Jinro’s recognition of soju’s substitutability with other spirits in its international export markets is not reconcilable with the position of the Korean government in these proceedings that soju is not “like” or “directly competitive or substitutable” with any Western distilled spirit. Overseas, Korean soju competes on a level playing field with all other distilled spirits, but at home Korea rejects any notion that the products are in competition, and insists on a reading of Article III that would protect soju through burdensome taxes on imports. The United States considers that this position finds no support in the letter or spirit of Article III:2.

6.202. The United States considers that there is also some empirical evidence supporting the general notion that consumers budget for alcoholic beverages separately than other goods.²³⁹ This study of consumers (Alley *et al.*) reveals that the consumption of alcoholic beverages is separate from their consumption of other goods. Hence, “after compensating for income changes, consumption of other goods is unaffected by price changes” of alcoholic beverages.²⁴⁰ Furthermore, in Alley and in two additional studies²⁴¹ there is evidence of substitutability between domestic and imported spirits in Canada and Finland, respectively. Accordingly, there is further support for the conclusion that all imported spirits compete with soju in the distilled spirits market in Korea.

Korean market developments

6.203. The United States argues that the development of the premium soju market is a most important indicator of the fact that Western spirits directly compete and are substitutable for soju. Soju sales increased significantly with the introduction of premium soju, whose sales volumes have surpassed the combined sales of all imported spirits. This development demonstrates that Korean consumers are receptive to trying and buying newly introduced types of spirits, including those with a higher prices. Furthermore, development of premium soju is clearly intended to move soju up market by borrowing the cachet from imported spirits, which contradicts Korea’s contention that soju is only the cheap drink of “commoners” or “ordinary folks”.

6.204. The United States argues that another development in the Korean market further dispels Korea’s notion that soju is in a market of its own: the production of flavoured soju and juice cocktails starting in 1995. Although it may well be that much of soju is consumed as described in Korea’s submission, these market developments show that new forms, venues and usage of various distilled spirits will continue to develop in Korea.

6.205. The United States considers that market developments and present conditions in Korea directly undermine Korea’s reliance on pre-tax price differentials as precluding substitutability between soju and Western spirits. Despite competitive distortions created by Korea’s liquor tax

²³⁹ The United States cites A.G. Alley, D.G. Ferguson, K.G. Stuart, *An Almost Ideal Demand System for Alcoholic Beverages in British Columbia*, 17 Empirical Economics 416 (1992).

²⁴⁰ *Id.* at 414.

²⁴¹ The United States cites Andrikopoulos, et al., *The Demand for Domestic and Imported Alcoholic Beverages in Ontario, Canada: A Dynamic Simultaneous Equations Approach*, 29 Applied Economics 945-953 (1997); Holm, *Alcohol Content and Demand for Alcoholic Beverages: A System Approach*, 20 Empirical Economics 75-92 (1995).

system, demand for Western spirits, particularly whisky, has increased as the relative prices of whisky and soju declined (there were 100% and 250% reductions in the applicable liquor tax rate and import custom duties, respectively. During this period, sales of whisky in Korea increased over 136 percent as compared to a 13 percent increase in soju sales. These differing rates of growth in sales of whisky and soju amidst tax and duty reductions on imports demonstrates that the products are in competition.

6.206. The United States claims that without precise data regarding Korean consumer purchasing activity, it is virtually impossible to determine with complete certainty that product demand, in this case whisky, is driven by factors unrelated to the demand and price of the other product in question, i.e. soju. However, the United States considers that several market developments suggest that changes in market share between soju and whisky are not unrelated:

- 1) A noticeable slow-down in soju sales occurred in the early 1990's as the import duties in Korea were lowered on whisky and import restrictions were eliminated, propelling increased sales of whisky and other Western spirits.
- 2) It was not until 1996, when a new soju product was introduced (premium soju), that soju sales rebounded. Between 1995 and 1996, sales of soju increased by 5 percent, exceeding the growth rate for the previous three years combined.
- 3) In 1997, in the midst of a sharp currency depreciation and economic difficulties, sales of Western spirits, particularly whisky, declined, while soju sales actually increased.

Thus, according to the United States, the two concurrent trends of Korean consumers trading up to Western spirits while trading up to premium domestic soju are a strong indication of the substitutability between Western spirits and soju.

4. The Dodwell Study

6.207. The United States argues that the results of the Dodwell study provide ample evidence that Korean consumers treat soju and imported Western spirits as substitute products. The United States notes first that a cross- price elasticity study might be a helpful addition to the Article III:2 analysis, but it is not a necessary one. The emphasis on case-by-case analysis in the drafting history of Article III, and the practice among GATT and WTO panels, make it clear that it would not be appropriate to establish a general rule concerning the percentage shift in consumer preferences. The complaining parties have not put forward any precise estimate, but some empirical results of studies conducted in various national markets indicate that there is a statistically significant trade-off between types of spirits.

6.208. First, the United States notes that the Dodwell study was patterned after the ASI study utilised in the *Japan-Taxes on Alcoholic Beverages II*,²⁴² in which the panel stated "contained persuasive evidence that there is significant elasticity of substitution among the products in dispute."²⁴³

6.209. According to the United States, the small anomalies in the Dodwell study should not lead the panel to a conclusion that the Dodwell study reflects "independent movements of independent variables." In the US view, drawing such a conclusion on the results of the Dodwell study is tantamount to concluding that relative prices of soju, premium soju and imported spirits have no impact on consumption decisions. In fact, the overall trends in the Dodwell study should lead the Panel to the opposite conclusion: consumer preferences in the Korean market for distilled spirits are significantly related to relative prices of soju and imported distilled spirits.

²⁴² Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.29.

²⁴³ *Ibid.*, para. 6.32.

6.210. According to the United States, the anomalies pointed out by Korea are merely deviations from what is usual, normal or expected.²⁴⁴ The US argument is that a study that relies on sampling to draw inferences about an overall population may yield results that contain some random variation, and therefore will be susceptible to occasional anomalous results.²⁴⁵ In the US view, what is important in the Dodwell study is that the overall trend displayed in the sample responses suggests that relative prices are a factor in consumption of distilled spirits, and that consumers normally will substitute imported spirits for soju as the relative price of soju rises.

6.211. According to the United States, the analysis of the Dodwell survey results as described in the first US submission detailed the percentage changes in those choosing Western spirits (excluding premium soju) as the relative price of standard soju rises. Therefore, the aggregate effects of nearly all of the scenarios demonstrate that respondents increasingly choose Western spirits when faced with higher relative prices for standard soju.

6.212. The United States notes that Korea's critique of the Dodwell study alleges flawed results and methodological weaknesses. Yet, despite these assertions, the study establishes a connection between changes in relative prices of soju and western spirits and purchasing behaviour. The Dodwell survey followed the methodology of the ASI study, attempting to determine whether the typical Korean spirits customer varies consumption preferences between soju and Western spirits as relative prices of spirits change. In the US view, the study did not attempt to determine the actual shares or shifts in market shares between spirits products, an objective that would not be relevant to this proceeding. Rather it sought to establish whether Korean spirits consumers view the products as substitutable. The fact that the observed percentages of survey responses do not perfectly correlate with actual soju market shares does not undermine the study's conclusions, and focusing on it overlooks the study's objective.

6.213. The United States notes that Korea further asserts that the Dodwell study reflects a sample bias and posed ambiguous questions. According to the United States, with respect to the survey questions, it is unreasonable to impute confusion to the entire survey population. With respect to the sample, inclusion of survey respondents having recently purchased soju and whisky suggests that, at least for brown spirits, respondents' familiarity with these products runs contrary to the assertion that the survey questions implied a one-time or experimental purchase. Finally, the separation of brown and white distilled spirits does not affect the fundamental movement of respondents from standard soju to Western spirits as standard soju's relative price increased.

6.214. The United States also notes that Korea questioned, as did the Panel, the grouping of premium soju with other Western distilled spirits in the Dodwell study. According to the United States, as with whisky (standard and premium), it was considered appropriate to establish more than one price point

²⁴⁴ In the US view, Korea's critique of the Dodwell study focuses on random anomalies to the exclusion of the underlying findings that Korean consumers view standard soju and imported spirits as substitute products. For example, Korea's critique highlights that in chart 1 of the Dodwell study, the percentage of respondents choosing premium scotch falls as the price of standard soju rises from 1,100 to 1,200 won. The critique ignores that in the same scenario a rising percentage of respondents chose standard whisky and cognac as soju prices rose. In aggregate, the percentage choosing Western spirits in this scenario actually rose, indicating respondents' responsiveness to changes in the relative prices of Western brown spirits and soju. Moreover, the aggregate trends in nearly all the scenarios indicate increasing percentages of respondents choosing Western spirits amidst the relative rise of standard soju prices. In focusing narrowly on selective inconsistencies Korea has obfuscated the underlying study results evidencing that respondents frequently choose to substitute imported spirits for standard soju as the relative price of these products narrowed. See First Korea Sub., Attachment 2, at pp. 4-5.

²⁴⁵ In the US view, in only one of the price scenarios (medium brown spirit price levels) in the Dodwell study did the aggregate results run counter to theory. However, it should be noted that in terms of respondents, a net of 3 respondents choose non-Western spirits as the relative price of standard soju reached its highest level.

for diluted soju given that diluted soju products differed in price. Setting a price benchmark for the soju category based on the actual prices for the higher price premium soju to the exclusion of standard soju would have ignored the majority of the overall diluted soju market. Standard soju, due to its market share significance, was chosen as the benchmark for comparison. The fact that premium soju was selected as an alternative product, alongside Western spirits, to standard soju, and that some respondents switched to premium soju, does not undermine the validity of the study's conclusion.

5. The measures are applied "so as to afford protection to domestic production"

6.215. The United States does not address this issue in its rebuttal submission, but in its oral statements argues that, with respect to this element of the case, the Appellate Body stated in *Japan – Taxes on Alcoholic Beverages II*, the protective application of a tax can most often be discerned from "the design, the architecture and the revealing structure of the measure," which includes the very magnitude of the dissimilar taxation.

6.216. The United States further argues that Korea has largely ignored this element of the analysis. However, the Korean measures at issue do present a structure applied so as to afford protection to domestic production. According to the United States, the very large differentiation in tax rates between imported and domestic products, on the basis of a law that consists mainly of arbitrary exclusions from the definition of Korea's domestic product, soju, can only be considered protective. Moreover, in contrast to the facts presented in the *Japan* case, the protection of soju in Korea can be equated even more directly with the protection of a domestic industry. In Japan, there were significant imports of soju from Korea (which the panel in *Japan – Taxes on Alcoholic Beverages II* found were the same product as shochu), but in Korea, there have been only negligible imports of soju -- or shochu -- from any other country.

6.217. The United States further notes that Korea makes the claim that soju cannot be considered "domestic" production at all, because its raw material is often imported. According to the United States, this assertion ignores Korea's own legal structures, however. It is true that the main ingredient for soju is ethyl alcohol, 70% of which is imported. But, unlike whisky, ethyl alcohol is a raw material that can be used for a variety of end products. Ethyl alcohol is classified separately under HS heading 2207, and the process of manufacturing soju results in a substantial transformation of that raw material, while any imported soju is classified under HS heading 2208. Whisky, whether bottled or in bulk, is classified under HS heading 2208. Thus, it is plain that soju is a domestic product, while whisky is exclusively imported.

6.218. Finally, according to the United States, Korea's invocation of progressive social policies as a pretext for this discrimination is unrelated to the structure of its law, which is drawn on the basis of arbitrary physical characteristics and not on price of the product. While Korea may have a social policy objective of imposing lower internal taxes on inexpensive products purchased by lower income consumers, Article III does not permit Members to draw artificial product categories for tax purposes so as to discriminate against imports and protect domestic production. According to the United States, the same or similar arguments by Japan have been rejected in two panel proceedings.

C. KOREA

1. The Nielsen Study

6.219. Korea states at the outset that in order to rebut assertions of the complainants in the Dodwell Study and elsewhere in their submissions, it has commissioned another study, carried out by the company A.C. Nielsen (Nielsen study).²⁴⁶

6.220. Korea states that the Nielsen study concluded that while all Korean restaurants, Chinese restaurants and mobile street vendors sell standard soju, most cafés/western style restaurants and bars sell whisky. The study also found that 29.3% of the respondents consumed alcoholic beverages at home with their meals, while 81% were found to have consumed such beverages with meals at restaurants. The study claims that diluted soju was the alcoholic beverage predominantly consumed with meals. Drinking diluted soju with meals was most popular at Korean restaurants (73%), followed by Japanese restaurants (18%). According to the study, of the seven beverages offered to the respondents, none were consumed with meals at cafés/western style restaurants, bars and hotel bars. Finally, the survey found that soju is predominantly consumed straight (98.6%), while whisky is usually consumed "on the rocks" (with ice) (63.8%).

6.221. In Korea's view, therefore, the Nielsen study substantiates its argument that there is no demand substitutability between soju and the western-type drinks at hand in the Korean market.

2. General comments

6.222. Korea argued in its first submission and continues to maintain that a violation of Article III:2 cannot be made in the abstract. According to Korea, in order to begin to prove the existence of a violation, the complainants must show that there is a 'like' or directly competitive or substitutable relationship between specific products in a specific market. The decision as to whether two products have such a relationship is based upon an overall appreciation of many factors, such as their physical similarities, their end uses, price, and consumers' tastes and habits. Two products may be similar to some degree in some ways, and different to some degree in other ways.

6.223. Korea claims that the complainants have preferred to discuss each relevant criterion in the abstract and for all the products at once. Taking each criteria separately allowed them to make generalisations about all the products without addressing the specific arguments that Korea raised for each individual product. In Korea's view, as a result of that approach, the complainants do not provide a total view of the relationship between any particular product pair.

6.224. According to Korea, the effect of this approach is three-fold. First, it allows the complainants to gloss over or ignore differences between products. Second, it allows them to highlight and exaggerate the importance of exceptional cases. Third, through this approach they make it more difficult for the Panel to have a clear overall view of any one product pair.

6.225. Korea also asserts that what the complainants lack in evidence and argument, they try to make up for by allusions to Korea's past, its alleged protective measures, its lack of imports etc. According to Korea, its past as a developing country is not at issue in this case. What is at issue is Korea's market today. Korea refers to a neutral study funded by the EC Commission which observed that:

²⁴⁶ Korea claims that unlike the Dodwell Study, the Nielsen Study has focused on factual evidence rather than speculation. Rather than asking respondents 'what would you do?', it has asked them 'what do you do?'

The Korea market is no longer a market protected by the Government with market shares contested by local producers. In fact, it is becoming a truly global market, where multinational companies convene to compete with one another for the lucrative and promising Korean market.²⁴⁷

3. Generalisations about the Korean products

6.226. Korea notes that consistent with their contention that all distilled spirits are the same, the complainants also refuse to recognise differences in the Korean spirits at issue in this case, claiming that 'soju', whether it be standard or distilled, is one product.

6.227. Korea has insisted from the beginning that standard soju and distilled soju are too different for these two products to be lumped together. Korea seeks to show that in trying to rebut this fact, the complainants first draw support from the fact that standard soju and distilled soju share, in part, the same name. According to Korea, the similarity in the names of standard soju and distilled soju is meaningless (for example, one would not consider 'beer' and 'root beer' to be 'like' or directly competitive or substitutable on the basis of their names).

6.228. Korea further notes that the complainants then go on to argue that the physical differences between standard soju and distilled soju are insignificant. However, those physical differences are obviously enough to affect consumer behaviour, as standard soju and distilled soju do not compete, indeed do not have the same end uses, and are sold at vastly different prices. The complainants have not been able to counter those arguments. In addition, it should be noted that the distinction between standard soju and distilled soju existed prior to this case, that these two products fall into different tax brackets,²⁴⁸ and that despite the EC's statements to the contrary, distilled soju is not exempt from tax.

6.229. Korea states that another point made by the complainants is that the difference between distilled and standard soju is really not important because, "*they can be, and are, often blended with each other.*"²⁴⁹ The complainants then point out that whisky is often blended too. Korea points out that the complainants again offer no proof whatsoever for their allegation that distilled and standard soju are often blended. Accordingly, this example of the reference to whisky is irrelevant to a comparison between standard and distilled soju.

6.230. Korea refers to what it calls another astonishing, assertion of the complainants that, '*swift transition*' occurred in the mid 1970s from distilled to standard soju, which and '*was possible only because, in the eyes of Korean consumers, the two varieties of soju are the same product*'²⁵⁰ Korea recalls that standard soju was introduced in 1962 because, due to food shortages, distilled soju made of rice could no longer be produced. Production of distilled soju only started again in 1991. If a swift transition from one product to another following food shortages is an indication of a close relationship between them, Korea recalls that Parisians also made a '*swift transition*' from eating beef meat to eating rat meat during the Fall of Paris in the 1870s, due to a food shortage.²⁵¹ According to Korea, peoples' behaviour in times of food shortage says very little about which products consumers would consider substitutes in normal circumstances.

²⁴⁷ See Sofres Report, Introduction.

²⁴⁸ According to Korea, while the US notes that standard soju and distilled soju have the same rate of Education Tax (10%), they fail to mention that the liquor tax on distilled soju is 50%, while the liquor tax on standard soju is 35%. Another mistaken attempt at trivialising the distinctions between distilled and standard soju is the EC's assertion that the distinction in the tax law was introduced only in 1991 (see EC written rebuttal, at para. 34), supposedly in response to pressure from the EC. In fact, the distinction was already made in 1962.

²⁴⁹ See EC written rebuttal, at para. 38.

²⁵⁰ See EC written rebuttal, at para. 35.

²⁵¹ See Horne, Alistar, *The Fall of Paris: The Siege and the Commune 1870-71*, London 1965.

6.231. Korea states that the complainants argue that the only reason Korea wants to distinguish between standard soju and distilled soju is because it wants to 'sacrifice' distilled soju, which makes up 0.2% of the 'soju market' in order to 'spare' standard soju. According to Korea, it has no intention of sacrificing distilled soju. While distilled soju differs from the imported beverages in different ways than standard soju, it still differs from them too greatly to be 'like' or directly competitive or substitutable for those products.

6.232. Korea further argues that this allegation that Korea is willing to 'sacrifice' distilled soju to 'spare' standard soju is characteristic of another facet of the complainants' approach to this case. In Korea's words, where it suits them, the complainants trade their inverted telescope for a microscope, 'zooming in' on exceptional cases that seem to support their argument. In the same way that looking at the situation from a great distance obscures the reality, zooming in too closely also means that your view is distorted.

6.233. Korea notes that the complainants allege that Korea is willing to 'sacrifice' distilled soju because it only represents 0.2% of the 'soju market'. What this highlights is the fact that the complainants are asking the Panel to do the opposite: they would like to use examples drawn from this 0.2% in order to prove a point about the other 99.8% of 'soju' sold in Korea, which is standard soju. For example, the complainants want the Panel to ignore the substantial price differences between standard soju and the western-style liquors at issue in this case, on the basis of the high prices of that 0.2%.

4. Actual (or potential) competition

6.234. Looking carefully at the evidence and arguments that the complainant have presented, Korea submits that the arguments are misleading, flawed, or insufficient to meet the complainants' burden of proof. According to Korea, therefore, the complainants have not established that there is a direct competitive or substitutable relationship, actual or potential, between soju and the imported distilled spirits that are within the scope of this dispute.

(a) Physical differences

6.235. Korea points out that there are important physical differences between the products at issue. These differences have an impact on consumer preferences and hence on the competitive relationship between the products. According to Korea, the complainants have attempted to trivialise those differences by looking at the products from a great distance, such that they can say that all the products have 'essentially the same characteristics'. In Korea's view, however, even a slight physical difference might be enough to render two products not competitive. For example, if a consumer does not like the taste of one particular additive, its addition to a product will eliminate that consumer as a potential buyer -- even if that additive does little to change the appearance or chemical composition of the product.

6.236. Korea also points out that the complainants display ignorance of the very real possibility that two products that are ostensibly similar might not compete. For example, Korea cites the US argument that 'under Korea's theory, different flavours of soft drinks such as Coca-Cola and Fanta do not compete, but it is doubtful that anyone familiar with the market would agree.' Korea disagrees with this. According to Korea, the directorate of the European Commission responsible for competition law matters has more than once drawn a distinction between cola-flavoured carbonated soft drinks and other types of soft drinks, deciding in the recent *Coca-Cola/Amalgamated Beverages* merger that the relevant market was the market for cola-flavoured carbonated soft drinks, explicitly

excluding other flavours of carbonated soft drinks.²⁵² National competition authorities have come to the same conclusion.²⁵³

6.237. Korea argues that, the European Communities, in its discussion of physical differences, tries to take consideration back to the moment of distillation, at which point, it argues, 'all spirits are nearly identical' because 'all of them are concentrated forms of alcohol.' Korea argues that firstly, the principal test for whether products compete is the marketplace. Spirits are not sold at the point of distillation. Moreover, the difference in physical characteristics, starting with a difference in raw materials, is not negated by distillation. In addition, there are important post-distillation processes that also have an impact on the physical characteristics of products. Brown spirits, for instance, are generally matured in wooden casks and derive their flavour from this process, and from the original distilled ingredients.

6.238. According to Korea, the analysis at the point of distillation is meaningless as the subsequent addition of additives or ingredients can, and in the liquors discussed here, does, make a crucial difference for consumers when they choose a particular liquor in a particular market, such as the Korean market. Korea concludes, therefore, that although all spirits may be 'nearly identical' at the point of distillation, the most casual observation clearly shows that does not mean that drinkers are indifferent between them.

6.239. According to Korea, if physical characteristics at the point of distillation were meaningful, that would lead to the conclusion that products as disparate as fuel or pharmaceutical products are also directly competitive and substitutable with, for example, vodka.²⁵⁴

6.240. Korea also asserts that the complainants try to use evidence about production process to make up for the essential evidence about markets that is missing from their presentations. According to Korea, no evidence offered by the complainants shows that 'distilled spirits' is a group that is relevant to consumer choice in the Korean market. Korea asks: Why is 'distilled spirits' such a group rather than 'brown distilled spirits' or, 'white distilled spirits'? Why not 'alcoholic beverages' – spirits, wine and beer? Why not 'cold drinks', alcoholic or not?

6.241. In Korea's view, any one of these might be a grouping relevant to consumption – or might not be. Whether it is or not depends on the tastes and preferences of consumers. According to Korea, the effects of a failure to adequately research relations between products in consumption cannot be escaped by reference to modes of production. In particular, it cannot be demonstrated that distilled spirits is a relevant grouping for consumers on the basis that 'having essentially the same characteristics, soju and other distilled spirits and liqueurs are objectively apt to serve the same end uses'.

6.242. According to Korea, a member of a group of products that are related in consumption need not be a substitute for all other members of the group – just for some other members of the group. Korea states that a high-end Ferrari and a low-end Renault Clio are both motor cars, and could be seen by a person of sufficiently limited imagination as 'having essentially the same characteristics' (four wheels, one engine, steering wheel) and to be 'objectively apt to serve the same end uses'. The fact that both are motor cars, though, is not enough to allow deduction of elasticity of substitution between

²⁵² Korea cites Commission Decision of 22 January 1997 declaring a concentration to be compatible with the common market and the functioning of the EEA Agreement, Case No IV/M.794 *Coca-Cola/Amalgamated Beverages*, 1997 OJ L 218, p. 15.

²⁵³ Korea cites for example Decision no 96-D-67 of the French Conseil de la Concurrence (Competition Council) of 29 October 1996, *Coca Cola Beverages*.

²⁵⁴ Korea alleges that the EC stated during its oral statement (p.12) that: neutral spirits are a raw material which can be used to produce a variety of alcoholic beverages, including for example vodka and gin, as well as other products, such as fuel or pharmaceutical products.

them. Indeed, in the case of Ferraris and Clios, it seems very likely that the elasticity in substitution between the two products is nil: that if the price of Clios changes by 1 per cent (or 10 percent or 100 per cent), the effect on demand for Ferraris will be zero.

6.243. Likewise, according to Korea, given the notable differences between standard soju and the western-style liquors there is no reason to assume that there would be elasticity of substitution between them. The complainants need to show this, but have failed to do so.

6.244. Korea also claims refers to the EC claim that 'according to Korea, the main difference between soju and gin is that gin is flavoured with juniper berries.' According to Korea it is true that Korea argued that juniper imparts a very particular flavour to gin that some consumers do not like. However, this was one of many differences, not least differences in price and end use, that Korea pointed out with respect of gin.

6.245. Korea notes, furthermore, that in interpreting the term 'substitutable', the United States, rather than proving that for Korean consumers a western-style liquor like whisky is directly²⁵⁵ substitutable for standard soju, despite the very considerable price difference, cites the example of bottled water and tap water, two products that ostensibly have similar physical characteristics and similar end-uses.

6.246. According to Korea, products that conceivably can be substituted for each other yield a very broad field. Korea states for example, that one could say that woollen sweaters and coal can be substituted for each other. If you are cold, you could either put on a sweater or throw another lump of coal on the fire. Washing machines and socks could be substitutable. The easier and cheaper the availability of laundry facilities, the fewer socks a person needs in order to have a constant clean supply. With this view of substitutability, baby carriages and wheelbarrows could be substitutable!

(b) Price

6.247. According to Korea, on the basis of the facts provided in the complainants' Dodwell Study, it is apparent that there is a huge discrepancy in the pre-tax prices of the products at issue. Korea states that taking whisky and standard soju as an example, the Dodwell Study data shows that the ratio of their prices varies from 6.3 to 12 times, with no overlap in price at all. Furthermore, according to Korea, the weighted average figures that Korea provided in its first submission showed that whisky is on average 11 times more expensive than standard soju.²⁵⁶ Large pre-tax price differences are shown for all the imported liquors at issue. This casts serious doubts on the existence of a directly competitive and substitutable relationship between these products, and highlights an important difference between this case and *Japan - Taxes on Alcoholic Beverages II*.

6.248. Korea points out that there are enormous pre-tax price differences. Based on the figures provided by the Dodwell study, Korea found the following pre-tax price differences:

Standard soju v.	whisky(premium)	ratio of 1 to 12
	whisky(North American)	ratio of 1 to 10.8
	whisky(standard scotch)	ratio of 1 to 7.2
	whisky(bottled in Korea)	ratio of 1 to 6.3
	brandy/cognac	ratio of 1 to 19.2
	vodka	ratio of 1 to 5.7
	gin	ratio of 1 to 5
	rum	ratio of 1 to 6.2

²⁵⁵ Korea maintains that the United States, the European Communities and Korea are in agreement that the word 'directly' applies to both 'competitive' as well as to 'substitutable'.

²⁵⁶ Korea refers to Attachment 5 to Korea's first submission.

6.249. Korea indicates that the Dodwell study data shows that the ratio of price difference varies from 6.3 to 12 times with no overlap in price at all. Furthermore, according to Korea, the weighted average prices showed that whisky is 11 times more expensive than standard soju. In response to the European Communities' claim that weighted average prices are "meaningless," Korea states that a weighted average price is an accepted means of getting a typical price for a product. Large pre-tax price differences are shown for all the imported liquors at issue. This casts serious doubts on the existence of a directly competitive and substitutable relationship between these products, and highlights an important difference between this case and *Japan—Taxes on Alcoholic Beverages II*.

6.250. Korea considers that pre-tax price differences of this magnitude must be taken into account in discussing whether it can reasonably be argued that any of these products are "like" or directly competitive or substitutable. Korea argues that these price differences refute any argument that it was taxes that have "frozen" consumer preferences. Furthermore, argues Korea, as to directly competitive or substitutable products, it must be addressed whether, in the face of these price differences prior to the application of tax, the tax differentials at issue in this case can be said to "afford protection" to domestic production.

6.251. Korea argues that the complainants have been unable to provide a response to the proposition that large pre-tax price differential leads to the absence of a directly competitive or substitutable relationship. Rather than addressing the price discrepancy between standard soju and the imported liquors head on, the complainants attempt to divert the Panel's attention to premium diluted soju, which is the somewhat more expensive variety, representing some 5% of total diluted soju volume.

6.252. Korea refers to the EC argument that using pre-tax prices for the purposes of comparison does not remove the "distortive effect from the disputed taxes", because the tax has kept low-priced imports from entering the market. Korea reminds the parties that, unlike Japan, it has *ad valorem* taxes. In Korea's view, while it might be argued that a high specific tax would keep low-cost products out of the market, an *ad valorem* tax is just that – it is linked to the price of the product, and therefore, the lower the price, the lower the tax amount.

6.253. Korea states that in determining whether two products are directly competitive or substitutable products, price cannot be excluded. In Korea's view, it is obvious that when one product is many times more expensive than another, it is difficult to argue that those two products are in competition. Korea notes that the US and EC competition authorities consider price as one of the most relevant factors.²⁵⁷ Korea also recalls that during the Panel meetings, the EC representative stated that competition law analysis was relevant to an analysis of Article III:2.

6.254. Korea draws attention to the importance of the reasoning in *Japan – Taxes on Alcoholic Beverages II*, wherein it was stated 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.²⁵⁸

²⁵⁷ Korea notes that in its written rebuttal the EC states that only consumers' responses to changes in relative prices are relevant and not absolute price differences). In competition law, price is one of the assessed criteria to determine whether there is competition between products. In such an analysis, prices are assessed both in nominal and relative terms (see Commission Decision of 22 July 1992, Case No. IV/M 190 Nestle Perrier, OJ L 356, p.1). In Korea's view, the difference in nominal terms is of such a degree that it renders improbable any change in the consumers' responses resulting from relative price changes.

²⁵⁸ Panel report, para. 6.31.

6.255. Korea argues that common sense tells us that the larger the price differences between two products, the less influence a change in the price of one will have on the demand for the other. In Korea's view, the complainants have not been able to overcome this common sense presumption.

6.256. According to Korea, the price difference between premium diluted soju and standard diluted soju is far less important than the price difference between standard diluted soju and western-style spirits. Korea claims that premium diluted soju is, on average, less than 80% more expensive than standard diluted soju,²⁵⁹ and the difference in price reflects the other very small differences between premium and standard diluted soju.

6.257. Korea also refers to an assertion by the European Communities, which in Korea's view is unfounded: 'western-style spirits are more expensive, to a large extent as a result of discriminatory taxation. If western-style spirits were taxed as soju, they would be less expensive and Korean consumers could afford to drink them with meals more often.' Korea's argument is that western-style spirits are indeed more expensive, but the rest of this statement does not follow.

6.258. Korea points out that using the Dodwell data provided by the EC, the pre-tax price differences between these beverages is great. These price differences would thus be maintained if tax rates were harmonised, and they are too great for it to follow that consumers would suddenly find imported alcoholic beverages an affordable alternative to diluted soju for meal-use, even disregarding the matter of taste. According to Korea, even the European Communities cannot think that its evidence shows that the addition of a few hundred won to the price of a bottle of diluted soju will have any substantial effect on demand for, for example, whisky.

6.259. Korea also states that another unfounded allegation appeared in the EC oral statement, where it stated that:

"Tax and tariff changes were followed by a substantial reduction of prices and a considerable increase in the sales of whisky. This increase took place at the expense of soju. Whereas the market share of soju fell from 96 per cent in 1992 to 94 per cent in 1996, during the same period, whisky increased by a similar percentage from 1.5 per cent to 3 per cent. Soju's declining market share in an expanding market evidences that soju and whisky are in direct competition".²⁶⁰

6.260. Korea states that it is probably true that if the price of whisky falls, the volume of whisky purchased will increase. According to Korea, that the quantity of whisky purchased is responsive to the price of whisky, does not, however, further the EC and US case. According to Korea, they need to show that this increase was at the expense of soju – that the demand for soju is responsive to the price of whisky.

6.261. Korea argues that if whisky sales increase at a greater percentage rate than soju sales, the share of whisky in the hypothetical 'soju-whisky market' will rise, and that of soju will fall. In Korea's view, that is entirely consistent with sales of soju rising at the same rate both before and after the increase in the share of whisky. The increase in whisky market share and the fall in soju market share says nothing about whether whisky grew at the expense of soju.

6.262. According to Korea, the point can be underlined by taking two goods that most people will accept to be unrelated – say whisky and floor polish – and aggregating them into an artificial market.

²⁵⁹ As appears from Korea's answer to question 5 of the second set of questions from the Panel, the weighted average price of standard diluted soju (excluding premium soju) is 306.58 won, while the weighted average price of premium diluted soju alone is 539.70 won.

²⁶⁰ See EC oral statement, p. 6.

In that 'market', the share of whisky might rise: whisky sales might grow at a higher percentage rate than sales of floor polish. But this does not prove or even suggest that whisky sales have grown at the expense of floor polish sales. Indeed, since the two products are, *ex hypothesi*, unrelated, it is clear that they have not.

6.263. In Korea's view, this 'proof' that whisky has grown at the expense of floor polish is in no way different from the 'proof' offered by the European Communities and the United States that whisky has grown at the expense of soju in the 'whisky-soju market'. Whisky's gain of market share in the 'whisky-soju market' shows that sales of whisky have grown at a faster percentage rate than soju: it shows no more and no less.

6.264. According to Korea, the arguments of the European Communities and the United States that market evolution in Korea supports their claim that whisky and soju are substitutes deserve no weight. In Korea's view, sales in whisky have certainly increased in Korea as its price fell, which is to be expected. Korea argues that in itself that fact has no bearing on the case. What the European Communities and the United States need to show is that the increase in sales of whisky was at the expense of sales of soju, which in Korea's view, they have not done.

6.265. Korea argues that the complainants display an interesting approach to the alcoholic strength of products. According to Korea, the complainants argue that a difference in alcoholic strength should not be taken into account in certain instances (such as, it should not affect the determination of whether products meet the strict 'like' product criteria). In Korea's view, the complainants only analyze price in this way in a last-ditch attempt to deal with evidence that is very damaging to their case. Korea further argues that the EC cannot bring itself to compare alcohol-adjusted prices of an average standard soju price -- instead, it compares an atypical bottle of standard whisky to a bottle of premium soju, and still comes out with a 2 to 3 times price difference.

6.266. Korea argues that the EC is focusing on exceptions in describing the Korean market. When it comes to the price of premium soju in this case, they take the most expensive premium soju brand (Kimsatgat) as representative. The sales volume of such high-priced premium soju is minimal. Korea further argues that the European Communities takes inexpensive whisky as an example, which is atypical as well.

6.267. Korea also argues that the calculations of the European Communities are misleading. When taking the price per degree of alcohol based on weighted averages, so as to obtain a representative price, whisky is still 7.96 times the price of standard soju per degree of alcohol. Looking at premium soju alone, whisky is 4.71 times the price of premium soju per degree of alcohol.²⁶¹ Again, these are pre-tax prices.

6.268. Korea asserts that contrary to its contention in *Japan – Taxes on Alcoholic Beverages II*, that pre-tax prices were within a relatively short range, the European Communities now claims that there were actually significant price differences in Japan, and submits figures that are supposed to show this. According to Korea, the European Communities even goes so far as to suggest that the Japan - Taxes on Alcoholic Beverages consciously disregarded substantial price differences.²⁶²

6.269. Korea observes that prices of western-style liquors and the Japanese shochus, once the tax is removed, appear to be rather close, with a number of overlaps.²⁶³ Furthermore, Korea notes that Japan chose not to dispute the EC's contentions about prices and price competition. However, rather

²⁶¹ Calculations based on data from the National Tax Administration.

²⁶² EC written rebuttal, at para. 130.

²⁶³ See Annex 2 to EC written rebuttal.

than speculating about the evidence, and the arguments presented to the panel in Japan - Taxes on Alcoholic Beverages, Korea submits it is safer to recall the explicit finding by that panel:

(T)he Community argued that the retail prices of shochu and of the other distilled spirits and liqueurs are within a relatively short range once the liquor taxes and the ad valorem taxes are deducted. This, in the Community's view, confirms that all of them are, at least potentially, competitive in terms of price.²⁶⁴

6.270. Korea also notes that the Panel repeated the Community's argument:

[t]hat, but for the discriminatory taxes imposed pursuant to the Liquor Tax Law, many western-style liquors would be less expensive than shochu in real terms.²⁶⁵

6.271. According to Korea, one can only conclude that the European Communities was describing the facts in one way before the Japanese liquor taxes Panel, and is now changing its story before this Panel. In Korea's view, these two versions simply do not match. Korea asks how the European Communities was able to say that pre-tax, prices of many western-style liquors would be less expensive than Japanese shochu, and now say that pre-tax prices of western style liquors in Japan were actually significantly higher than shochu?

6.272. Korea further argues that neither the Panel nor the Appellate Body in their legal findings reflected on any significant price differences in *Japan – Taxes on Alcoholic Beverages II*. According to Korea, it is clear from the evidence presented to this panel that in Korea, after the removal of the liquor taxes, none of the western-style liquors would become cheaper than Korean soju. On the contrary, very substantial price differences would remain.

6.273. Korea maintains that, together with the other distinguishing factors such as end use (whisky is not a meal drink, etc.) these price differences demonstrate that there is no directly competitive or substitutable relationship between the western-style drinks in dispute and standard soju.

(c) End use

6.274. Korea states that it has also shown in its submission that the end uses for diluted soju differ greatly from those of the imported liquors at issue in this case. In particular, Korea states that it has pointed out that the overwhelming use of diluted soju is as an accompaniment to meals -- a use for which the imported liquors are considered unsuitable and too expensive.

6.275. According to Korea, the complainants have not been able to provide an answer to this argument. While the European Communities allegedly acknowledges that standard soju is 'often consumed with meals', it argues that there are exceptions, such as sojubangs. However, meals are served as well at sojubangs. In Korea's view, to the extent that Koreans sometimes drink soju without a meal, these are the exceptions that confirm the rule.

6.276. Korea notes that neither of the complainants has been able to demonstrate concretely that any of the five western-style liquors in dispute are consumed with meals in Korea.²⁶⁶

6.277. According to Korea, the European Communities closes its eyes to the existing differences in end use, simply asserting that, in the case of vodka: 'Vodka and soju are like products because they

²⁶⁴ Panel Report on *Japan – Taxes on Alcoholic Beverages*, para. 4.82.

²⁶⁵ *Ibid.*

²⁶⁶ According to Korea, the EC has merely asserted that 'other spirits can be and sometimes are drunk with meals', without providing examples and their relative importance (EC oral statement, p. 8).

have virtually the same physical characteristics and, therefore, serve for the same end uses.’²⁶⁷ In Korea’s view, even if the EC assertions about physical characteristics were true, the one does not necessarily follow from the other, and the actual behaviour of customers belies the EC assertion.

6.278. Korea further argues that according to the United States, bottled water and tap water must be directly substitutable within the meaning of Art. III.2 GATT, despite their large difference in price, because they serve similar end uses. According to Korea, if one accepts that, one could start to argue that price differences alone need not justify tax differences. That argument might seem to go against Korea’s case, although it must be recalled that Korea’s case not only relies on price differences, but also on differences in physical characteristics (and taste), as well as differences in end use (meal drink versus non-meal drinks).

6.279. According to Korea, consumers are not silly. If they are consistently willing to pay a much higher price for one product, compared to a seemingly similar product, then small differences are probably very important to them, and thus for the market performance of these products. According to Korea, the United States and the European Communities obviously have difficulties accepting that, as a difference in market performance would block the application of Art. III.2.

6.280. Korea further argues that in some developing countries bottled water is safe, and tap water may not be safe for tourists. For tourists, that makes quite a difference, and they will probably be willing to pay a higher price for bottled water. Again, the US’s argument is flawed by its refusal to look at market-specific situations. Korea asks whether Article III:2 GATT would prohibit developing countries from charging a higher tax rate on bottled water than on their tap water?

6.281. Korea further argues that in developed countries as well, bottled water may in fact target an entirely different group of consumers or have different end uses than tap water. Korea gives the example that in Brussels parents are advised not to use tap water to prepare baby formula, as tap water contains too many additives and residues. Parents therefore use much more expensive and purer bottled water. Further, according to Korea, in the United States restaurants commonly serve pitchers of tap water with meals. Nevertheless, quite a number of customers order bottled water, for reasons such as health or taste. According to Korea, despite their ostensible physical similarities and capability for the same end use, these products are not substitutes at all in many countries and markets. Korea asserts that it has been able to ascertain that tap water and bottled water are taxed differently, at least in the EC.²⁶⁸

6.282. Korea also notes the US argument that ‘end use can differ between substitute or competing products. For example, one would not use oranges in an apple pie . . . but these products do compete for consumer spending on fruit purchases.’²⁶⁹ Korea notes the alleged US commitment to the idea that consumers have a fixed budget for classes of expenditure, for example, for fruit purchases and distilled spirit purchases, and wonders, if this proposition is to be central to the US case, whether it is going to provide any evidence in support of it.

6.283. According to Korea, even if that view of the world could be substantiated, the United States in effect concedes, in the quotation above, that apples belong to two distinct budgetary items – consumer spending on fresh fruit and consumer spending on pie fillings. It also allegedly concedes that oranges do not compete in the pie filling segment. In a country where the principal use for fruit is making pies, therefore, substantial changes in the price of apples may have little or no impact on the

²⁶⁷ See EC oral statement, p. 3.

²⁶⁸ Korea states that in Belgium tap water is subject to a VAT of 6% while bottled water is subject to a VAT of 21%.

²⁶⁹ See US oral statement, para. 8.

demand for oranges. In Korea's view, this would be powerful evidence that in that particular country apples and oranges are not directly competitive or substitutable.

6.284. In the present case, according to Korea, the end use for diluted soju with which imported liquors do not compete, is far and away the most important use to which diluted soju is put: it is typically consumed with meals, and the imported beverages are not.²⁷⁰ In Korea's view, that major difference in end use means that the products at issue in this case are neither 'like' nor directly competitive or substitutable.

6.285. Korea adds that, rather than addressing Korea's specific arguments about end uses, the United States tries to divert the discussion back into generalities, saying 'distilled spirits around the world are used for socialisation, relaxation and celebration.' The standard that the US sets for itself is much too low. There are innumerable types of foods and drinks that could be said to serve these general purposes. However, that does not mean that all of those things are 'like' or directly competitive or substitutable.

6.286. Korea notes that both complainants attribute the argument to Korea that in order to be directly competitive or substitutable, products would have to share 'all' possible economic uses. According to Korea, that is not what Korea has been saying, but it has been referring to the most important end use of each liquor. In Korea's view, it has observed that the most important end use of standard soju is different from the most important end use of western-style liquors.

6.287. Korea reiterates that standard soju is typically a 'meal' drink, while the western-style liquors at issue in this case are not drunk with meals, but rather in room salons and other high-class bars where standard soju is not even on offer.

6.288. Korea notes that the European Communities admits that 'soju is more often consumed with every-day meals than western-style spirits', but it argues that this is so 'simply because western-style spirits are more expensive'.²⁷¹ According to Korea, the European Communities would like this Panel to believe that if taxes were harmonised, Koreans would start drinking western-style spirits with their meals, in spite of the fact that, whisky, for example, would still be on average 11 times more expensive than standard soju. Korea disagrees, especially in light of the fact that regardless of price, Koreans do not consider whisky to be appropriate to drink while eating.

6.289. Korea argues that, those facts being uncontested, the European Communities has then tried to say that Korea has been exaggerating, and alleges that Korea has claimed that soju is 'always' drunk with meals. Korea denies claiming that, but has stated that the bulk of standard soju is drunk with meals, which is its most important end use. Korea further alleges that the European Communities claims that sojubangs are one of the most typical places for drinking soju, and supposedly a place where meals are not served. In fact, according to Korea, sojubangs are an exceptional outlet and they do serve meals. This contrasts with the end use of western-style liquors which are hardly, if ever, drunk with meals. According to Korea, the Nielsen study which Korea attached to its written rebuttal bears this out.

6.290. According to Korea, the complainants have not provided any evidence to dispel this important difference in end use. One point they have made much of is that some respondents to Nielsen said that they drank whisky with their meals. That was a very small percentage indeed, and could also be a human error. The complainants are focusing on exceptions again. The ordinary fact of life is that very few, if any, Koreans would buy whisky to drink with their meals at home. They receive whisky as a gift, and enjoy this on a special occasion that is usually not a meal.

²⁷⁰ According to Korea, this is shown by the Nielsen study.

²⁷¹ EC written rebuttal, at para. 115.

6.291. Korea states that soju is not suited to penetrate the establishments where western-style liquors are sold. The main characteristic of soju is that it is an inexpensive meal drink. Barring exceptions, you would not expect to find such a drink in bars. This was borne out by the Nielsen study, which Korea submitted. In Korea's view, the complainants have submitted no evidence to contradict this. The Hankook study, which they submitted earlier on the distribution patterns of liquors only refers to whisky, and ignores soju.²⁷²

6.292. Korea further argues that western-style liquors are not, or very rarely, found in Korean restaurants, mobile street vendors and Chinese restaurants. These establishments always serve standard soju. Western style liquors are found more often, though not always, in Japanese restaurants (presumably as a before or after meal drink, as customers reported that they do not drink whisky with Japanese meals). Japanese restaurants always serve soju. Again, there is a notable difference in distribution.²⁷³ Korea notes that the EC Hankook Study does not even mention restaurants.

6.293. Korea notes the recent visits of US Embassy personnel to Korean restaurants. According to Korea, they are nine of the most expensive restaurants in Seoul. The fact that Embassy officials visit these restaurants explains, Korea suspects, why they had whisky in stock. It really says very little about the drinking behaviour of the vast mass of the Korean population.

(d) Places of sale and consumption

6.294. One of Korea's arguments that standard and distilled soju do not compete with imported liquors has been that diluted soju and distilled soju are not even available in many of the outlets in which imported liquors are consumed, notably, in room salons and other high class bars. In order to provide the Panel with support for that proposition, Korea commissioned the Nielsen study. This study surveyed room salons, night clubs and danlanjums, asking which alcoholic beverages they offered. According to Korea, in this survey, 96.7% responded that they sell whisky, while 0% responded that they offered diluted soju.

6.295. Korea argues that, contrary to what the European Communities seems to suggest, Korea has not argued that whisky has not 'gained considerable distribution penetration'. Korea's point is rather that diluted soju and the western-spirits are not available in the same outlets, an important indicator of a difference in end use and lack of competition. According to Korea, its emphasis has been in particular on the fact that standard soju does not penetrate the establishments where the western-style liquors are available.

6.296. Korea also states that it does not find persuasive the US exhibit showing, for example, Seagram Extra Dry Gin and Alexander vodka next to Korean premium soju in a convenience store.²⁷⁴ According to Korea, the same photograph shows that Gillette shaving foam is also displayed next to these alcoholic beverages. Korea's argument is that convenience stores are pressed for shelf space. The fact that two items are displayed next to each other would hardly be compelling evidence of a competitive relationship in any context, but in the context of a small Korean convenience store, is truly devoid of meaning.

(e) Consumer spending "categories"

6.297. Korea also claims that instead of the classic more detailed analysis outlined above, the United States suggests that the Panel only needs to "consider whether the products in question compete for consumer spending on a category of goods." Korea further claims that the United States asserts that

²⁷² See EC Annex 10.

²⁷³ According to Korea, these are the findings of the AC Nielsen study.

²⁷⁴ US Exhibit G.

"consumers in Korea, like anywhere else, budget their spending on alcoholic beverages, and subsequently spend that budget according to taste, prices and social occasions." Korea believes that the United States is confusing a model of reality with reality. According to Korea, academic researchers may find it interesting to hypothesize that consumers act as if they first decide how much to spend on a category of goods, and then on how that amount will be divided between the goods within the category. That academic researchers may find it interesting to hypothesize, however, is very far from saying that this is how consumers have been shown to behave 'in Korea, as elsewhere'.

6.298. According to Korea, the more important point is that the notion of a category of goods begs the central question in this proceeding. Korea asks how the United States knows what categories are relevant for actual consumers – in particular, for Korean consumers? In Korea's view, it presents no evidence to underpin its conjectures. Korea adds that the United States itself seems unsure of what the relevant category is. Korea notes that sometimes the United States says that it is 'alcoholic beverages', but at other points it is 'alcoholic spirits.' According to Korea, 'alcoholic beverages', which includes wine and beer, is very different, especially in Korea, from 'alcoholic spirits'.

(f) Future competition

6.299. Korea also states that the complainants suggest that the market is developing so that the imported beverages and standard soju and distilled soju might compete in the future.²⁷⁵ Korea considers this assertion to be speculative, at best. If the pre-tax price differences remain the same, there is no reason to assume that future consumers will consider them to be direct substitutes.

6.300. Korea notes the US argument that, Korea's population is changing and becoming more 'internationally-oriented' and it may be that in the future the market for imported beverages will grow. In Korea's view, however, the idea that Koreans may wish to drink more whisky does not mean that they will abandon standard soju as the drink to accompany their meals. The growth, for example, of the whisky market could be completely independent of the standard soju market.

6.301. Korea claims that this was observed by the EC Guide on exports of alcoholic beverages to Korea:

"Soju in particular remains virtually unaffected by imported alcoholic drinks. Furthermore, soju is insulated from economic downturns and maintains a loyal following of steady consumers".²⁷⁶

6.302. Korea argues that if in the future, the market does develop such that standard and distilled soju and the imported liquors compete, then the complainants are free to resort again to WTO proceedings. However, at the present time, the products are not competing, and that lack of competition has not been shown to be tax-related.

5. Broad or narrow interpretation of products in dispute

6.303. Korea notes the EC argument that the GATT drafters aimed to provide stricter rules with respect to internal tax measures (Article III:2) than with respect to other internal regulations (Article III:4), rather than the opposite which is supposedly argued by Korea.

6.304. Korea further notes the EC argument that by including directly competitive or substitutable in Article III:2, the drafters intended to create stricter rules for tax discrimination than for internal

²⁷⁵ See for example, the EC oral statement at p. 5 and the US oral statement at para. 19 et. seq.

²⁷⁶ Korea cites the Sofres report, p. 22.

regulation. If not, they would have limited themselves to 'like products' just as in Article III:4. Korea submits that this is as yet undecided.

6.305. Korea points out that firstly, in *Japan - Taxes on Alcoholic Beverages*, the Panel said that the coverage of Article III:2 might or might not be identical to that of Article III:4.²⁷⁷ In Korea's view, therefore, it is not clear, as the European Communities claims, that the GATT drafters aimed to provide stricter rules with respect to internal tax measures than with respect to other internal regulations.

6.306. According to Korea, however that may be, it does not alter the fact that Article III:2 treads heavily upon national sovereignty. Korea refers to the Appellate Body's statement in *Japan - Taxes on Alcoholic Beverages*, that 'the members of the WTO have made a bargain'.²⁷⁸ In Korea's view, that bargain implies limitations on the sovereignty of the Member in exchange for benefits which they expect to derive as a Member of the WTO.

6.307. Korea argues that in this context, WTO Members agreed that Article III:2 prohibits tax discrimination on 'like products' and on directly competitive or substitutable products. Thus, the language of Article III:2 expresses the concessions that the WTO members were ready to make in this regard. In Korea's view, every concession represents a limitation of the sovereignty of the members. A broad interpretation of the expressed restriction could threaten the carefully negotiated balance between the restriction and the benefit which the members expected from this restriction.

6. "So as to afford protection"

6.308. Korea notes the EC statement that Korea has dealt with the 'so as to afford protection' matter in a 'perfunctory' manner.²⁷⁹ According to Korea, while it is true that Korea does not spend a great deal of time on the 'so as to afford protection' facet of this case, this is mainly because Korea is so convinced that there are no 'like' or directly competitive or substitutable relationships in this case, such that the 'so as' part of this case will never be reached.

6.309. However, Korea has also argues that taxes in this case are not 'so as to afford protection' -- that the price differences in this case are too great for the tax to have afforded any protection to domestic production, in particular the production of standard soju. Korea notes that according to the European Communities, it is illogical to mention these price differences here: if the products concerned are found to be directly competitive or substitutable 'despite the pre-tax price differentials',²⁸⁰ then these price differentials are not really meaningful. In Korea's view this is not a very compelling point, coming from party which has been arguing that price differences are not relevant to a directly competitive or substitutable finding, and that it is sufficient for the Panel to look at physical characteristics only. Thus, according to Korea, if this Panel, despite the force of precedent, followed the EC view on directly competitive or substitutable, the absolute differences in pre-tax prices would be an entirely separate issue to be addressed in connection with the 'so as to afford protection' requirement.

6.310. Because the differences in price are so large, Korea contends that the additional price difference that can be attributed to the tax would not have any effect on consumer behaviour, and therefore could not afford protection to a domestic industry. Korea states that apart from its dubious appeal to logic, the European Communities does not show how the liquor taxes can afford protection,

²⁷⁷ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.20. The Appellate Body did not take a position on this issue.

²⁷⁸ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 15.

²⁷⁹ EC written rebuttal, at para. 1.

²⁸⁰ EC written rebuttal, at para. 166.

to standard soju in particular, given the considerable differences in pre-tax prices with western-style liquors.

6.311. Korea notes that, in contrast, the United States has recognised the pertinence of the price differences to this third leg of Article III:2. While it also contests the relevance of Korea's price-based arguments to the determination of 'like' or directly competitive or substitutable relationships, it argues that 'differences in prices . . . [are] more appropriately considered in the third element of analysis under Article III:2: whether the taxes are applied so as to afford protection to domestic production.'²⁸¹ However, Korea notes that the US has not addressed the price differences cited by Korea in connection with the 'so as to afford protection' requirement.

6.312. Accordingly to Korea, it is clear that the complainants have not carried their burden of proof regarding this third requirement of Article III:2 either. They would have had to show that, despite the much higher pre-tax prices of western-style liquors, the tax differential had protected domestic production of standard soju.

6.313. In respect of distilled soju Korea's defence has been different, as the pre-tax prices of distilled soju are even higher than or in about the same range as western-style liquors. However, according to Korea, the sales of this traditional, artisanal product are minimal. The complainants have not shown how the continued presence of this product, taxed at the current rate, would hurt them.

7. Comments of Korea to the EC Trendscape survey

6.314. Korea notes that at the second substantive meeting of the Panel, the European Communities submitted a new consumer survey which Korea had not seen before.

6.315. Korea submits that interpretation of this survey is not easy, and that the European Communities, by presenting the survey so late in the proceedings, has deprived Korea of the possibility of exploring these problems by questioning specific aspects of it before the Panel.

6.316. Korea claims that some of the "Key Findings of the Consumer survey"²⁸² strongly support points made by Korea by showing, for example, the considerable degree of specialization of Korean outlets for these products. According to Korea, the Trendscape Survey shows that soju is almost never consumed in hotel bars, western restaurants, cafés, room salons and night clubs, but is the drink of choice in Korean restaurants. The survey also allegedly backs up Korea's assertions that whisky is almost never consumed in Korean, Japanese or Chinese restaurants.

6.317. Korea states that the survey also contains results that are inconsistent with Korea's understanding of Korean drinking habits, and is puzzled that 66% of Trendscape respondents claim to drink soju "without a meal" (though only 3% "without food"); and that 86% claim to drink whisky "with food" (though only 7% "with a meal").

6.318. Korea also notes that only 34% of those surveyed by Trendscape responded that they drank soju with their meal. According to Korea, the respondents might have been thinking about meals consumed at home, where according to the Nielsen study, 29.3% of the respondents consumed diluted soju with their meal.

6.319. Korea argues that the Trendscape result is inconsistent with Korea's understanding of the market as far as "on-premise" consumption is concerned. Korea refers to the Nielsen study, wherein it was found that 73% of consumers drank diluted soju with their meals in Korean restaurants.

²⁸¹ US written rebuttal, at para. 70.

²⁸² Trendscape survey, Charts entitled "Key Findings of Consumer Survey".

6.320. Korea further argues that, to interpret the Trendscape results properly, it is necessary to know how respondents distinguished between "meal" and "food". According to Korea, the distinction between "food" and "meal" is vague and dependent on context in Korean and English. Korea recalls that in referring to the main end use of soju as meals, it has excluded snacks.

6.321. Korea maintains that western-style liquors like whisky are not normally drunk with meals (i.e. lunch or dinner) whereas most soju is consumed with meals.

6.322. Korea also argues that another ambiguity arises from the Trendscape Survey's use of the term "umsik" for "food". According to Korea, the usual meaning of "umsik" in Korean is "food and drink", and as such "umsik" can be interpreted broadly to include drinks as well as snacks. In Korea's view, this ambiguity would mean that respondents who, for example, eat peanuts with their whisky may well have answered that they drink whisky "with food".

6.323. Korea asserts that there is also an ambiguity in the definition of "with meals". Korea poses the question whether "with meals" was necessarily interpreted by their respondents as eating contemporaneously with drinking, or whether it was interpreted more liberally to include "before dinner" and "after dinner" meals.

6.324. Korea points out that there is also an ambiguity in the sense that it is unclear whether the respondents, being faced with questions about food and meals at the same time, would have considered the questions as mutually exclusive. In Korea's view, some respondents might have thought that the questions about "food" were intended not to include "meals", while others might have assumed that because meals are food, then soju which is usually consumed with meals is as of necessity consumed with food too.

6.325. Korea submits that since the complainants have submitted this survey too late, it did not have the opportunity to pursue the ambiguities with questions through the Panel. Korea adds that this late submission of this survey also means that there is insufficient time to evaluate its evidentiary value, and therefore, the panel should disregard it.

D. EC AND US COMMENTS ON THE NIELSEN STUDY

6.326. The complainants responded to this survey, which was commissioned at the instance of Korea, by pointing out that there were several categories of overlapping end-uses. They state for example, that all Japanese restaurants served soju and 40% of them served whisky; a further 6.7% served brandy or cognac. According to the complainants, of the responding Western-style restaurants and cafés, 90% served whisky and a lesser number served other types of western-style beverages, and 21.7% served soju.

6.327. The complainants also note that while only 1.7% of the individual respondents drank whisky at home with meals, only 29.3% of all respondents consumed any alcoholic beverages at home with meals. In the complainants view, the proper comparison was that between the 1.7% and the 29.3%, thus leaving 5.8% of all respondents who consumed alcoholic beverages at home as drinkers of whisky with their meals.

6.328. The complainants have also questioned some of the findings of the Nielsen study, arguing that these results are actually indications of overlapping end-uses. The complainants note that there were almost no western-style beverages in Korea until the last five years following changes in the duty rates on imported distilled beverages.

6.329. The complainants argue that alcoholic beverages, like many foods and beverages, are habit based products. In their view, people tend to purchase what they are used to and change their tastes

only over a period of time. They must become familiar with the taste of new products and will only make minor substitutions for the familiar product at first and more significant changes will tend to occur over a period of time until a fairly stable rate is achieved.

6.330. According to the complainants, the trends shown in the Nielsen study, as well as the substitutability shown in the EC market survey (the Dodwell study), show unmistakable evidence of the beginnings of substitutability and common end-use by imports.

6.331. The United States claims that the Nielsen study also contradicts Korea's emphasis that soju is only drunk straight in alleged contrast to Western spirits. According to the United States, survey respondents reported that in addition to being drunk straight, standard soju is consumed mixed with cola, cider, juice or some other manner. The results confirm that even if standard soju were predominantly consumed straight by survey respondents, it was not consumed *only* straight. Moreover, survey respondents were asked how they "normally" like to drink standard soju and whisky, and they were limited to a single response, suggesting that the reporting of multiple styles of consumption were avoided by the design of the question.

6.332. The United States further notes that the results of the Nielsen study also run counter to the supposedly rigid styles of whiskey consumption Korea paints in its submissions and first oral statement. For example, one-third of the survey respondents reported preferring consuming whisky straight and a smaller percentage indicated, similar to standard soju, a preference for whisky mixed with cola, cider, and juice. According to the United States, with a third of respondents preferring their whisky straight, just as Korea claims standard soju is largely consumed, it is clear that whisky and soju consumption styles overlap significantly.

6.333. The United States further claims that the Nielsen study also directly undermines Korea's assertion that soju is "never drunk mixed." Korea says this assertion was based on "common knowledge,"²⁸³ but apparently such common knowledge may not be a reliable source of information. Korea has insisted that the burden is for the complaining parties to show its factual assertions to be untrue. In our view, the Nielsen study's direct contradiction of Korea's so-called common knowledge places doubt on all similar unsubstantiated assertions by Korea concerning consumption in its market.

6.334. The United States asserts that, in response to the Korean Nielsen study, the U.S. Embassy in Korea identified nine large traditional Korean restaurants in Seoul that serve traditional Korean food based on the common knowledge among Embassy staff. U.S. embassy employees then asked whether the establishments served whiskey and whether they served soju. It turned out that every single one of these nine restaurants serves both soju and whisky.²⁸⁴ The United States does not claim to have taken a representative market survey, but such a survey is not necessary for the point at hand. We are simply saying that Korea's depiction of stratified end uses in different restaurants in Korea is contradicted by a simple tour of its capital city. These observations based on simple anecdotal evidence stand in stark contrast to the Nielsen finding that no surveyed Korean style restaurants served whisky and soju, whether in Seoul or elsewhere. This tends to confirm that the Nielsen study selectively sampled the restaurants known to limit the variety of spirits, representing an additional bias in the sampling. Moreover, the Trendscape survey, which the EC has described in detail earlier, further contradicts the Nielsen results by also showing that whisky is consumed at venues such as Korean restaurants where soju is the main item. Additionally, the Trendscape study shows that soju, similar to whisky, is most often enjoyed without meals.

6.335. According to the United States, even if the Panel were to accept these contradictions and biases, the Nielsen survey, highlighted by the EC, survey in fact lends credible support to the U.S.

²⁸³ Korean response to a U.S. Question.

²⁸⁴ US Exhibit S.

position in this case by indicating significant overlaps in usage between soju and Western spirits. Again, given the recent removal of barriers to entry, it is not expected that Western spirits will be consumed in every venue and in equal proportions to the traditional Korean spirit of soju. Nevertheless, the survey indicates whisky is consumed with meals, whisky is served in three out of six types of restaurants surveyed (four out of seven if you include hotel bars), and whisky and soju are both consumed straight, or mixed with cola, cider or juice.

VII. ANSWERS TO QUESTIONS

A. EUROPEAN COMMUNITIES

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

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

²⁸⁵ Appellate Body Report, *supra.*, p. 25.

²⁸⁶ Ibid.

²⁸⁷ Ibid.

that delays or prevents imported products from ever reaching that level of market penetration. Clearly, such an approach is at odds with the well-established principle that Article III protects "competitive opportunities". There is no reason to limit such "opportunities" to those that are available to a product in the very short term. Article III protects any competitive opportunities that a given product may have by reason of its inherent characteristics.

- (g) In connection with this question, the European Communities further argued that the Dodwell study does not purport to provide a precise measurement of cross-price elasticity. In order to do that, it would have been necessary to carry out an econometric analysis based on historic sales and price data. In the present case, however, that type of analysis was precluded by the fact that western spirits have been virtually excluded from the Korean market until only a few years ago. This means that the available sales and price data are too few to allow a statistically valid analysis.
- (h) The Dodwell study has a more modest purpose. It aims at testing by means of a consumer survey the hypothesis that a reduction in the prices of western spirits and/or increase in the prices of soju resulting from the elimination of the existing tax differentials will lead to an increase in the consumption of western-style spirits at the expense of soju. The results of the Dodwell study clearly validate that hypothesis.
- (i) Additionally, the study indicates that the extent of potential substitution could be significant. For example, in one of the possible after-tax harmonization price scenarios the percentage of respondents who would choose whisky instead of standard soju would increase from 14.2% to 23.8%. While, for the reasons explained elsewhere, it was appropriate to distinguish in the survey between premium and standard soju, this has the consequence that the survey only measures the shift of respondents from standard soju to western spirits, and not the additional shift from premium soju to western spirits. Furthermore, since the prices of premium soju are not increased in parallel with the prices of standard soju (so as to reflect the fact that taxes would be increased on all diluted soju), but rather decreased, the survey overestimates the shift from standard to premium soju at the expense of the shift from standard soju to western spirits. In comparison, in the same scenario, the percentage of respondents choosing premium soju would increase from 12.6% to 19.8%. Thus, the Dodwell study suggests that the elasticity of substitution between standard soju and whisky could be higher than the elasticity of substitution between standard soju and premium soju, two products which have been described by Korea as being close "substitutes".
- (j) Moreover, it should be borne in mind that a consumer survey like the Dodwell study necessarily underestimates the degree of potential competition between soju and western spirits.
- (k) In the first place, the Dodwell survey can show only the immediate reaction of consumers to price changes. Yet, spirits consumption is to a large extent based on habits, which only change gradually. This means that, over a certain period of time, the price changes resulting from the elimination of tax differentials will lead to a more substantial shift from soju to western spirits than the one shown in the Dodwell study.
- (l) Secondly, it must be recalled that western spirits are new entrants in the Korean market and still hold only a small share of that market. This has two implications.

The first one is that the respondents are generally less familiar with western spirits than with soju. This leads to a lower response in the survey than in the case of two products which were both well known to the respondents. The second implication is that western spirits still have considerable potential to increase their share of the market through marketing efforts (in advertising, distribution, etc.). The impact of those efforts would be considerably boosted by the price changes envisaged in the Dodwell study. On the other hand, the continued application of protective taxation would discourage such efforts. The interaction of these two factors, however, is not and cannot be addressed by a survey like the Dodwell study.

- (m) Finally, the Dodwell study considers only the price changes that could result directly from the elimination of the existing tax differentials. It does not take into account that the elimination of tax differentials could lead as well to a decrease of the pre-tax prices of western spirits and, consequently, to further substitution.

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

- (a) In *Japan - Taxes on Alcoholic Beverages II*, the complainants expressed different views with respect to the interpretation of the third element of Article III:2, second sentence. The European Communities argued that the measures at issue afforded protection to domestic production because a majority of the sales of the less taxed product (shochu) were domestically produced in Japan. In turn, the United States argued that the measures afforded protection to domestic production because their structure and design evidenced that they were not aimed at achieving any legitimate policy objective but only at providing an advantage to Japanese shochu. The approach established by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* appears to combine both positions. While putting the emphasis on the objective aim of the measures, as revealed by their structure and design,²⁸⁸ the Appellate Body also noted the fact that Japanese shochu was "isolated" from imports of shochu²⁸⁹. Thus, the Appellate Body seems to have considered that the demonstrated actual protective effects of a measure may be taken into account as an indication that a measure is aimed at protecting domestic production.²⁹⁰
- (b) On the other hand, there is no suggestion in *Japan - Taxes on Alcoholic Beverages II* that in order to meet the third element of Article III:2, the tax measures must afford a minimum "degree" of protection to the less taxed product. The Appellate Body agreed with the Panel that the reasoning required under Article III:2, second sentence, is the following:

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.²⁹¹
- (c) Thus, the third element of Article III:2, second sentence, is concerned only and exclusively with the question whether, by taxing one product less than another

²⁸⁸ Ibid., p. 29.

²⁸⁹ Ibid., p. 31.

²⁹⁰ See also the Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, pp. 31-32.

²⁹¹ Ibid., p. 29.

directly competitive or substitutable product, the measures "favour" domestic production over imports, not with the extent of the "protection" afforded to the less taxed²⁹² product. In other words, the third element of Article III:2, second sentence, is not about how much protection is afforded, but rather about who is protected.

- (d) The view that in order to establish a violation of Article III:2 it is necessary for the complainants to show that the measures actually afford a certain "degree" of protection by effectively reducing sales of imports above a *de minimis* level would be in contradiction with the well established principle that GATT Article III is concerned with the protection of competitive opportunities and not of actual trade flows. More specifically, according to the Appellate Body:

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

- (e) In sum, the European Communities is of the view that the third element of Article III:2, second sentence, does not introduce another *de minimis* threshold, in addition to those which result from the application of the first and the second element. If two products are "directly" competitive or substitutable, any tax differential above the *de minimis* level must be deemed to affect that competitive relationship and, as result, to "protect" the less taxes product. The only remaining issue is then whether the "protection" given to the less taxed product favours a "domestic production".

7.3. In response to a question concerning the price mix of exports to Korea compared to other markets, the European Communities states that:

- (a) The pre-tax prices of western spirits are not higher than the pre-tax prices of soju only because of Korea's Liquor Tax system. The differences in prices reflect also differences in production and transportation costs as well as the impact of tariffs. Nevertheless, the pre-tax prices of western spirits are higher than they would be under a neutral tax system.
- (b) As already explained in the EC submissions, one of the effects of Korea's tax regime is that higher priced premium brands account for a disproportionate share of the sales of western spirits. For example, as shown by Annex 1, premium brands account for as much as 70 per cent of all sales of Scotch whisky in Korea. The same Annex shows that in a number of representative export markets with a neutral system of taxation the proportion of premium brands is much lower: 3 per cent in Australia; 6 per cent in New Zealand and 14 per cent in Venezuela. The preponderance of premium brands in the Korean market as compared to other export markets is further confirmed by the fact that whereas in 1997 the average unit price of all exports of Scotch whisky (for 70 cubic litre bottles at 40% volume) was £2.79, the average unit price of the exports of Scotch whisky to Korea was £4.42.

²⁹² In contrast, under Article III:2, first sentence, it is not necessary to demonstrate that a difference in taxation between two types of "like" products leads to discrimination between imports and "domestic production". Like products must always be taxes equally.

²⁹³ Ibid., p. 16.

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

- (a) The basic criteria applied in order to define the relevant product market for the purposes of EC Competition law are the same as those applied in order to establish whether products are directly competitive or substitutable for the purposes of GATT Article III:2, second sentence".²⁹⁴
- (b) There is, nevertheless, an essential difference. When applying GATT Article III:2, first sentence, Panels must take into account the "potential" competition which would materialise between the products concerned in the absence of the tax differential in dispute and not the "actual" competition existing under current taxation conditions. In contrast, competition authorities tend to consider tax differentials as a permanent barrier to competition and disregard any additional competition which may arise from removing that barrier.²⁹⁵ As a result, the scope of the "relevant product" markets defined for competition purposes will generally be narrower than the scope of "directly competitive products" defined for the purposes of Article III:2, second sentence.
- (c) It must also be borne in mind that the notions of "competition" and of "substitutability" are relative ones. From an economic perspective, two products are not either "competitive" or "non competitive". Rather, products are "more or less" competitive. For that reason, as important as the criteria for defining a relevant market or for defining the notion of "directly competitive or substitutable products" is the degree of competition which is deemed relevant in each case. That degree will determine the standard by which the criteria are to be interpreted. That standard may vary depending on the purpose of the legal provision to be applied. It may vary also from one jurisdiction to another.
- (d) This link is expressly recognised in an EC Commission Notice on the definition of relevant markets for Competition law purposes, which states that "the concept of relevant market is closely related to the objectives pursued under Community competition policy".²⁹⁶ Further, that Notice acknowledges that the definition of the relevant market may vary depending "on the nature of the competition issue being examined."²⁹⁷

²⁹⁴ The applicable EC competition regulations define the notion of "relevant product market" for the purposes of EC Competition law as follows:

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

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

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

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

²⁹⁶ Notice, para 10.

²⁹⁷ Notice, para 12.

- (e) In this regard, it is clear that the objective of competition law is very different from the objective pursued by GATT Article III:2, and more generally by the WTO Agreement. The general objective of competition law is to preserve a certain degree of competition against action by the market participants. If the competition authorities of a certain country aim at maintaining a high degree of effective competition, they will apply the relevant criteria strictly, thereby arriving at a narrow definition of the relevant market.
- (f) On the other hand, the purpose of GATT Article III:2, second sentence is to prevent Members from applying internal taxation so as to afford protection to domestic production. Unlike the objective of competition law, the objective of Article III:2, second sentence, is furthered by a broad interpretation of the relevant criteria, rather than a strict one.
- (g) For the above reasons, the EC is of the view that the decisions taken by its competition authorities with regard to the definition of relevant product markets are devoid of relevance for the purposes of applying the notion of "directly competitive or substitutable products" in this dispute.
- (h) In this regard, a parallelism can be drawn to the notion of "like product". The criteria for applying the notion of "like products" are the same in all the GATT provisions where that notion is found. Yet, in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body confirmed that the notion of "like products" is a relative one which may have a different scope in each GATT provision concerned.²⁹⁸ In Article III:2, first sentence, it must be construed narrowly. In other GATT provisions, it may be construed more broadly. *A fortiori*, the notion of "directly competitive or substitutable" may also have a different scope in Article III:2 of GATT and in the competition laws of Members, which pursue an altogether different objective.
- (i) More relevant for the interpretation of GATT Article III:2 is the case law of the European Court of Justice (ECJ) regarding the application of Article 95 of the EC Treaty,²⁹⁹ whose wording is almost identical to that of GATT Article III:2 and therefore, unlike EC Competition Law, shares a similar purpose. In a long line of cases, the ECJ has concluded that all distilled spirits are either "similar" (the equivalent concept of "like") or "directly competitive or substitutable".³⁰⁰

²⁹⁸ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, pp. 21-22

²⁹⁹ Article 95 of the EC Treaty reads as follows in the pertinent part:

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

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

³⁰⁰ The standard reasoning followed by the ECJ in those cases is the following:

"There is, in the case of spirits considered as a whole, an indeterminate number of beverages which must be classified as "similar products" within the meaning of the first paragraph of Article 95, although it may be difficult to decide this in specific cases, in view of the nature of the factors implied by distinguishing criteria such as flavour and consumer habits. Secondly, even in cases in which it is possible to recognise a sufficient degree of similarity between the products concerned, there are nevertheless, in the case of all spirits, common characteristics which are sufficiently pronounced to accept that in all cases there is at least partial or potential competition. It follows that the application of the second paragraph of Article 95 may come into consideration in cases in which the relationship of similarity between the specific

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

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

B. UNITED STATES

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

- (a) The standard that should be used to establish that two products are "directly competitive or substitutable" within the meaning of Article III:2 is a case-by-case examination that may consider a number of factors. There is no one standard that can operate across all cases. Cross-price elasticity is but one factor that may be helpful in conducting an analysis of whether products are directly competitive or substitutable. It is unlikely that a very low cross-price elasticity in and of itself will be sufficient to make a determination in any particular case.
- (b) The quotation from the second US submission expresses the economic point that any shift away from one product to another in response to a relative rise in the first product's price is a sign of cross-price elasticity and therefore substitutability. However, the US response did not purport to establish what degree of substitutability was "direct" within the meaning of Article III:2. Clearly the word "directly" in the Note *Ad* Article III:2 places some limits on the scope of Article III:2. However, this case does not present a situation where it is necessary to test those limits. In this case, the products are physically similar, and several other factors support the fact that the products are directly competitive or substitutable.
- (c) The Panel should be in a position to determine substitutability largely on the basis of common physical characteristics, which are reflected in a common HS heading,³⁰²

varieties of spirits remains doubtful or contested" (Judgement of the ECJ of 27 February 1980, *Commission of the European Communities v Kingdom of Denmark*, Case 171/78, ECR 1980, 447, at par. 12)

³⁰¹ Panel Report on *US - Standards for Reformulated and Conventional Gasoline*, adopted on 20 May 1996, WT/DS2/R, para 6.11-6.12

³⁰² According to the United States, contrary to Korea's allegation, the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* did not reject the existence of a single tariff heading as significant guidance in examining substitutability. The Appellate Body distinguished between tariff nomenclature and tariff bindings,

and the Dodwell study presents evidence of a supplementary nature. The Appellate Body in *Japan - Taxes on Alcoholic Beverages II* did not, as Korea has claimed incorrectly, require a market analysis or prescribe the use of a cross-price elasticity study as the sole means of establishing whether products are directly competitive or substitutable. To the contrary, the issue only arose because some parties argued it was inappropriate to place undue emphasis on the market place generally or such studies specifically. The Appellate Body first determined that it "did not seem appropriate" to look at the actual market in addition to physical characteristics, common end uses and tariff classification. In approving the Panel's use of the ASI cross-price elasticity study (which the Dodwell study emulated) the Appellate Body underscored that cross-price elasticity of demand was not the "decisive criterion" for its determination that the products were directly competitive or substitutable. The Appellate body Report finds no support for the suggestion that a failure to show a positive cross-price elasticity in general or a particular cross-price elasticity can be the basis for concluding that products are not directly competitive or substitutable under GATT Article III:2.

7.7. In response to a question about whether there is a *de minimis* standard in assessing the question of "so as to afford protection", the United States argues that:

- (a) the criterion for meeting the third element of the analysis under the second sentence of Article III:2 is set out by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*:

"[P]rotective application can most often be discerned from the design, the architecture, and the revealing structure of the measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such a protective application, as the Panel rightly concluded in this case. Most often, there will be other factors to be considered as well. In concluding this inquiry, panels should give full consideration to all the relevant facts and all the relevant circumstances in any given case".³⁰³

- (b) In concluding that the panel had not erred in determining that the tax was protective solely on the basis of the large differentials between tax rates applied to shochu and Western spirits, the Appellate Body appears to have reasoned that the large differences between such physically similar products could not be otherwise explained. The United States considers that the magnitude of the differences in tax rates between such similar products in this case compel the same inference. On the other hand, however, the Appellate Body did not determine that panels must find a large differential in rates in order to find protective application; the differentials in rates is addressed by the second element of the Article III:2 analysis, whether the products are not "similarly taxed".
- (c) It would not be appropriate to determine that a measure does not have a protective application simply on the basis of significantly different pre-tax prices. A number of factors can affect pre-tax prices, such as exchange rates, and recent experience has

which it said could include a wide range of products and therefore must be viewed with caution in examining the term "like". Appellate Body Report, *supra.*, pp.21-22.

³⁰³ Appellate Body Report, *supra.*, p. 29.

shown how quickly those factors can change. It would not be appropriate to base determination of protective effect on a "snapshot" of pre-tax prices. Instead, the Appellate Body Report makes it clear that the panel must examine all the facts and circumstances concerning the structure of the law. In this instance, the structure of Korea's Liquor Tax Law distinguishes between products on the basis of arbitrary physical characteristics in a way that can only be explained by an intention to identify and define products that happen to be imported. Combined with Korea's long history of protecting soju from imports of western spirits, the differential tax rates then further support the conclusion that the law is structured to protect imports.

- (d) There is no de minimis interpretation of the concept "so as to afford protection to domestic production." The prohibition is absolute - any measure applied so as to afford protection of a directly competitive or substitutable import that is not "similarly" taxed is providing too much protection.
- (e) In light of the Appellate Body's emphasis on the structure of the measure, it would not be appropriate to limit the inquiry to the tax differentials and require a complaining party to determine the extent to which in the current market, with respect to current products at current prices, the taxes are effective in reducing sales of imports. Such an approach would, at a minimum, be at odds with the basic principles of the WTO Agreement. As Korea's law applies obviously punitive taxes on Western spirits not on the basis of price differences, but on the basis of arbitrarily physical criteria, the higher rates adversely affect all products within the criteria - including products in a wide range of prices available in the United States.

7.8. In response to a question concerning the price mix of exports to Korea compared to other markets, the United States argues that:

- (a) The pre-tax prices of imports reflect costs such as transportation and tariffs (20% ad valorem in Korea), costs that are not reflected in prices of domestic products. The punitive taxes on Western spirits likely contribute to higher pre-tax prices than would otherwise exist under a neutral tax structure".
- (b) The majority of imports of distilled spirits into Korea are from the European Community, and accordingly, the United States is not in a position to draw any general conclusions about marketing of obvious brands in the Korean market at this time. Aside from some bulk shipments, the overwhelming majority of US exports are of Jack Daniels and Jim Beam Whisky, brands which enjoy particular international name recognition. Such name recognition is of particular value in developing a presence in new markets due to the high costs of exporting.
- (c) The US Government does not have access to the pre-tax prices charged by distilled spirits around the world by particular brand, which, according to industry representatives, is considered confidential information by the respective companies.

7.9. In response to Panel questions and arguments raised by Korea with respect to competition issues, the United States notes that it did not consider it would be appropriate to borrow market analysis under national competition laws in analyzing what products are "directly competitive or substitutable" for purposes of Article III:2. The United States considers it important to bear in mind the different objectives of antitrust law, on the one hand, and of GATT Article III:2 on the other. Article 3.2 of the DSU makes clear that the provisions of the GATT 1994 and other WTO agreements are to be construed "in accordance with customary rules of interpretation of public international law." As the Appellate Body has noted on several occasions, Articles 31 and 32 of the Vienna Convention

of the Law of Treaties embody the customary international law of interpretation. Article 31 sets forth the basic principle that treaties are to 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.”

7.10. According to the United States, consistent with this principle, GATT Article III:2 should be interpreted in the light of the overall purpose of Article III, which is “to avoid protectionism in the application of internal tax and regulatory measures.”³⁰⁴ Article III is an anti-discrimination provision aimed at ensuring that government measures do not skew competitive conditions in favor of domestic products. Competition laws, by contrast, address privately-created threats to market competition, regardless of whether the competing producers or products are domestic or foreign. Because the object and purpose of the two sets of rules are quite different, it would not be appropriate to borrow and apply a competition analysis in deciding whether a tax measure is consistent with GATT Article III:2.

C. KOREA

7.11. In response to a question concerning the ingredients and comparability of pre-mixes, Korea states that:

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

³⁰⁴ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 16.

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

<u>Pre-mixes</u> (Lemon/cherry remixes)	<u>Standard soju</u> (Green, Chungsaek soju)
Sugar	Sugar
Citric Acid	Stevioside
Co2 Gas	Citric Acid
Lemon/Cherry concentrate	Mineral Salt
Acerola juice concentrate	Amino acid
Lemon/cherry spices	Solbitol
Food colours	
Fructose	
Stevioside	

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

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

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

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

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

(a) Choice subject to large random elements

- (i) If one were seeking an explanation of ostensible inconsistencies of choice in real life, the idea that choice is subject to a large random element would be an obvious first hypothesis. It leads to a view of buyers choosing good X one day or hour and good Y the next, depending on mood or a host of other circumstances. The relative price of X and Y might affect the frequency with which each is chosen. In a short enough period of observation, however, the random element might dominate, so that some consumers will appear to respond to a rise in the price of X by buying less Y.
- (ii) As an explanation of inconsistencies in answers to a questionnaire based upon hypothetical prices, however, this hypothesis is problematic. An interview will normally be short, so that mood or other factors that might drive the purchase of one good rather than another might reasonably be assumed to be constant throughout the interview. If that assumption is correct, however, random elements affecting demand cannot be called upon to explain inconsistencies in results.
- (iii) Of course, the assumption that mood is constant through the interview may be false. If it is false, however, interpretation of the results of the survey faces a different problem. In the present context, for example, the purpose of the Dodwell survey is to isolate the effects of changes in prices from other factors that might affect demand. But if mood or other factors change within the interview, or if respondents are allowed to imagine themselves making one choice in one mood, and another choice in another mood, the interview has failed to isolate changes in prices from other factors affecting demand. Its results will give a false picture of the effect of prices on demand.

(b) Mistakes in reporting responses

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

(c) Possible explanation of unexpected responses

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

(d) Gifts and prices

- (i) Respondents who think they are being asked about a single bottle purchase, may answer questions with the purchase of a bottle of spirits as a gift in mind. In that case, however, they might respond to price changes in ways that appear perverse. A reduction in price might make a spirit less desirable as a gift, and an increase might make it more desirable. The position would

be further complicated if respondents answered some questions thinking in terms of gifts, and some questions thinking in terms of personal consumption.

- (ii) But while the gift motive might in principle explain ostensibly perverse reactions to changes in price, it lacks explanatory power in the present case. That is because, first, it is inconsistent rather than perverse reactions that are primarily at issue here. Second, the inconsistent reactions in chart 2 are responses to changes in the price of soju, not whisky, and standard soju is not usually given as a gift: it is too cheap to play that role.
- (e) Whisky and soju are complements in consumption
 - (i) There is no great difficulty in imagining circumstances in which two alcoholic beverages are complements, at least for some drinkers. In some communities, for example, whisky is typically drunk with a beer "chaser". Alternatively, drinkers might follow a ritual of drinking two rounds of whisky and then two rounds of beer. In either case, beer and whisky might behave as complements rather than substitutes - rather than a rise in the price of whisky increasing the quantity consumed of beer, which is what would happen if beer and whisky were substitutes, the rise in the price of whisky might reduce the quantity consumed of beer.
 - (ii) Drinkers may act as if whisky and a beer chaser, for example, is a single drink. Thus, an increase in the price of either beer or whisky will reduce the number of drinks taken. It will therefore reduce the quantity consumed of the drink whose price has remained constant.
 - (iii) The problem, though, is that in Dodwell Chart 2, whisky and soju act like substitutes when the price of soju rises from 1 000 to 1 100 won, but like complements when the price of soju rises from 1 100 to 1 200. It is not the latter fact that is hard to explain (at least in principle!) - it is the inconsistency between the two.
 - (iv) One might think in terms of a population made up of some drinkers who regard scotch and soju as substitutes, and some who regard them as complements. For some price changes the first group dominates, while for others the second group determines the direction of the net change.
 - (v) Before pressing along that theoretical path, however, it is well to recall what is driving the problem. At issue is the effect of a 100-won change in the price of a bottle of soju³⁰⁶. But for soju and scotch to be complements, they must be drunk in a tight combination with one another. What then counts is the price of the combination. But with the price of scotch so many multiples of the price of soju, a 10 per cent change in the price of soju will have only a very small effect on the price of a soju-whisky *combination*. For a 100-won rise in the price of soju to cause the number selecting premium whisky to fall from 41 to 36, and the number selecting standard scotch to fall from 56 to 49 requires a sensitivity to price that is neither plausible nor suggested by anything else in the Dodwell findings.

³⁰⁶ At the current exchange rate, 100 won equals US\$ 0.0691 and ECU 0.0637 (as of 23 March 1998).

- (f) Korea concludes by noting that in its first submission, it described the inconsistencies as "troubling", but commented that the Dodwell Study "has much more serious problems".³⁰⁷ Korea sees no reason to change that assessment.
- (g) Korea also continues to believe that the attention of respondents might have wandered during their progress though the 16 sets of hypothetical prices offered them by Dodwell interviews (to say nothing of that of the interviewers themselves). That hypothesis is the one that seems to best fit the facts.

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

- (a) For the benefit of the Panel Korea hereby provides an answer related to the water content of both standard and distilled soju and also explains briefly the manufacturing process to better understand the differences.
- (b) In case of standard soju, water is added before and after distillation. Prior to distillation, one steams tapioca and/or sweet potatoes so that they are in a mashed form. Second, water is added. Third, enzymes and yeast are added so that the mashed tapioca and/or sweet potatoes will ferment. This fermentation process will lead to a 10-11 per cent alcoholic content liquid which is in a sludge form. The ingredients constitute 20 per cent, water 79.9 per cent and yeast 0.1 per cent.
- (c) Then the material undergoes continuous distillation until one obtains as pure an alcohol as possible (95 per cent ethyl alcohol). After distillation, water is added and then six to seven additives are inserted. Ethyl alcohol (joojung) constitutes 26.4 per cent and water constitutes 73.6 per cent at this stage.
- (d) Contrary to the notion that standard soju is simply a diluted form of distilled soju, the latter uses different base materials, primarily rice and sometimes other grains. Water is added only prior to distillation. No water is added after distillation. Producing a 45 per cent distilled soju through single distillation is a know-how developed by Korean producers over several hundred years.
- (e) In case of distilled soju, one takes white rice and steams it. Afterwards, one adds water and yeast which acts as a catalyst to commence the fermentation process. The ingredients take up 40 per cent, water 59 per cent and yeast 1 per cent. After the material ferments, one has a product which has a low alcoholic content. Then the fermented product undergoes a single distillation so that the final product has 45 per cent alcoholic content. No water is added after distillation.

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

	<u>Before distillation</u>	<u>After distillation</u>
Standard soju	79.9%	73.6%
Distilled soju	59.0%	0%

³⁰⁷ See Attachment 2 of Korea, p.6.

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

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

	Jinro Gold	Jinro Export
Alcohol content	25%	25%
Citric acid	x	x
Sugar (natural)		x
Fructose	x	
Oligosaccharide	x	
Stevioside	x	
Refined salt	x	
Amino acid	x	

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

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

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

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

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

- (b) Price has an impact upon the competitive relationship between products. Where prices vary greatly, this can mean that two products do not compete. In the example given by the Panel of cheap wine and a rare Bordeaux, it might be that in a particular market the large difference in price means that the two products do not compete, and are therefore neither "like" nor directly competitive or substitutable products. This is so because most consumers will not consider a \$1 000 bottle of wine to be a substitute for a \$5 bottle of wine, notwithstanding apparent similarities concerning physical characteristics between the two products (colour, packaging, alcoholic content).
- (c) That conclusion is likely to be supported by other divergences. Indeed, the fact that a person chooses to pay more for a rare bordeaux when he or she has the option of buying a cheap table wine is a measure of the differences between the two products. Between a cheap wine and a vintage bordeaux, for example, important differences might be the age of the wines, the type, year, and provenance of the grapes used, the blending, the way the wine was cared for and stored, all of which have an impact on the organoleptic qualities of the wine. The rare bordeaux might come from a famous vineyard or chateau, and the purchaser might not be interested in drinking the wine at all, or at least not with a regular meal. He might see it as an investment or as a wine for very special occasions. These types of differences would also support the conclusion that these products are not "like" or directly competitive or substitutable products.
- (d) In the case at hand, Korea has shown that price is an important factor in the directly competitive or substitutable products, and therefore, "like" product analysis. The complainants' own evidence (notably, the Dodwell Study) indicated that there are no overlaps in the prices of standard and premium soju on the one hand, and western-style spirits on the other hand. Thus, the most expensive form of standard soju (i.e., premium) is still much less expensive than the cheapest western-style spirits. In contrast, prices of wine might cover a whole range of prices.
- (e) Moreover, the products in this case also differ in a number of other ways, in particular in their physical characteristics and end uses. Korea maintains that an overall assessment of the products at issue in this case must lead to the conclusion that these products are neither "like" nor directly competitive or substitutable products.

³⁰⁸ See Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.22.

7.17. In response to a question about the likeness or competitiveness of physically similar products, Korea states that:

- (a) When two products are physically identical in the sense that no known test or procedure can distinguish between them, it seems to Korea that the products must be like. Physical identity in this strict sense, however, seems to imply either that the market prices of the products are the same, or that only one of them is sold, or that consumers are ignorant of their likeness. If two products both appear in a market, selling at different prices, but chemists, physicists, or other experts maintain that they cannot distinguish between them, there is therefore a problem. In effect, there is a conflict of evidence experts say they cannot detect any differences but consumers of the products act as if they can.
- (b) In that event, Korea does not believe that the expert evidence alone is enough to declare the products either "like" or "directly competitive or substitutable products". To take that step, it is necessary to refute the hypotheses that the expert tests are incapable of detecting differences that are significant to consumers; or that the experts have not properly designed or targeted their tests to detect them; or that they are misinterpreting their results.
- (c) With respect to "physically identical or nearly so", it seems to Korea that the addition of "or nearly so" to "physically identical" raises difficulties. One problem is circularity; defining "nearly so" so that any change in the product that has only a small effect on consumer demand is judged to leave a "nearly identical" product, whereas any change that has a substantial effect on demand is judged to lead to a different product. Such a definition of "nearly identical" would render this question meaningless - if such a definition is used, products that fall under it are likely to be directly competitive or substitutable products.
- (d) Korea believes, however, that many changes that are "small" in a technical sense will lead to products that are very different by the test of market performance. To take one example, the addition to a food or drink product of small amounts of an unpleasant substance, or a substance perceived to be unpleasant, may, if known to consumers, cause demand for the product to fall to zero, even though the substance does not alter taste or threaten health and its presence cannot be detected by consumers. The "small" addition may convert a sought-after product into one that is no longer saleable at any price. Moreover, the elasticity of substitution between the original product and the "nearly identical" product may be zero or insignificant. Korea is far from convinced that "nearly identical products" with different market demands and prices and a low or zero cross-price elasticity of demand should be considered directly competitive or substitutable products.
- (e) Korea believes that products may be physically identical or nearly so but not directly competitive or substitutable products. Korea believes that differences that are small in a technical sense may be important to buyers, and that performance in the market place is the ultimate test of directly competitive or substitutable. Alternatively stated, Korea does not believe that there is any technical short-cut that can determine direct competitiveness or substitutability without reference to market performance.

- (f) The relevant physical distinctions are those that are important to customers. The WTO is concerned with markets, and markets are ultimately dependent on consumer tastes and habits. In the present case, regarding spirits, Korea has pointed to the following distinguishing physical characteristics:
- (i) raw materials, additives
 - (ii) production process
 - (iii) alcohol percentage
 - (iv) flavour, smell and colour
- (g) Together with the difference in end-use and price, the distinctions indicate the lack of a directly competitive and substitutable relationship between Korean sojus on the one hand, and the western-style liquors at issue on the other hand.
- (h) When looking at physical characteristics, the appropriate measure of relevance is the importance to consumers. In the present case, Korea has argued that the differences in physical characteristics, together with other market-related factors (such as price and end use), indicate that none of the western-style liquors competes directly with any of the two Korean sojus on the Korean market.

7.18. In response to a question about comparing premium diluted soju to standard diluted soju, Korea states that:

- (a) Korea included premium diluted soju in its comparison of diluted soju with other liquors because the differences between premium and standard diluted soju, as compared to the differences between diluted soju (including premium soju) and imported liquors, are of minor importance. Premium diluted soju is only an "upgraded" version of standard soju. Thus, premium diluted soju could be compared to a Renault's compact car "Clio" with leather seats which, although it is a luxury version, is still a compact car. To proceed with this analogy: imported liquors are Mercedeses, Jaguars and Rolls Royces compared to diluted soju. The price of a Renault Clio, even equipped with leather seats, is substantially lower than the cheapest Mercedes, let alone a Jaguar or Rolls Royce.
- (b) By taking the same criteria by which one distinguishes products in a like-or directly competitive or substitutable products-analysis, the differences resulting from a premium and standard comparison are small. For example, the price difference between standard diluted soju and premium diluted soju amounts to a factor of 1.76, as opposed to a factor of 5 for the cheapest imported liquor (gin), and more than 19 for the most expensive imported liquor (cognac/brandy).
- (c) For one of the leading premium diluted soju brands, Kimsatgat, the primary difference has been that one of the seven possible additives (stevioside) is replaced by honey. In contrast, for the imported liquors at issue (whisky, vodka, gin, brandy, rum) there are differences in taste, physical characteristics, and end-use. The taste of gin, for instance, is quite different from the taste of diluted (including premium) soju, due to the different physical composition. Gin is not drunk with Korean meals, whereas diluted (including premium) soju is, and so on.
- (d) This analysis led Korea to the conclusion that standard diluted soju and premium diluted soju are sufficiently similar and sufficiently competitive that they should be grouped together in the analysis required by this case. To be sure, Korea has treated

distilled soju separately from diluted soju, as between these two products the differences are significant (price, use, marketing, raw material, tax classification).

7.19. In response to a question about competition between types of whiskies, Korea states that:

- (a) There is no reason to assume that imported whiskies are not directly competing with or unlike domestic whiskies because of the price differences cited. The prices cited concern individual brands. Both domestic and imported whiskies cover the whole gamut of prices (for instance, cheap whiskies are bottled in Korea, but also expensive ones). Taking into account all sales, domestic whisky is on average somewhat more expensive than imported whisky.³⁰⁹
- (b) There are no other differences (such as physical characteristics or end use) to suggest that imported and domestic whisky are positioned differently on the Korean market. Next to the small difference in price, this is relevant as well. As Korea has emphasized before, the decision of whether products are "like" or directly competitive or substitutable products is a matter of an overall appreciation of their relationship, weighing all the relevant factors. Of course, no distinction is made in Korea's liquor and education tax rates between imported and domestic whisky.

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

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

³⁰⁹ See Korea's, Attachment 5.

³¹⁰ Judgment of the Court of Justice of the European Communities of 14 February 1978, Case 27/76, *United Brands Company and United Brands Continental BV v Commission of the European Communities*, 1978 ECR 207.

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

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

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

7.24. In response to a question whether the questions and methodology in the Dodwell study are similar to those used in the ASI study in *Japan- Taxes on Alcoholic Beverages II*, and whether Korea disagrees with that Panel's use of the ASI study in reaching its conclusions, Korea states that it is confident that the Panel in *Japan – Taxes on Alcoholic Beverages II* examined the ASI study with appropriate care. Korea, however, has not studied the detail of the ASI report, which was submitted to a different panel in a different case, and is concerned with a market in a different country. It is therefore unable to comment on the merits of the ASI study. Moreover, Korea doubts the value of a post-mortem on either the ASI study itself, or the use of it by the Panel in *Japan – Taxes on Alcoholic Beverages II*. If the ASI study is free of the flaws of the Dodwell study, its use by the Panel was proper, but that fact cannot provide a sound argument for reliance on the flawed Dodwell study in this proceeding. If the ASI study is as defective as the Dodwell Study, the fact that the Panel relied on it cannot make a sound case for repeating the same mistake.

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

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

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

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

(d) If the US criterion is intended for application to the real world, however, imperfections of information provide additional reasons to reject it. In the real world, there are problems of error in the construction and organisation of samples and problems of statistical error – to say nothing of the blundering of those "fallible human beings" that have

become a feature of recent EC argument in this case. Even if the US criterion were accepted in principle, the existence of such sources of mistakes in estimation would require a substantial margin to allow for errors in estimation – a margin that the US position denies.

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

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

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

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

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

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

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

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

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

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

VIII. THIRD-PARTY ARGUMENTS

A. CANADA

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

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

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

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

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

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

³¹¹ Appellate Body Report, *supra*, p. 29.

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

B. MEXICO

1. Background

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

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

8.9. Mexico asserts that at the beginning of the 1990s Korea reduced some of its internal taxes. In the case of the liquor tax, as of 1 July 1991 Korea reduced the rate applicable to whisky and brandy from 200 per cent to 150 per cent; in January 1994 to 120 per cent; and in January 1996 to 100 per cent. The category "other liquors" benefited from a single reduction from 100 per cent to 80 per cent in July 1991. A tax of 35 per cent was levied on soju³¹³ until 1991, when soju was divided into two subcategories, "diluted soju" and "distilled soju", taxed at 35 per cent and 50 per cent respectively.

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

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

2. Legal Aspects

(a) General

8.12. Mexico claims that:

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

(b) Article III.2, first sentence

8.13. Mexico notes that the first sentence of Article III. 2 of the GATT 1994 stipulates that:

"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

³¹³ According to Section I-A of Korea's Schedule, soju belongs to tariff heading 2208.90.4000.

or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products".

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

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

- (a) Soju is a like product to the spirits of HS heading 22.08.³¹⁵
 - (i) The notion of "like products" varies according to the provision of the GATT 1994 to which it applies. Thus, in practice, likeness of products is established on a case-by-case basis. With respect to Article III.2, the practice of various panels³¹⁶ in the past suggests the application of the criteria of final use of the product in a given market, consumer taste and habits, and the properties, nature and quality of the products.
 - (ii) Spirits of HS heading 22.08, including tequila and mescal, have the same final use as soju in that they are drunk on their own, with spicy food "because the drink's harshness cuts the spiciness of the food." They also correspond to the tastes and habits of consumers of spirits and are equivalent in terms of their properties, their nature and their quality. Mexico states that it should be noted that soju like tequila and mescal, is divided into two categories: white tequila and mescal correspond to diluted soju, while matured tequila and mescal correspond to distilled soju. In both cases, the beverages are normally drunk on their own in small glasses. In Mexico's view, like diluted soju, both tequila and white mescal are clear very common and sold in great quantities, while matured tequila and mescal are more expensive drinks whose production process is more sophisticated and which, in many cases, are packaged in special bottles and offered as gifts.
- (b) Even if the tariff classification does not suffice in itself to determine whether the products are "like products", it should be noted that both tequila and mescal are in the same tariff subheading (six-digit classification) as soju, i.e. HS subheading 2208.90.³¹⁷ It should be recalled that the six-digit classification is the maximum level of precision in the HS. Moreover, the Appellate Body in *Japan - Taxes on Alcoholic*

³¹⁴ Appellate Body Report, *supra.*, para 1 of Section H, page 18-19.

³¹⁵ This heading includes tequila and mescal, which are Mexican products.

³¹⁶ See *Border Tax Adjustments* (L/3464, 18S/97); *The Australian Subsidy on Ammonium Sulphate* (BISD II/188); *EEC - Measures on Animal Feed Proteins*, adopted on 14 March 1978, (BISD 25S/49); *Spain - Tariff Treatment of Unroasted Coffee*, adopted on 11 June 1981 (BISD 28S/102); *Japan - Taxes on Alcoholic Beverages I*, *supra* and *United States - Taxes on Petroleum and certain Imported Substances*, *supra*.

³¹⁷ Mexico states that it is particularly interesting to note that in arguing that diluted soju and vodka are not "like products" or "directly competitive or substitutable for each other", Korea points out that they are classified under different HS subheadings. This would imply that Korea somehow recognizes the importance of the classification of products, and that more specifically, tequila and mescal are like products and directly competitive or substitutable for each other.

Beverages II stipulates that "if sufficiently detailed tariff classification can be a helpful sign of product similarity".³¹⁸

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

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

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

(c) Article III.2, second sentence

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

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

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

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

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

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

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

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

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

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

8.20. Mexico also notes that in *Japan - Taxes on Alcoholic Beverages II*, which presented practically the same characteristics as the case at issue the Appellate Body concluded that:

"[s]hochu and other distilled spirits and liquors listed in HS 22.08, except for vodka, are 'directly competitive or substitutable products'".³²⁰

Mexico considers that this conclusion is applicable to the case of Korean soju as well, given the alleged likeness of the Korean and Japanese markets.³²¹ The Panel in that case accepted the evidence submitted by Japan³²² according to which a shochu-like product is produced in Korea.

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

³¹⁹ Appellate Body Report, *Canada - Certain Measures Concerning Periodicals*, *supra*.

³²⁰ Appellate Body Report, *supra*, Section I, p.32.

³²¹ According to Mexico, although Korea, in its first submission (paragraph 91, page 21), ignores the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* and states that the Panel cannot issue a report referring to all products falling under HS22.08 in the abstract, it subsequently recognizes the importance of the tariff classification in determining the likeness of the products.

³²² Panel Report, *supra*, para.6.35. Japan also pointed out that Korean law contained a definition similar to Japanese law, dividing *shochu* into two subcategories: "diluted *shochu*" (*shochu A*) and "distilled *shochu*" (*shochu B*).

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

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

8.23. The Government of Mexico requests that the Panel:

- (a) find that Korea has contravened its obligations under the first sentence of Article III.2 of the GATT 1994 in that its internal taxes levied on various spirits of HS heading 22.08 (including tequila and mescal) are higher than those applied to soju;
- (b) find that Korea has contravened its obligations under the second sentence of Article III.2 of the GATT 1994 in that its internal taxes afford protection to the domestic production of soju;
- (c) find that the provisions applying to the Liquor Tax Law and the Education Tax Law nullify and impair the benefits accruing to Mexico under the GATT 1994;
- (d) recommend that Korea amend its measures to bring them into conformity with the provisions of the GATT 1994.

C. KOREA'S RESPONSE TO THIRD-PARTY ARGUMENTS

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

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

³²³ Mexico noted that Japan mentioned the likeness of its *shochu* with Korean, Chinese and Singapore *soju*.

8.26. Korea, however, takes issue with the third party submission of Mexico. According to Korea, Mexico's submission proceeds from the mistaken assumption that Mexico, being a third party, somehow has the rights of a complainant to this dispute. Korea notes that Mexico requests this Panel to find that the Korean Liquor Tax Law and Education Tax Law have nullified or impaired the benefits accruing to Mexico under the GATT 1994. In Korea's view, in order to obtain such a finding, Mexico should have taken recourse to normal dispute settlement procedures itself.³²⁴ Mexico has not done so.

8.27. Korea also argues that another misunderstanding of Mexico is that Mexico assumes that it is entitled to introduce products of its own choice into this proceeding, by referring to Tequila and Mescal. Korea does not recall that Mescal has been mentioned at any point in time by the United States or the European Communities. According to Korea, Tequila was mentioned only in the most perfunctory manner. In Korea's view, if the Panel finds, as Korea has requested, that the only products properly brought into this dispute by the European Communities and the US are certain western-type liquors, notably whisky, brandy, vodka, rum and gin, then that is where the matter ends. Korea concludes that Mexico, being a third party, can only support the conclusions of one of the parties (presumably, the complainants) in this dispute and cannot expand the scope of this dispute.

8.28. Korea notes that Mexico also argues that Korea's tax system and customs duties are suspect. Mexico refers to, 'a two-stage protection mechanism'. In this connection Mexico draws attention to the fact that Korea maintains somewhat higher tariffs on soju imports than on imports of other distilled liquors. According to Korea, the explanation is much more straightforward than the sinister intentions Mexico believes to have found. No trading partner has asked Korea to reduce its tariffs on soju, and has been willing to bargain for such a reduction.

8.29. Significantly, according to Korea, Mexico clearly misinterprets the legal standard of Article III.2. In Korea's view, the key issue here is to determine which western-type liquors are in a sufficiently close competitive relationship with Korean sojus on the Korean market. In this connection, Korea has pointed out that standard soju is an inexpensive drink, which Koreans like to drink with their spicy meals. Mexico responds that Tequila and Mescal also go well with spicy food. Korea argues that although it may well be the case that in Mexican consumers like to drink Tequila or Mescal when they eat spicy Mexican food, that is not the issue in this dispute.

8.30. According to Korea, the issue in this dispute is which liquor Koreans like to drink with their meals; and, more generally, what the position of Tequila and Mescal is on the Korean market (assuming for a moment these products would be concerned by this dispute, which they are not). Korea argues that Mexico has not adduced any evidence to suggest that Korean consumers like to drink Tequila and Mescal with Korea's spicy cuisine; or that Koreans drink Tequila or Mescal straight and not mixed as a cocktail. More generally, according to Korea, Mexico has not shown that Tequila or Mescal directly compete with Korean soju.

8.31. Korea notes that Mexico makes much of the fact that the tariff classification of Mescal, Tequila and soju are the same. According to Korea, this is not true. The sub-classifications, tariff bindings, and applied rates for tequila and soju are different. Moreover, Mexico goes so far as to say that all products falling under the basic four digit classification HS 22.08 are 'like products'. Even the complainants do not go that far.

8.32. Korea refers to the Appellate Body in the *Japan - Taxes on Alcoholic Beverages II*, wherein it was said that tariff classifications, when they are sufficiently detailed, can be a helpful indication to decide whether the relationship between products that compete directly with each other is in fact so

³²⁴ See Article 10.4 DSU.

close that they can be considered 'like'.³²⁵ For this reason, Korea referred to the tariff classification of vodka and standard soju, as this is the only product combination which the European Communities and the United States claim to be 'like'. With respect to Tequila and Mescal, the threshold question is not even met: there is no indication to begin with that these products compete directly with the Korean sojus on the Korean market, let alone that they are so competitive on the Korean market that they could conceivably be considered 'like'.

8.33. Korea reminds Mexico, and the other complainants in this case, once more of the Panel's holding in the *Japan – Taxes on Alcoholic Beverages II*: 'consumers' tastes and habits. change from country to country'.³²⁶ According to Korea, if this case will serve a purpose, it is to show that markets are different. Korea adds that the Japanese market is not, as asserted by Mexico, like the Korean market, the Korean market cannot simply be equated with the Mexican market, etc.

8.34. According to Korea, therefore, before any conclusions about the possibility of discriminatory taxation within the meaning of Article III.2 are drawn, one has to make a detailed analysis of the market

³²⁵ Appellate Body Report, *supra.*, at p. 21. See also Panel Report, *supra.*, at para. 6.22, stating that 'like' products are a subset of directly competitive and substitutable products.

³²⁶ Panel Report, *supra* at para.6.21.

IX. INTERIM REVIEW

9.1. In letters dated 7 July 1998 the European Communities, the United States and Korea all requested an interim review by the panel of certain aspects of the Interim Report issued to the parties on 26 June 1998. The requests dealt with certain aspects of the descriptive portion of the Interim Report including the summaries of the arguments as well as with the Findings. None of the parties requested a further meeting with the Panel.³²⁷

9.2. The major issue of concern of the parties with the descriptive portion (other than some individual and technical points which we have accommodated) was inclusion of the oral statements of the parties. In the initial version of the descriptive portion of the report, little was included from the oral statements. Oral statements generally are intended to be summaries of the written statements, not presentations of new evidence or arguments. Nonetheless, we have accommodated the requests as appropriate. However, we must note a particular difficulty in this regard in accommodating some of the comments of the United States. In part of the comments, the United States did not request specific portions of their oral statements to be included in specific spots in the descriptive portion. Instead, the United States offered a redrafting of its arguments that effectively recast whole portions of their presentation.

9.3. We have taken note of the implicit approach of the United States that parties to a dispute should submit draft summaries of their arguments for inclusion in the descriptive portion of a panel report. However, this is an approach that should be agreed with all the parties at the outset of a proceeding rather than made by one party at the close of the proceedings. Future panels may wish to adopt such an approach. Unfortunately, no suggestions were made and no discussion of this approach was held at an early stage of these such proceedings. Therefore, we cannot accept the wholesale changes requested by the United States. Instead, we attempted to include in the descriptive part some of the sections of the U.S. oral statements reflecting the issues identified by the United States.

9.4. With respect to the Findings, the European Communities requested language changes in several paragraphs. We agree with most of the recommended changes as clarifications of the existing language and have amended paragraphs 10.43, 10.53, 10.100 and 10.101, accordingly.

9.5. The European Communities disagreed with the finding in paragraph 10.57 that the complainants provided "no evidence whatsoever" with respect to distilled alcoholic beverages not identified during the course of the proceedings. The EC's argument is that they have identified physical characteristics and end-uses common to all distilled alcoholic beverages and, therefore, that all such beverages identified in HS classification 2208 should be included. These general statements included very weak evidence with respect to products not even identified. In addition, these other beverages were not even included in the Dodwell study. Economic studies such as the Dodwell study are not necessary, but they are very useful. In other words, such market surveys are a source of information, not a limitation. Paragraph 10.57 has been amended to clarify this point.

9.6. The United States made a number of recommended changes in language that we agree provides greater clarity to the existing language. Therefore, we have amended the language in paragraphs 10.1, 10.41, 10.42, 10.43, 10.47, 10.51, 10.74, 10.95, 10.97, 10.100 and 10.101, accordingly.³²⁸

³²⁷ The Interim Report constitutes Section IX of the Final Panel Report. Inclusion of this section makes the Findings portion of the Report Section X. References to paragraph numbers and comments of the parties have been adjusted accordingly.

³²⁸ The United States made a reference to paragraphs 10.42-10.43 in one comment. We assume they were referring to paragraphs 10.41-10.42.

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

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

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

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

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

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

9.13. Korea stated that it had great difficulty accepting the outcome of the case. In Korea's view, the complainants failed to prove the necessary elements to establish a violation of Article III:2. In its General Comments, Korea states, among other things, that soju is consumed "primarily" with meals and that whisky and other spirits are consumed "primarily" as cocktails. We note as a general matter that Korea was drawing far too fine a distinction between end-uses for purposes of Article III:2, second sentence. We note that, even in Korea's approach (which we do not accept), it is only a matter of the "primary" use where there are differences. There are overlapping end-uses even within the Korean definition.

9.14. Korea further states that "Korea finds it difficult to accept that the Panel puts into doubt Korea's description of its own market". Korea implies that any party to a dispute has an exclusive authority to assess the facts relating to its domestic market. We find no support for such a proposition

in GATT/WTO jurisprudence. Indeed, that is the very function of a panel in a case such as this, to assess the facts and arguments and make findings based on a weighing of the evidence presented.

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

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

9.17. With respect to paragraph 10.52, Korea noted that the figures for premium diluted soju should state that it is five percent of the soju market not the distilled beverages market. We have corrected the reference. Korea also noted that premium soju sales currently have slowed. We do not think this detracts from the conclusions. As complainants noted, sales of imports have also slowed in recent months due to the current financial crisis in Korea.³³¹ The higher priced products such as premium diluted soju and imports have fallen off and sales of lower priced products have increased. The parties did not present extensive arguments about the relationship of the sales of the products to events occurring during the recent financial crisis³³² and we did not refer to such a period extensively, but, if anything, the similar trends in sales of imports and premium diluted soju (as well as the differential movement of standard diluted soju) in the situation can be taken to support our Findings. We made clarifications to paragraph 10.52 to reflect these comments.

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

³³⁰ We take note that Japan stated in the panel proceedings of *Japan – Taxes on Alcoholic Beverages II* that soju and shochu were essentially identical products. *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 4.178.

³³¹ See EC Answer to Questions, Question 1 from the Panel at 1-2, and accompanying chart.

³³² We note that the Nielsen study and the Trendscape survey were done in 1998.

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

9.19. Korea also stated that it strongly objects to the Panel's alleged approach of narrowing the price differences between the products and argues that the Panel "conveniently" mismatched products because some comparisons were made between imports and premium diluted soju rather than standard diluted soju. However, in the textual discussion of the price differences, the first sentence of the listing stated the price difference between premium diluted soju and standard diluted soju. There followed a listing of the price differences between some imports and premium diluted soju. We included a footnote with further price differences between imports and premium diluted soju and standard diluted soju. We do not understand what Korea apparently thought was concealed by these figures as all information was included. Nonetheless, we will amend the paragraph and footnote to calculate the remaining figures for purposes of clarity. We made the appropriate changes to paragraph 10.94.

9.20. Also with respect to paragraph 10.94, Korea objected to the Panel's alleged reliance on prices based on alcohol strength to support its conclusions. We made no such reliance. In mentioning price adjusted for alcohol strength in a footnote to the paragraph, we merely observed that this was the manner of the price comparisons used in the case of *Japan – Taxes on Alcoholic Beverages II* and noted that the absolute price ratio differences in the present case were more similar to those in that case than would otherwise appear from a casual reference to the appendices in that case. Or, alternatively, if the prices in the Japanese case were *not* adjusted for alcohol strength, the price ratios between the imported and domestic products in Japan are shown to be more similar to the price ratios of imported and domestic products in Korea than would otherwise appear to be the case. We further clarified the language in the paragraph and footnote to reflect this concern.

9.21. Korea disagreed with our treatment of distilled and diluted soju. They note that the Korean Fair Trade Commission ("KFTC") statement outlines one difference regarding distillation methods, but that there are others including differences in price. However, the KFTC did not simply state that the method of distillation was a difference; it stated that it was "the *basic* difference".³³³ After noting this we went on to discuss the other differences, including price. We declined to change paragraph 10.54 in this regard.

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

9.23. Korea requested the panel to amend the Findings in paragraphs 10.63 and 10.64 to "incorporate and consider" Korea's arguments in its Second Oral Statement on whether bottled and tap water are competitive products. We listened to Korea's statements in this regard and considered them. Lack of a specific citation to every single argument made by parties in the Findings does not in any manner imply that such arguments were not considered. We did not find the Korea analogy about tap

³³³ Emphasis added.

water and bottled water probative or useful. The analogy is incomplete and refers to different products in different countries and thus no useful inference could be drawn for the inquiry at hand. However, we have added Korea's requested statements to the descriptive portion of the Report but have declined to amend these paragraphs in this regard.

9.24. Korea argued with the statement in paragraph 10.78 that soju and shochu are traditional drinks in their respective countries. Korea argues that sake "is *the* traditional drink of Japan".³³⁴ We did not state that shochu is *the* traditional drink of Japan. We referred to it and soju as traditional drinks without further qualification. We do not agree that there is only one traditional drink per country. Various regions or groups within countries may have traditional drinks. We declined to alter this paragraph.

9.25. With respect to paragraph 10.79, Korea noted that references to colourings with respect to premium soju are inaccurate. With respect to mention of the photographic exhibits submitted by complainants, Korea objects to references to pictures of premium diluted soju. We do not agree with the objection; advertisements of premium soju are relevant. Korea also objected to use of advertisements aimed at the Japanese market. Paragraph 10.80 deals with much of the Korea disagreement. However, we take note of their point with respect to some of the photographs. For instance, Exhibit I should not be included in this specific footnote because it is a Japanese product. However, we again note the statement by Japan in *Japan – Taxes on Alcoholic Beverages II* that soju and shochu are essentially identical products.³³⁵ We also take note that Exhibit D is distilled soju rather than diluted soju. However, given our conclusions regarding distilled and diluted soju, no substantive difference results. The paragraph and footnote references were amended as appropriate.

9.26. Korea also objected to references in paragraphs 10.79 and 10.80 to Jinro's website advertisement because, according to Korea, all advertising is essentially local. We do not agree with this argument. As discussed in these and other paragraphs, we consider such evidence relevant. The question is one of evidentiary significance, i.e., how much weight should be given to such evidence. We declined to further amend these paragraphs in this regard.

³³⁴ Emphasis added.

³³⁵ *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 4.178.

X. FINDINGS

A. CLAIMS OF THE PARTIES

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

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

B. PRELIMINARY ISSUES

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

- (i) the specificity of the panel requests of the complainants;
- (ii) the complainants' alleged non-compliance with certain provisions of the DSU relating to the conduct of consultations;
- (iii) alleged breaches of the confidentiality of the consultation process;
- (iv) alleged late submission of evidence; and
- (v) permission to have private counsel attend the Panel meetings and address the Panel.³³⁶

1. Specificity

10.4. Korea argues that the European Communities, in its request for a panel, has referred to a preferential tax rate on soju vis-a-vis certain alcoholic beverages falling within HS heading 2208.

³³⁶ The question of confidentiality of consultations was first identified in a footnote to Korea's First Submission and further explained by Korea at the first Panel meeting. The issues of specificity of the complaints and adequacy of the consultations were raised for the first time in Korea's Statement at the first Panel meeting. The complainants were given the opportunity to address the issues of confidentiality, specificity and adequacy of consultations in writing in their rebuttal briefs and we delivered our decision on these matters at the beginning of the second Panel meeting. The issue of the alleged late submission of evidence was raised by Korea following the second Panel meeting. We address the question here for the first time. The issue of private counsel was raised and addressed prior to the first meeting of the Panel.

Korea states that the European Communities has not, even in its written submission, clarified its position on the category of alcoholic beverages falling within the scope of this dispute.

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

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

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

Korea, therefore, requested the panel to issue a preliminary ruling, limiting the products at issue in this dispute.

10.7. Korea also submits that it is unable to identify which items the United States is referring to by its reference to 'ad-mixtures' in its request for a panel. Korea also claims that the complainants did not clearly distinguish the domestic liquors that are supposed to be more favourably taxed in Korea. Korea states, in particular, that the complainants have not distinguished between Korea's distilled soju, an artisanal product sold at very high prices in tiny quantities, and subject to a 50% tax rate, on the one hand, and, on the other hand, diluted or standard soju, which is an inexpensive drink, consumed in large quantities with meals and taxed at a rate of 35%. Korea argues that in their requests for a panel, both complainants have referred to only one 'soju' product, without acknowledging that there are, in reality, two different products, with two different tax rates.

10.8. The European Communities notes that its request for a panel refers to "... certain alcoholic beverages falling within HS 22.08", but rejects Korea's assertion that it has, through its first submission, broadened the scope of its complaint as contained in the request for a panel. The European Communities submits that its first submission refers to "soju and all other distilled spirits and liqueurs falling within HS 22.08". In the EC view, these statements are consistent. According to the European Communities, its panel request is more than sufficiently specific to meet the minimum requirements of Article 6.2 of the DSU.

10.9. The United States argues that Article 6.2 of the DSU requires, inter alia, that the request for a panel "identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly." According to the United States, its panel request satisfies both these requirements, and it also clearly includes all distilled spirits within HS heading 2208, as maintained in the first US submission. The United States argues that in accordance with Article 6.2, its request for the establishment of a panel defined the Korean measures at issue: the general Liquor Tax Law and the Education Tax; and provided a brief summary of the legal basis of the complaint.

10.10. The United States refers to *European Communities - Regime for the Importation, Sale and Distribution of Bananas (Bananas III)*, where the Appellate Body, according to the United States, noted that this provision concerning the legal basis requires that the request for a panel must be

sufficiently specific with respect to the claims being advanced, but need not lay out all the arguments that will subsequently be made in the party's submission.³³⁷ The United States argues that Korea's request that the Panel limit the proceeding to five specific products (whisky, brandy, vodka, rum, and gin) is equally without basis in Article 6.2. According to the United States, the panel request, which defines the terms of reference of the panel, refers to taxation of "other distilled spirits" -- i.e., distilled spirits other than soju. By using the term "such as," the United States claims that it sets forth the five products and "ad mixtures" as examples, and not as an exclusive list. According to the United States, the extent to which the United States and the European Communities establish that all such products are "like" or "directly competitive or substitutable" is a matter to be determined through the course of these proceedings, beginning with the first written submission to the Panel.

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

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

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

10.13. The Appellate Body noted in *Bananas III* that:

As a panel request is normally not subjected to detailed scrutiny by the DSB, it is incumbent upon a panel to examine the request for the establishment of the panel very carefully to ensure its compliance with both the letter and spirit of Article 6.2.³³⁸

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

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

10.15. Korea argues that each imported product must be specifically identified in order to be within the scope of the panel proceeding. The complainants argue that the appropriate imported product is all distilled beverages. They claim, in fact, that for purposes of Article III, there is only one category

³³⁷ Appellate Body Report on *European Communities – Regime for the Importation, Sale and Distribution of Bananas (Bananas III)*, adopted on 25 September 1997, WT/DS27/AB/R, at para. 141.

³³⁸ Ibid., at para. 142.

³³⁹ Ibid., para. 142.

in issue. They claim to have identified specific examples of such distilled alcoholic beverages for purposes of illustration, not as limits to the category.

10.16. The issue of the appropriate categories of products to compare is important to this case. In our view, however, it is one that requires a weighing of evidence. As such it is not an issue appropriate for a preliminary ruling in this case. This is particularly so in light of the Appellate Body's opinion in *Japan - Taxes on Alcoholic Beverages II*,³⁴⁰ that all imported distilled alcoholic beverages were discriminated against. That element of the decision is not controlling on the ultimate resolution of other cases involving other facts; however, it cannot be considered inappropriate for complainants to follow it in framing their request for a panel in a dispute involving distilled alcoholic beverages. While it is possible that in some cases, the complaint could be considered so vague and broad that a respondent would not have adequate notice of the actual nature of the alleged discrimination, it is difficult to argue that such notice was not provided here in light of the identified tariff heading and the Appellate Body decision in the *Japan - Taxes on Alcoholic Beverages II*. Furthermore, we note that the Appellate Body recently found that a panel request based on a broader grouping of products was sufficiently specific for purposes of Article 6.2.³⁴¹ We find therefore, that the complainants' requests for a panel satisfied the requirements of Article 6.2 of the DSU.

2. Adequacy of consultations

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

10.18. Both complainants assert that Korea's claim would appear to be that they have infringed Articles 3.3, 3.7 and 4.5 of the DSU because they did not attempt to reach a mutually acceptable solution to the dispute in the course of the consultations that preceded the establishment of this Panel. The complainants refer to the panel decision in *Bananas III* for the proposition that the conduct of consultations is not the concern of a panel but that the panel need only concern itself with the question whether consultations did in fact take place,³⁴² and point out that Korea cannot dispute the fact that consultations were in fact held on three separate occasions between itself and both the United States and the EC. The complainants state that, in any event it is not true that they refused to engage in a 'meaningful exchange of facts' during the GATT Article XXII consultations. They allege that it was Korea's attitude during the consultations which prevented such exchange from taking place.

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

Consultations are . . . a matter reserved for the parties. The DSB is not involved; no panel is involved; and the consultations are held in the absence of the Secretariat.

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

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

³⁴² Panel Report on *Bananas III*, *supra* at paras. 7.18-7.19.

While a mutually agreed solution is to be preferred, in some cases it is not possible for parties to agree upon one. In those cases, it is our view that the function of a panel is only to ascertain that the consultations, if required, were in fact held. ...³⁴³

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

3. Confidentiality

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

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

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

10.23. We note that Article 4.6 of the DSU requires confidentiality in the consultations between parties to a dispute. This is essential if the parties are to be free to engage in meaningful consultations. However, it is our view that this confidentiality extends only as far as requiring the parties to the consultations not to disclose any information obtained in the consultations to any parties that were not involved in those consultations. We are mindful of the fact that the panel proceedings between the parties remain confidential, and parties do not thereby breach any confidentiality by disclosing in those proceedings information acquired during the consultations. Indeed, in our view, the very essence of consultations is to enable the parties gather correct and relevant information, for purposes of assisting them in arriving at a mutually agreed solution, or failing which, to assist them in presenting accurate information to the panel. It would seriously hamper the dispute settlement process if the information acquired during consultations could not subsequently be used by any party in the ensuing proceedings. We find therefore, that there has been no breach of confidentiality by the complainants in this case in respect of information that they became aware of during the consultations with Korea on this matter.

4. Late submission of evidence

10.24. Korea complains that its rights of defense were violated by the late submission of a market study (the Trendscape survey) by the European Communities. Korea had submitted a study done by the AC Nielsen Company as part of its responses to questions arising from the first substantive meeting of the Panel. The European Communities responded to this with, among other things, the Trendscape survey presented at the Second Meeting of the Panel. The Panel gave Korea a week to respond to this and critique the results, methodology and questions used in the Trendscape survey.

³⁴³Ibid., para. 7.19. The issue was not appealed.

Korea argues that this time was insufficient, that it did not have copies in Korean of all the questions - asked, and that it did not have time to provide further questions or comments based upon the answers.

10.25. We do not consider that Korea's rights under the DSU were violated. The European Communities submitted its rebuttal survey at the next available opportunity after receiving Korea's Nielsen survey. Had Korea chosen to submit its survey at the first substantive meeting and the European Communities failed to respond at the next opportunity (in such a case, it would have been in the rebuttal submission), there obviously would have been more merit to the claim because then the European Communities, it could have been argued, delayed submitting their evidence. As it transpired, the European Communities submitted a new piece of evidence at the next available opportunity which Korea then was able to examine for a week in order to provide comments. The survey was not of a particularly complex type and, in our view, Korea had adequate time to respond given the nature of the evidence. The Trendscape survey is not critical evidence to the complainants' case; it serves as a supplement to arguments already made. If we considered that it represented critical evidence, Korea's request for further time for comment would have been given greater weight. While all parties to litigation might prefer open-ended potential for rebutting the other side's submissions, we believe that for practical reasons submissions must be cut-off at some point and such a point was reached in this case. Thus, neither the timing nor the importance of the evidence in question support a finding that Korea's rights have been violated in this instance.

5. Private counsel

10.26. Korea indicated at the outset of the panel process that it wished to have the right to private counsel at the substantive meetings of the Panel. In Korea's view, in order to fully defend its interests and match the much greater resources of the complaining parties, Korea decided to retain the services of expert counsel with long standing experience in matters of international economic law and international economics.

10.27. Korea refers to the recent opinion of the Appellate Body in *Bananas III*, in which the Appellate Body stated that it found nothing in the WTO Agreement, the DSU, its Working Procedures, in customary international law or the prevailing practice of international tribunals, which prevented a Member from determining its delegation to the Appellate Body's proceedings.³⁴⁴ Korea adds that the Appellate Body also noted that representation by counsel of a government's own choice in proceedings before it (the Appellate Body) might well be a matter of particular significance to enable WTO Members to participate fully in WTO dispute settlement proceedings. According to Korea, the same holds true with respect to delegations presenting a case before a Panel. Korea further submits that under customary international law, it has the sovereign right to determine the composition of its delegation to panel hearings.³⁴⁵ Korea also believes its right to counsel of its choice is consistent with what it considers to be basic due process principles implicit in the DSU. Korea indicated that it appreciated that the Panel might have concerns about the confidentiality of the proceedings. Korea assured the Panel that it would ensure that any member of its delegation, including private counsel, will fully respect the confidentiality of the proceedings in accordance with applicable rules.

10.28. The European Communities indicates that it has no objection, in principle, to the presence of private counsel as part of Korea's delegation during substantive meetings of the Panel. The European Communities states, however, that they attach great importance to the preservation of confidentiality of panel proceedings. The EC acceptance was, therefore, made conditional upon Korea assuming full responsibility for any breach of confidentiality which may result from the presence at the Panel

³⁴⁴ Appellate Body Report, *supra.*, p. 8.

³⁴⁵ Korea refers to *Korea - Restrictions on Imports of Beef*, adopted on 7 November 1989, BISD 36S/202.

meetings of non-governmental persons. The European Communities take regard of the assurances given by Korea to the effect that its private counsel, like any other member of its delegation, would fully respect the confidentiality of the proceedings.

10.29. The United States notes that the Members of the WTO have agreed to abide by the rules and procedures in the DSU. They have agreed that dispute practice in the WTO will be guided by, and will adhere to, the established practice applied in disputes under the GATT 1947 system. According to the United States, this practice has excluded the routine presence of private lawyers in panel proceedings. The United States asserts that the GATT and WTO practice reflects the dual nature of the dispute settlement rules in the DSU; namely, reaching mutually agreeable solutions and adjudicating disputes. In the view of the United States, a decision by this panel to permit participation of private lawyers in panel meetings is not a trivial step. The effectiveness of WTO dispute settlement is a major accomplishment of the WTO as an international organization. The balance of elements that created this success has evolved by experience over considerable time. It is also the US view that if the Panel wishes to permit private lawyers or non-lawyer advisors to be in this proceeding, the Panel should consider this decision with great care, and impose appropriate safeguards with respect to the conduct of such persons.

10.30. The United States further argues that Panel must require effective safeguards that ensure that private counsel will not leak confidential business information or other privileged information generated during the panel process, and that if they do, there will be meaningful consequences. According to the United States, there is no excuse for damaging the interests of private parties by leaks of confidential business information; such leaks will in turn damage the reputation of WTO dispute settlement among trading businesses who are the strongest supporters of open trade.

10.31. Having considered the request of Korea for the right to use private counsel at the panel meetings, and the responses the European Communities and the United States, we decided to permit the appearance of private counsel before the Panel and to allow them to address arguments to the Panel in this case. In our view, it is appropriate to grant such a request in order to ensure that Korea has every opportunity to fully defend its interests in this case. However, such permission is granted based on the representations by Korea that the private counsel concerned are official members of the delegation of Korea, that they are retained by and responsible to the Government of Korea, and that they will fully respect the confidentiality of the proceedings and that Korea assumes full responsibility for confidentiality of the proceedings on behalf of all members of its delegation, including non-government employees.

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

10.33. The United States offered several suggestions for new rules and procedures in regard to these questions. However, in our view, the broader question of establishing further rules on confidentiality and possibly rules of conduct specifically directed at the role of non-governmental advisors generally is a matter more appropriate for consideration by the Dispute Settlement Body and is not within the terms of reference of this Panel.

C. MAIN ISSUES

1. Interpretation of Article III:2

10.34. Article III:2 provides two standards for examining complaints about a Member's internal taxation laws. The first sentence of Article III:2 provides:

The products of the territory of any Member imported into the territory of any other Member 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.

The second sentence provides:

Moreover, no Member shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

Paragraph 1 of Article III provides:

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

The meaning of the second sentence in light of its reference to the first sentence is further clarified in *Ad Article III* as follows:

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.³⁴⁶

10.35. Thus, the first sentence of Article III:2 examines whether products of an exporting country are taxed in excess of the taxes on the "like" domestic product. The second sentence examines whether products of an exporting country are taxed similarly to domestic products which are "directly competitive or substitutable." Both sentences first examine the relationship between the domestic and imported products; however, the second sentence involves additional and different inquiries with respect to two other elements; namely, an examination of the *extent* of the difference in taxation³⁴⁷ and whether the taxation differences are applied so as to afford protection to the domestic industry.

10.36. The general approach in past Article III:2 cases has been to examine first whether any of the products at issue are "like." However, previous cases have found that the category of like products is

³⁴⁶ *Ad Article III* has equal stature under international law as the GATT language to which it refers, pursuant to Article XXXIV. See also Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra*, at p. 24.

³⁴⁷ If the products are determined to be "like" then *any* taxation of the imported product in excess of the domestic product is prohibited. There is no *de minimis* possibility as there is under the second sentence where *Ad Article III* provides only that they must be "similarly taxed."

a subset of those products which are directly competitive or substitutable.³⁴⁸ It therefore seems more logical to us to approach the issue by examining the broader category first.

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

10.38. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* stated that "like product" should be narrowly construed for purposes of Article III:2. It then noted that directly competitive or substitutable is a broader category, saying: "How much broader that category of 'directly competitive or substitutable products' may be in a given case is a matter for the panel to determine based on all the relevant facts in that case."³⁴⁹ Article 32 of the Vienna Convention provides that it is appropriate to refer to the negotiating history of a treaty provision in order to confirm the meaning of the terms as interpreted pursuant to the application of Article 31. A review of the negotiating history of Article III:2, second sentence and the *Ad Article III* language confirms that the product categories should not be so narrowly construed as to defeat the purpose of the anti-discrimination language informing the interpretation of Article III. The Geneva session of the Preparatory Committee provided an explanation of the language of the second sentence by noting that apples and oranges could be directly competitive or substitutable.³⁵⁰ Other examples provided were domestic linseed oil and imported tung oil³⁵¹ and domestic synthetic rubber and imported natural rubber.³⁵² There was discussion of whether such products as tramways and busses or coal and fuel oil could be considered as categories of directly competitive or substitutable products. There was some disagreement with respect to these products.³⁵³

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

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

³⁴⁸ Panel Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.22. This finding was not modified or reversed by the Appellate Body. See, Appellate Body Report, *supra.*, at p. 23.

³⁴⁹ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

³⁵⁰ EPCT/A/PV/9, at p. 7.

³⁵¹ E/Conf.2/C.3/SR.11,p.1 and Corr. 2.

³⁵² *Ibid.* at p. 3.

³⁵³ E/Conf.2/C.3/SR.40 at p. 2.

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

between two products or groups of products requires evidence that consumers consider or could consider the two products or groups of products as alternative ways of satisfying a particular need or taste.

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

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

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

10.42. In our view, it is also the case that quantitative analyses, while helpful, should not be considered necessary. In examining the Korean market, a determination of the precise extent of the competitive overlap is complicated by the fact that, as the 1987 and 1996 panels noted in the *Japan – Taxes on Alcoholic Beverages I and II*, the intervention of government policies can cause distortions, including understatement, of the quantitative extent of the competitive relationship. Indeed, there must be some concern that a focus on the quantitative extent of competition instead of the nature of it, could result in a type of trade effects test being written into Article III cases. That is, if a certain *degree* of competition must be shown, it is similar to showing that a certain *amount* of damage was done to that competitive relationship by the tax policies in question. The Appellate Body stated:

Moreover, it is irrelevant that the "trade effects" of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent, Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.³⁵⁶

10.43. The question for us to decide is whether in Korea the domestic and imported products are directly competitive or substitutable. This requires evidence of the direct competitive relationship between the products, including, in this case, comparisons of their physical characteristics, end-uses, channels of distribution and prices.³⁵⁷

³⁵⁵ Panel Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.30.

³⁵⁶ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 16. Obviously, the expectation of competitive conditions must be a reasonable one.

³⁵⁷ These are the categories of evidence we have examined in this case to determine whether the products in question are directly competitive or substitutable. Obviously, the availability and probative value of categories of evidence may differ from case to case.

2. Evidentiary issues

(i) *Cross-price elasticity*

10.44. The Appellate Body approved the panel's decision in *Japan – Taxes on Alcoholic Beverages II* to look not only at products' physical characteristics, common end-uses, and tariff classifications, but also at the market place. It approved the examination of the economic concept of "substitution" as one means of examining the relevant markets. The use of cross-price elasticity of demand was approved but it was specifically noted that it is not the decisive criterion.³⁵⁸ While a high degree of cross-price elasticity of demand would tend to support the argument that there is a direct competitive relationship, it is only one evidentiary factor. If there is a high quantitative level of competition between products, it is likely that the qualitative nature of the competition is direct. However, the lack of such evidence may be due to the governmental measures in question. As noted, both panels in *Japan – Taxes on Alcoholic Beverages I and II* made the observation that government policies can influence consumer preferences to the benefit of the domestic industry. It was stated that:

a tax system that discriminates against imports has the consequence of creating and even freezing preferences for consumer goods. In the Panel's view, this meant that the consumer surveys in a country with such a tax system would likely understate the degree of potential competitiveness between substitutable products.³⁵⁹

This is particularly a problem if the products involved are consumer items that are so-called experience goods which means that consumers tend to purchase what is familiar to them and experiment only reluctantly. This issue will be discussed further below. Thus the question is not of the degree of competitive overlap, but its nature. Is there a competitive relationship and is it *direct*? It is for this reason, among others, that quantitative studies of cross-price elasticity are relevant, but not exclusive or even decisive in nature.

(ii) *Evidence from outside the Korean market*

10.45. Other elements of evidence besides cross-price elasticity are relevant to the analysis. In our view, another element of relevant evidence is the nature of competition in other countries. We are mindful of the admonition of the Appellate Body in the case of *Japan -- Taxes on Alcoholic Beverages II*, that these disputes must be evaluated on a case-by-case basis taking into account the conditions in the market in question. However, as we are looking at the nature of competition in a market that previously was relatively closed and still has substantial tax differentials, such evidence of competitive relationships in other markets is relevant. Similarly, we consider it relevant as to how Korean manufacturers of soju are marketing their beverages outside Korea. According to Korea, the panel should strictly limit its view to what happens in the Korean market place. Nothing that happens outside Korea can be considered relevant in determining whether the products in question are directly competitive or substitutable within Korea. Also, Korean manufacturer's export marketing efforts are to be given no weight. In our view, this is an overly restrictive approach and does not accord with market realities. It is true that the question to be answered concerns the Korean market, but that in no way implies that what happens in regard to the same products outside of the Korean market is irrelevant to assessing the actual and potential market conditions within Korea.

³⁵⁸ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

³⁵⁹ Panel Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.28, citing, Panel Report on *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, adopted on 10 November 1987, BISD 34S/83, at para. 5.9.

10.46. In some cases, the only market evidence available may be with respect to non-domestic markets due to the tax, duty and regulatory structure in the country in question. Sometimes, the only reasonable manner of assessing what the market situation would be absent such policy structures is to look at other markets and make a judgement as to whether the same patterns could prevail in the case at hand. However, we do not need to decide such a stark issue in this case; there is considerable evidence available as to what is taking place within the Korean market. We do not need, in this case, to give substantial weight to conditions in markets outside Korea, but such factors are relevant and should be taken into consideration in determining the nature of the competitive relationships involved here.³⁶⁰ As noted above, the panels stated in *Japan – Taxes on Alcoholic Beverages I and II* that systems of government tax policies may have the effect of freezing consumer preferences in place in favour of the domestic product. To completely ignore such evidence from other markets would require complete reliance on current market information which may be unreliable, due to its tendency to understate the competitive relationship, because of the very actions being challenged. Indeed, the result could be that the most restrictive and discriminatory government policies would be safe from challenge under Article III due to the lack of domestic market data.

(iii) *Potential competition*

10.47. Another question that has arisen is the temporal nature of the assessment of competition. All parties agree that the Panel should look at both actual and potential competition. However, Korea argues that potential competition does not include future competition. They argue that at most, the Panel must make a "but for" decision. That is, but for the taxes would the products be directly competitive or substitutable at the present moment. Korea further argues that if the market changes, then the complainants are within their rights to raise the matter again at some time in the future.

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

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

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

³⁶⁰ See, Appellate Body Report on *European Communities – Customs Classification of Certain Computer Equipment*, *supra.*, at para. 93.

³⁶¹ We also note that a requirement of substantial current market presence would be a particularly high hurdle for less wealthy exporters.

³⁶² Appellate Body Report in *Japan Alcoholic Beverages II*, *supra.*, at p. 16 (emphasis added).

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

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

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

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

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

The same dictionary defines "expectation" as follows:

expectation 1. The action of waiting for someone or something. . . .4. A thing expected or looked forward to.³⁶⁶

10.50. The interpretation proposed by Korea is not consistent with the standard meaning of the terms in question both of which clearly have a temporal element to their definitions. We will not attempt to speculate on what could happen in the distant future, but we will consider evidence pertaining to what could reasonably be expected to occur in the near term based on the evidence presented. How much weight to be accorded such evidence must be decided on a case-by-case basis in light of the market structure and other factors including the quality of the evidence and the extent of the inference required. To try to limit the inquiry as to what might happen this instant were the tax laws changed would involve us in making arbitrary distinctions between expectations now and those in the near future. Obviously, evidence as to what would happen now is more probative in nature than what would happen in the future, but most evidence cannot be so conveniently parsed. If one is dealing with products that are experience based consumer items, then trends are particularly important and it would be unrealistic and, indeed, analytically unhelpful to attempt to separate every piece of evidence and disregard that which discusses implications for market structure in the near future.

3. Products at issue

10.51. In order to determine whether the imported and domestic products are directly competitive or substitutable, it is necessary to properly identify such products. With respect to the domestic product, soju, there are two primary categories identified. There is distilled soju and diluted soju. Distilled soju has been described as soju made from a mix of additives and water blended into an alcohol

³⁶³*Brazilian Internal Taxes*, BISD II/181 at p. 185, para. 16 (emphasis added).

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

³⁶⁵L. Brown (ed), *The New Shorter Oxford English Dictionary* (Clarendon Press, 1993), Vol. 2 at p. 2310 (emphasis in the original).

³⁶⁶*Ibid.* Vol. 1 at p. 885 (emphasis in original).

solution extracted by a method of single-step distillation.³⁶⁷ It is identified separately in the Korean tax law, although not in Korea's WTO Schedule of tariff bindings. Distilled soju accounts for less than one percent of soju sales in Korea. Distilled soju is taxed at a higher rate than diluted soju.

10.52. The other type of soju is what we have described as diluted soju. There was considerable discussion about the proper appellation for this product. The complainants described it as diluted soju and Korea maintained that it should be referred to as standard soju. We have adopted the name diluted soju for the product for purposes of descriptive clarity only, without any intention of thereby drawing substantive conclusions from the name. Within this category there is standard diluted soju and premium diluted soju.³⁶⁸ Standard diluted soju is a lower priced product that has been dominant since the 1960's. Premium diluted soju, which generally has additives for flavouring, has been introduced in the past few years. It is higher priced and the advertising for it has cultivated a more "up-market" image. Its market share has grown rapidly and it now represents approximately five percent of soju sales.³⁶⁹ All parties have agreed that premium and standard diluted soju are variations of one product. Diluted soju is described as:

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

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

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

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

We are not convinced that this difference is significant. Moreover, in our view, to the extent there are differences between the two types of soju, distilled soju is more similar to the imported products than diluted soju. Distilled soju is higher priced than diluted soju; distilled soju (40-45 percent) has a higher alcohol content than diluted soju (20-25 percent); distilled soju often is used as gifts, an end-

³⁶⁷ See Korea First Submission, Attachment 1, Decision of the Fair Trade Commission of the Republic of Korea Case No. 9607, Advertisement 1023, 30 November 1996, at 3.

³⁶⁸ See discussion at footnote 20, above. To have decided otherwise would have left us discussing "standard soju" and "premium standard soju", terminology which would have been confusing.

³⁶⁹ The EC argues that it might account for as much as 10 percent of the market. Apparently, it is difficult to judge the market share precisely because there is no legal definition which would assist in compiling statistics. See para.6.24. Korea states that sales of premium diluted soju have declined recently. We also note that sales of imports have declined at the same time due, presumably, to the current financial crisis in Korea. The lower priced product, standard diluted soju has increased sales. These changes in levels of sales, if anything, can be taken as further support for the relationship of the products. See EC Answers to Questions, Question 1 from the Panel at pp. 1-2, and accompanying chart.

³⁷⁰ Korea First Submission, Attachment 1, *supra.*, at 3.

³⁷¹ *Ibid.*

use identified by Korea as one also pertaining to imports; distilled soju is aged as is the case with many of the imports. As is discussed further below, we do not think that these types of differences are sufficiently important to meaningfully distinguish between two products. We will proceed with an examination primarily of the competitive relationship of the imported products with diluted soju, including both standard and premium subcategories of diluted soju. If we find that diluted soju is directly competitive with and substitutable for the imported products, it will follow that this is also the case for distilled soju because distilled soju is intermediary between the imported products and diluted soju. Indeed, distilled soju is, on the one hand, more similar to the imported products than diluted soju and is, on the other hand, more similar to diluted soju than are the imported products.

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

10.56. The *Japan – Taxes on Alcoholic Beverages II* case provides unclear guidance for the present case. The panel in that instance made findings with respect to the western-style alcoholic beverages for which specific evidence was provided. However, the panel did not explicitly state that it was not making a determination with respect to the other products within HS 2208. The Appellate Body ruled that, as a matter of law, the panel erred in not making determinations with respect to all of the products within the terms of reference. The Appellate Body went on to find that all imported products identified by HS 2208 were directly competitive with or substitutable for the domestic product, shochu. In that case, the Appellate Body did not further explain its reasoning. We are unaware of the specifics of the *Japan – Taxes on Alcoholic Beverages II* case in this regard. While taking note of the Appellate Body's finding on this issue, we also recall the Appellate Body's statement that findings with respect to Article III:2 are to be made on a case-by-case basis.

10.57. In the present case, we are of the view that we cannot make affirmative findings with respect to products for which the complainants have provided virtually no evidence with respect to their physical characteristics, end-uses, retail outlets or prices.³⁷² It may be possible that the products identified by the complainants serve as adequate representatives of a broader category, but complainants did not provide such evidence and relied instead on assertions combined with reference to the prior Appellate Body decision regarding Japan. While, as stated, we will make reference to other markets when such markets provide relevant evidence to the determination, the evidence from the Japanese market and the determination of the Appellate Body in that case serves as an inadequate evidentiary basis for us to conclude that all products within HS 2208 are the appropriate category of imported products in the case of Korea. Indeed, to make the determination as requested by the complainants without further evidence could be to, in some circumstances, prejudge the case. If we were to follow their reasoning that the Appellate Body decision in *Japan – Taxes on Alcoholic Beverages II* case had determined the parameters of the imports for all cases, then because soju is

³⁷² The general statements by the United States and the European Communities regarding the use of the four digit tariff heading and the identified common physical characteristics and end-uses of distilled alcoholic beverages provides very weak evidence for inclusion of all products within HS 2208 given that some of those products were not even identified to the Panel.

within the HS category of 2208, it could be claimed that the whole issue of the case is decided without any evidence relating to the specific case of Korea. To look at it another way, complainants would like us to establish that all products within 2208, including soju, presumptively are covered and then leave it to Korea to prove that soju is not properly included with respect to the Korean market. This could, in some circumstances, have the practical effect of shifting the burden of proof onto the defending party without the complaining parties having first established a *prima facie* case. It may be that such evidence concerning the whole category could be developed with respect to the Korean market or may exist with respect to other markets, as apparently was the case with respect to the Japanese market, but in this case we can only make determinations with respect to the products specifically discussed by the complainants. These are vodka, whiskies, rum, gin, brandies, cognac, liqueurs, tequila and ad-mixtures.³⁷³ The complainants have not carried their burden of establishing a *prima facie* case with respect to the remainder of the products under HS 2208.³⁷⁴

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

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

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

³⁷³These are contained within portions of Korea's domestic tariff schedule, as follows:

2208.20	Spirits obtained by distilling grape wine or grape marc
2208.30	Whiskeys
2208.40	Rum and tafia
2208.50	Gin and geneva
2208.60	Vodka
2208.70	Liqueurs and Cordials
2208.90.10	Brandies other than that of heading No. 2208.20
2208.90.40	Soju
2208.90.70	Tequila

³⁷⁴See Appellate Body Report on *United States -- Measures Affecting the Imports of Woven Shirts and Blouses from India*, adopted 25 April 1997, WT/DS33/AB/R, at pp. 12-17.

manners for similar purposes. Therefore, based on the evidence, including that discussed more fully in section 4 below, we find that, on balance, all of the imported products specifically identified by the complainants have sufficient common characteristics, end-uses and channels of distribution and prices to be considered together.³⁷⁵

4. Product comparisons

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

(i) *Physical characteristics*

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

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

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

10.64. We do not agree with Korea's narrow interpretation. The Panel is examining the nature of the competitive relationship and determining whether there is an actual or potential relationship sufficiently direct to come within the strictures of Article III:2, second sentence. The physical characteristics themselves must be reviewed for if two products are physically identical or nearly so, then it obviously means that there is a greater potential for a direct competitive relationship. The United States argued that there can be two products of identical physical properties such as name

³⁷⁵ This decision does not prejudge the substantive discussion; rather we are merely identifying an analytical tool. It is possible that during the course of a dispute, evidence will show that an analytical approach should be revised. In this case, however, we note that the results of the inquiry described in the following sections confirm the appropriateness of grouping the imports together for purposes of analysis.

³⁷⁶ EC First Submission at para. 97; US First Submission at para. 68.

brand and generic aspirin which are marketed somewhat differently and perceived somewhat differently by consumers. Nonetheless, they would be considered directly competitive or substitutable and the identical or nearly identical physical characteristics would be a significant factor in the analysis. We find this analogy useful.

10.65. The panel on *Japan – Taxes on Alcoholic Beverages II* referred to the usefulness of examining marketing strategies.³⁷⁷ Marketing strategies that highlight fundamental product distinctions or, alternatively, underlying similarities may be useful tools for analysis. However, marketing strategies sometimes aim to create distinctions that are primarily perceptual between products with very similar physical characteristics. The existence of such perceptions based on marketing strategies rather than physical similarities and potential end uses does not mean that products are not at least potentially competitive. Indeed, it is natural and logical that marketers would recognize the possibility of capitalizing on the tax differentiation to create a marketing advantage.

10.66. As noted above, we have found it most fruitful to first examine whether the imported products are directly competitive or substitutable and only to turn to the question of whether they are like products second. The determination of whether two products are "like" has traditionally turned to a greater extent (although not exclusively), on the physical characteristics of products. It would be an incorrect reading of the law to argue that products' physical similarities were somehow less relevant for the category of directly competitive or substitutable products than for the subcategory of like products. To put it another way, if two products are physically identical or nearly so, it is highly probable that they are "like." They should not then be found to be not directly competitive or substitutable because marketing campaigns (or government tax regimes) have created a distinction in consumer perceptions. Such consumer perception distinctions are relevant but not determinative when the question is the *nature* of an actual or potential competitive relationship rather than merely a quantitative analysis of the current extent of competition. To find otherwise might allow allegedly discriminatory government measures to create self-justifying product distinctions between identical or nearly identical products.

10.67. We note that for purposes of the analysis under Article III:2, second sentence, products do not need to be identical to be directly competitive or substitutable.³⁷⁸ However, as discussed above, physical similarities are relevant to the inquiry, particularly with respect to potential competition. All the products presented to the Panel have the essential feature of being distilled alcoholic beverages. Indeed, Korea imports ethyl alcohol for use as the base ingredient for diluted soju. Such ethyl alcohol is also used in a similar process for vodka and shochu, among other products.³⁷⁹ All are bottled and labelled in a similar manner.³⁸⁰ In our view, the differences due to the filtration or aging processes of the beverages described are not so important as to render the products non-substitutable. Aging in barrels will impart some flavour to the product as well as a dark colour, usually amber. But differences in color do not render products non-substitutable. We note that rum also is sold in light and dark versions, albeit not as a result of barrel aging. There have been no arguments that the two types of rums are not competitive due to this physical difference. Some beverages have flavourings

³⁷⁷ Report of the Panel on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.28.

³⁷⁸ Appellate Body Report on *Canada -- Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, at p. 28.

³⁷⁹ See para. 6.153 and para.6.161. Korea has argued that this statement takes in too much. It would also imply that certain industrial products might also be like soju or directly competitive or substitutable for it. We agree that this commonality of source material is not, in and of itself, sufficient for our analysis in this case. However, it is a factor which we take into consideration for it does go to show that there is a fundamental similarity in the basic materials used in the manufacturing process.

³⁸⁰ Korea attempted to place a great deal of emphasis on the differences in bottle sizes and labelling. Korea argued that bottles of soju were very different from bottles of shochu which were, according to Korea, made to look more like whisky. We find these differences relatively minor compared to the similarities in presentation.

added, e.g., juniper berries are added to clear spirits to make gin. However, we find that these differences in flavour or colour are relatively minor. We note that soju may also contain various sweeteners and flavourings. Indeed, the premium soju that has entered the market recently, corresponding to the entry of the imported products, has increased amounts of these additives.³⁸¹ While there are some differences in the physical characteristics of the products, weighing the evidence presented, we find that there are fundamental physical similarities between the imported and domestic products that would support a finding that the imported and domestic products in question are directly competitive or substitutable.³⁸²

(ii) *End-uses*

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

1. all of them are drunk with the same purposes: thirst quenching, socialization, relaxation, etc.;
2. all of them may be drunk in similar ways: "straight," diluted with water or other non-alcoholic beverages or mixed with other alcoholic beverages;
3. all of them may be consumed before, after or during meals; and
4. all of them may be consumed at home or in public places such as restaurants, bars, etc.

10.69. These are very broad categories of end uses. In response to questions from the Panel, the complainants identified "relaxation" from the concentrated alcohol content as perhaps a defining characteristic. They also responded that such beverages as soft drinks could not be included even though they fit some of the end-uses description because they contained no alcohol.

10.70. Korea has structured its defense primarily around two related aspects of the case. First is price, which will be discussed below. Second is differing end-uses. The two are related because Korea argues that the overwhelming end-use for soju, particularly diluted soju, is drinking with meals in Korean-style and other traditional restaurants whereas western-style beverages allegedly are almost never utilized in such a fashion. One of the reasons, allegedly, for this distinction is the great price differences which make western-style beverages too expensive for such frequent use. There are other reasons put forward by Korea for the end-use distinction as well. For instance, soju is said by Korea to be a harsh drink particularly suitable for drinking with spicy Korean food.³⁸³

10.71. Prior to the second substantive meeting of the Panel, Korea produced a study by the A.C. Nielsen company which Korea argued documented the very distinct end-uses of soju and western-

³⁸¹ See para. 5.55 and para. 7.18.

³⁸² We note that these findings with respect to physical characteristics support our conclusion in section 3, above, that the identified imported products should be considered as a single category.

³⁸³ We note that Korea elsewhere emphasizes the sweetness of soju for purposes of distinguishing it from shochu. (See para.5.55.) Also, Korea submitted a copy of an advertisement for a standard diluted soju which emphasized its mildness. (Attachment 6 to Korean First Submission) This would seem to imply that Koreans would be willing to substitute allegedly less harsh western-style beverages were they to experience them. Furthermore, it is unclear how Korea's emphasis on the lower alcohol level of diluted soju relative to western-style beverages accords with the assertion of its singular harshness. Finally, it also is unclear why food should be seen as necessary to cushion the effect on the stomach of a *lower* alcohol drink compared to a higher alcohol drink.

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

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

10.73. Complainants have noted that there were almost no western-style beverages in Korea until the last five years following changes in the duty rates on imported distilled beverages. Furthermore, they argue, alcoholic beverages, like many foods and beverages, are experience based products. People tend to purchase what they are familiar with and change their tastes only over a period of time. They will only make minor substitutions for the familiar product at first and higher frequency will tend to occur over a period of time until a fairly stable rate is achieved.³⁸⁴ The trends shown in the Nielsen survey -- as well as the substitutability shown in the EC's market survey, the Dodwell study -- constitute, according to complainants, unmistakable evidence of the beginnings of substitutability and common end-uses by imports. Trends are significant with respect to such products. We think there is merit in these arguments and further note that this is another reason why the distinction offered by Korea between potential and future competition is too stark. Reasonable projections of increasing substitutability over a period of time are relevant and valid for determinations made pursuant to Article III:2.

10.74. Korea offers an analogy between the alcoholic beverage market and the automobile market which we do not find particularly useful. Korea argues that the imported products are Ferraris compared to soju's Renault Clio. However, the analogy is inapt. Automobiles are durable goods of great value relative to income that are only purchased periodically, generally only once every several years. It is probable that the purchaser of a Renault Clio has no option to purchase a Ferrari which might cost considerably more than the Clio purchaser's annual salary. Alcoholic beverages, on the other hand, are consumer goods which are purchased frequently, and even the Clio purchaser can afford to purchase a bottle of a more expensive beverage at least occasionally. The ratios between \$10 and \$100 products may be the same as between \$10,000 and \$100,000 products, but the purchasing decisions of ordinary consumers in the two situations are quite distinct.

10.75. The EC submitted a market survey conducted by Trendscape during the second substantive meeting of the Panel. It was of the same general type as Korea's Nielsen survey. It examined end-uses but did not go into specific price comparisons as did the earlier submitted Dodwell study. Korea

³⁸⁴ See para. 6.120

requests that we disregard the Trendscape survey. As discussed above, we decline to disregard the survey; however, we do not, in fact, accord much weight to the submission by the EC. It adds little of probative value to the extensive prior submissions of the parties. What was of more interest was the nature of some of the substantive disagreements of the parties concerning information contained in the Trendscape survey. Among other things there was a disagreement over the correct Korean terms and whether the questioners adequately distinguished between "meals" and "food." Korea apparently puts a great deal of store in this distinction, arguing that one must look exclusively at "meals" where Korean soju predominates rather than at mere "food" which might include snacks where western-style beverages might be consumed.

10.76. We do not consider this a meaningful distinction between end-uses of products, certainly not enough to establish separate and non-competing product categories for purposes of Article III:2, second sentence. Neither this nor other panels should be required to draw such fine distinctions permitting significant differences in the application of the law based upon such differences as saying one beverage is used for snacks and another for meals. In reviewing the evidence of this case, we are not convinced that such a distinction, even assuming Korea's argument that it exists is correct, is sufficient. If a distilled alcoholic beverage is drunk with snacks, the nature of the competitive relationship is that it can be drunk with meals, either as marketing campaigns change or persons become more familiar with products new to the market. Indeed, we are unconvinced in general that the distinction between drinking alcoholic beverages at meals and drinking them either before or after meals was, in the context of this case, sufficient to render the products not directly competitive or substitutable.³⁸⁵ Furthermore, we do not agree with the whole concept of basing a distinction on preferences for traditional drinks with traditional meals.³⁸⁶ Korean food may be spicy, but it is not uniquely so in such a manner that soju and only soju is suitable for consumption with meals. It may, in fact, transpire that most Koreans will continue to prefer their traditional drink of soju with traditional food, but based on the information in the surveys and the trends in consumption patterns, it does appear that some Koreans at some times prefer other beverages and that these trends towards substitutability are likely to continue, even with respect to end-use categories we consider overly narrow.

10.77. We also are of the view that the presence of ad-mixtures in the Korean market lends credence to the conclusion of the substitutability of the imported and domestic products. Korea argued that the domestic ad-mixtures are not soju, but as soju is defined in the Liquor Tax Law as essentially diluted ethyl alcohol with some flavorings and additives, it is unclear what point Korea is making with this alleged distinction. If alcoholic beverages can be and often are drunk mixed, either as pre-mixes or

³⁸⁵ Korea attempts to draw a number of product distinctions based on quite narrow differences. For example, Korea drew distinctions between some products based on whether they were given as gifts. Some of these assertions appeared to be contradictory. For instance, Korea stated that a distinction between diluted soju and brandy was that cognac and brandy were generally used as gifts, unlike diluted soju. However, Korea later stated that distilled soju was distinguishable from cognac and brandy because it was used for gifts while cognac and brandy were sold in "high-brow restaurants." (See para. 5.259 and para.5.295) When asked to explain, Korea responded with an even finer distinction as to what occasions particular gift beverages are used for. (See para. 7.23) Korea attempts to draw too fine a line between products for purposes of analysis under Article III:2, second sentence.

³⁸⁶ Korea has argued that the notion that distilled alcoholic beverages are not to be consumed with food is a peculiarly western notion. It is not clear that this assertion concerning "western notions" is necessarily true. Such drinks as vodka and whisky may very well be associated with traditional meals in some of the countries of origin. Furthermore, even if it is true that westerners do not generally drink distilled beverages with meals, it begs the question as to whether Koreans would like to, or sometimes do now, drink western style beverages with their meals. Also, Korea's assertion that "soju is a volume drink; vodka is not" (See para.5.269) could be questionable based on drinking behaviour in other markets. Again, while our decision is in regard to the Korean market, consumption patterns elsewhere are relevant, at least for purposes of assessing potential competitiveness.

mixed after purchase, it shows the potential for substitution between the base drinks and the lack of importance of the distinction which Korea attempts to draw based on alcohol strength.³⁸⁷

10.78. End-uses constitute one factor which is particularly relevant to the issue of *potential* competition or substitutability. If there are common end-uses, then two products may very well be competitive, either immediately or in the near and reasonably predictable future. In this regard, we do find it relevant, albeit of less relative evidentiary weight, to consider the nature of the competitive relationship in other markets. If two products compete in a market that is relatively less affected by government tax policies, it might shed light on whether those same two products are potentially competitive in the market in question. Such a comparison is not dispositive by any means; neither should it be ignored. Its relevance consists primarily in whether it tends to corroborate the trends seen in the market in question or whether it reveals inconsistencies with complainants' case which deserve further consideration. In this regard, we note that in Japan there was increasing end-use substitutability between western-style beverages and Japanese shochu as consumers became increasingly familiar with the new product. Both soju and shochu are traditional drinks in their respective countries. Both markets involved small but growing import penetration following partial liberalization. The trends that the panel and Appellate Body observed in Japan appear to be beginning in Korea.

10.79. Article III cases deal with markets³⁸⁸ and the response of Korean producers to changes in the markets provides significant evidence of at least a competitive relationship between soju and the imports. The trend towards increasingly overlapping end-uses are supported by the marketing strategies of the domestic Korean companies. These companies met the potential threat of imports of western-style beverages by creating and selling premium diluted soju. This beverage had more flavourings and was marketed in a manner more similar to western-style beverages than standard diluted soju. However, it remained within the definition of diluted soju in the Korean tax law. The physical characteristics were changed enough to be more similar to such imports while still enjoying the price advantages provided by lower tax rates. The complainants also produced evidence that these products were being advertised as competitive with western-style beverages.³⁸⁹ Indeed, one advertisement referred to soju as a vodka-like product and also showed a new product called barley soju which clearly is intended to be comparable to imported products such as whiskies.³⁹⁰ Evidence was also produced from various sources including Korean Air's in-flight magazine showing very similar advertising strategies for distilled soju and western-style beverages.³⁹¹

10.80. Korea argued that advertisements in Korean Air's in-flight magazine should not be considered as aimed at the broad domestic market. Similarly, according to Korea, information from the website of the largest Korean soju producer, Jinro, in English or other advertisements in Japanese would be aimed at the export market not at the Korean domestic market, which is the only relevant one here. We take note of Korea's criticisms of these materials. However, we continue to disagree that the *only*

³⁸⁷ The question of mixes highlights another of the inconsistencies that emerge from Korea's narrow product-by-product comparisons. For example, Korea argues that an important distinction between soju and vodka is that soju is almost always drunk straight whereas vodka is a mixing drink. (See paras. 5.268-5.269) If this is an important distinction, it would seem an important similarity then between soju and whisky, for example, that the two are often drunk straight. Or if whisky is mixed, it generally is with ice or water which also would seem to highlight the similarity with diluted soju on the basis of alcohol strength of the consumed product. It is also unclear what the basis is for Korea's assertion that vodka is a mixing drink. While it frequently is served that way, it also is served straight.

³⁸⁸ Appellate Body report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

³⁸⁹ See US Exhibits E and F and EC First Submission, Annex 12. See also the Sofres Report, *supra.*, at pp. 23-24.

³⁹⁰ US Exhibit Q.

³⁹¹ US Exhibit D.

relevant market for collecting data is the Korean domestic market.³⁹² Rather the Korean market is the one that is the subject of our decision. In assessing the potential for products to be directly competitive with or substitutable for the domestic products it is relevant to look at how the domestic Korean companies produce, advertise and distribute their products in other markets as well as in Korea. Such evidence may be valuable for confirming or challenging trends and identifying important characteristics of the market which is the subject of the determination. In this case, the trends in the Japanese market where shochu and imported western-style beverages became increasingly used for the same purposes and the behaviour of Korean firms that met the challenge of imports with versions of soju increasingly similar to such imported beverages are relevant confirmation of what exists, albeit in a somewhat nascent form, in the Korean market.

10.81. The issue was raised whether the Panel should use the same criteria for defining markets under Article III:2 as under competition law. Korea was generally supportive of utilizing competition law market definitions for purposes of Article III and even went further and queried whether competition law market definitions might be too broad for purposes of Article III. Complainants argued, on the other hand, that Article III has a different purpose from competition law. Article III, they argue, is an anti-discrimination provision aimed at ensuring that government measures do not result in competitive conditions which favor the domestic industry. Therefore, the interpretation should be broad. According to the complainants, antitrust law has a different purpose of addressing the actions of individual firms or persons that threaten competition and such laws generally do not recognize any distinction between foreign or domestic persons. While the specifics of the interaction between trade and competition law are still being developed, we concur that the market definitions need not be the same. Trade law generally, and Article III in particular, focuses on the promotion of economic opportunities for importers through the elimination of discriminatory governmental measures which impair fair international trade. Thus, trade law addresses the issue of the potentiality to compete. Antitrust law generally focuses on firms' practices or structural modifications which may prevent or restrain or eliminate competition. It is not illogical that markets be defined more broadly when implementing laws primarily designed to protect competitive opportunities than when implementing laws designed to protect the actual mechanisms of competition. In our view, it can thus be appropriate to utilize a broader concept of markets with respect to Article III:2, second sentence, than is used in antitrust law. We also take note of the developments under European Community law in this regard. For instance, under Article 95 of the Treaty of Rome, which is based on the language of Article III, distilled alcoholic beverages have been considered similar or competitive in a series of rulings by the European Court of Justice ("ECJ").³⁹³ On the other hand, in examining a merger under the European Merger Regulation,³⁹⁴ the Commission of the European Communities found that whisky constituted a separate market.³⁹⁵ Similarly, in an Article 95 case, bananas were considered in competition with other fruits.³⁹⁶ However, under EC competition law, bananas constituted a distinct product market.³⁹⁷ We are mindful that the Treaty of Rome is different in scope and purpose from the General Agreement, the similarity of Article 95 and Article III, notwithstanding. Nonetheless, we observe that there is relevance in examining how the ECJ has defined markets in similar situations to

³⁹² It is not clear that all the advertisements were aimed completely outside the Korean market as Korea claims. The advertisements in U.S. Exhibit D appear to be in Korean as well as English.

³⁹³ See *Commission v. France*, Case 168/78, 1980 ECR 347; *Commission v. Kingdom of Denmark*, Case 171/78, 1980 ECR 447; *Commission v. Italian Republic*, Case 319/81, 1983 ECR 601; *Commission v. Hellenic Republic*, Case 230/89, 1991 ECR 1909.

³⁹⁴ Council Regulation No. 4064/89 of 21 December 1989 on the control of concentrations between undertakings.

³⁹⁵ Case No. IV/M 938 – *Guinness/Grand Metropolitan*.

³⁹⁶ *Commission v. Italy*, Case 184/85, 1987 ECR 2013.

³⁹⁷ *United Brands v. Commission*, Case 27/76, 1978 ECR 207.

assist in understanding the relationship between the analysis of non-discrimination provisions and competition law.³⁹⁸

10.82. In making our assessment with respect to degree and nature of overlapping end-uses, we wish to make clear that we are not putting a burden of proving the negative on Korea. Rather, we think that the complainants submitted adequate evidence, *inter alia*, in the form of the Dodwell study, anecdotal evidence, and evidence of trends and results in other markets to establish this portion of their case. We also have taken note of the information in the Nielsen and Trendscape studies. All the beverages described are utilized for socialization purposes in situations where the effect of drinks containing relatively high concentrations of alcohol is desired. They may be used in a variety of social settings, including with food, either meals or otherwise. Korea's attempts to rebut this argument ultimately were unpersuasive. The distinctions that Korea would have us draw are too narrow and transitory. We decline to base a decision on whether a particular type of food is a meal or merely a snack. Indeed, as discussed above, we are sceptical of the whole meal-based rationale which is an important part of the Korean case. In balancing the evidence in this regard, we are mindful of the examples offered by the drafters of Article III and *Ad Article III* who considered apples and oranges directly competitive or substitutable products. Thus, we conclude that, on balance, the evidence is that there are current and potential overlapping end-uses sufficient to be supportive of a finding that the domestic and imported products are directly competitive or substitutable.³⁹⁹

(iii) *Channels of distribution and points of sale*

10.83. There is a considerable degree of overlap between the questions of common end-uses and common channels of distribution. Often, consumer products will be distributed in a manner that reflects their intended end-uses. Channels of distribution tend to reveal present market structure while end-uses deals with both the current overlap, if any, and potential for future overlap. In the present case, it is evident that soju and western-style beverages are currently sold through similar retail outlets in a quite similar manner for off-premise consumption.⁴⁰⁰ Korea has argued that when taken from such outlets soju is consumed differently; this argument is addressed in the preceding section. Similarly, the complainants have shown that there are some similarities in other presumably more minor outlets such as duty free sales.

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

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

³⁹⁸ In finding the relationship of the provisions to each other relevant, we do not intend to imply that we have adopted the market definitions defined in these or other ECJ cases for purposes of this decision.

³⁹⁹ We note that the conclusions we reach in this section regarding end-uses supports our conclusion in section 3, above, that the identified imports should be considered a single category.

⁴⁰⁰ US Exhibit G; EC First Submission, Annex 11. See also paras. 6.93-6.94 and 6.188-6.189. We note that this evidence also shows that imports are sold in a similar manner to each other and supports our conclusion in section 3, above.

soju was sold than whisky in this allegedly western-style beverage channel of distribution. This seems to detract from the Korean claim that this type of on-premise channel of distribution overwhelmingly favoured whisky.

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

(iv) *Prices*

10.87. Complainants have submitted a study of Korean consumer behaviour (the Dodwell study) related to relative price movements of soju and various western-style beverages, including premium Scotch whisky, standard whisky, cognac, vodka, gin, rum, tequila and liqueurs. The Dodwell study purports to show what happens when either the price of soju increases or the price of western-style beverages decreases, both done in specific increments. The survey also attempted to determine whether there was any evidence of cross-price elasticity. In response to Korea's challenges to the data and methodology, the complainants responded that the study was not attempting to show actual calculations of cross-price elasticity ratios because of difficulties inherent in the situation. Complainants said that the imported products had not been available in sufficient quantities to provide adequate consumer familiarity with the products and, furthermore, the Korean tax measures at issue also skewed the pricing and product availability structure such that it would be difficult to calculate actual cross-price elasticity ratios. As noted above, the complainants argued that alcoholic beverages were experience goods. People tend to consume what they are familiar with. Brand and product loyalty are strong and consumers will change their patterns only slowly over a long period of time following significant marketing activity and dependent upon plentiful product availability. Complainants emphasized the statement in the study that it was intended to "determine whether any evidence exists of cross-price elasticity between different spirits categories" rather than actually calculating such elasticities. Complainants referred to this as a more modest goal that was achievable and all that was possible in the circumstances.

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

⁴⁰¹ Statement of Korea at First Meeting of the Panel at p. 8; Statement of Korea at Second Meeting of the Panel at p.20.

13.8% for imports at current levels to 23.8% when soju was again increased 20% in price and imports were at their lowest survey levels.⁴⁰²

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

10.90. The complainants repeated that the Dodwell study had much more modest purposes than calculating cross-price elasticities for alcoholic beverages in the Korean market. Complainants noted that the Korean market had only been even partially deregulated for a few years and cited the findings of both panels examining Japanese alcoholic beverage taxes to the effect that government regulations and taxes often can freeze consumer preferences. In light of this, according to complainants, it stands to reason that the Dodwell study must be based on a selection of persons who have tried western-style beverages in order that they might have a frame of reference. Because of the recent arrival of western-style beverages in the market, they had to be asked a series of hypothetical questions rather than asking merely for factual information about current behaviour. Also, given the nature of alcoholic beverage purchases as on-going decisions on relatively low cost consumables, it was correct to ask whether the respondents to the survey would be willing to purchase some western-style beverages if prices changed rather than asking them if they would change their fundamental drinking habits. Complainants noted that there always will be statistical anomalies in any survey, but that in the case of the Dodwell study the overall trends were clear even if there was an occasional negative correlation in the data. Finally, complainants have noted that the Dodwell study used the same research methods as the ASI study cited by the panel in *Japan – Taxes on Alcoholic Beverages II*.⁴⁰³

10.91. Korea correctly identifies some of the weaknesses and anomalies in the Dodwell study. The responses move in unexpected directions in some instances. However, on balance, we consider that the Dodwell study provided useful information regarding at least the potential competitiveness of the imported and domestic products. We also do not agree that some of the issues highlighted by Korea are detrimental to the results. We do not find it a flaw that the chosen respondents were not an accurate cross-section of all of Korean society. The surveyors selected 500 men between the ages of 20 and 49 from 3 Korean cities who had purchased soju in the past month and whisky in the past 3 months.⁴⁰⁴ The age, gender and geographic profiles make sense. It is illogical to ask someone if they would shift to another consumer product -- particularly a food or drink item -- following a price change if such a person had never sampled such a product, or a similar one, before and the group chosen seems to be the most likely to have done so. We also agree with complainants about the prospective nature of the questions. If one is asking about the response to potential price changes, it is

⁴⁰²First Submission of the United States at paras. 78-85.

⁴⁰³See Report of the Panel on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.32.

⁴⁰⁴EC Annex 13 at p. 3.

difficult to understand how a question about current behaviour will elicit a useful response. Also, when dealing with a consumable product which has a low price relative to income, it is not necessary that a respondent will permanently change drink preferences. The willingness to occasionally substitute one product for another when there is a relatively high frequency of purchase should be sufficient.

10.92. We must also note a general concern with some of the Korean criticisms of the Dodwell study. Article III serves to protect the expectations of competitive opportunities. Requiring a survey based on current, actual behaviour would prevent a potential market entrant from ever challenging government restrictions.⁴⁰⁵ Indeed, it must be recalled that the Appellate Body confirmed that such surveys are not the decisive factor in decision making under Article III:2, second sentence. We do not find the Dodwell study decisive, but it is consistent with other information and is therefore helpful evidence. When dealing with an inquiry in the nature of the competitive relationship between products, quantitative analysis is helpful, but not necessary.

10.93. There was also considerable disagreement between the parties on the level of price differences between soju and imported western-style beverages. Korea used weighted averages and claimed that whisky was nearly 11 times more expensive than soju, making the effect of the taxes negligible. Complainants responded that the price of standard Scotch whisky was only about three times more expensive than premium diluted soju. On the other hand there were even greater variations with categories such as whisky, for instance between bulk blended-in Korea brands and fine malt Scotches, but Scotch whisky nevertheless was generally considered a single category of beverages. The complainants also argued that because of the high taxes and duties, the imports had tended to be of the higher priced brands thus skewing the numbers used by Korea. Korea further argued that the high priced brand argument was illogical because, unlike the Japanese system of specific duties, the Korean tax system was *ad valorem*. Complainants said that in such a restrictive market, it was not unusual for firms to lead entry into the market with higher priced niche brands to build awareness and sell with an exclusive cachet in segments where premiums could be charged and the consumers had higher incomes and therefore would be relatively less affected by tax levels. Complainants offered some evidence to support their claim by showing consumption patterns of various brands in other selected markets where there was a heavier relative weighting of sales towards lower priced brands than in Korea.⁴⁰⁶

10.94. In examining the evidence before us, we found that, while there currently are significant price differences between the imported and domestic products, overall the differences were not decisive. Korea presented prices as weighted averages which obscured the higher prices for premium diluted soju, which was the small but fast growing category created specifically by Korean manufacturers to be most competitive with imports. The price of premium diluted soju appears to be approximately two times the price of standard diluted soju, while vodka was four times the price and standard whisky four and a half times the price of premium diluted soju.⁴⁰⁷ Distilled soju was twice the price of standard whisky.⁴⁰⁸ There are greater price differences within some categories, e.g., whisky,⁴⁰⁹

⁴⁰⁵ As noted above in our discussion of potential competition, requiring surveys exclusively on current actual behavior would make it even more difficult for less wealthy complainants to establish sufficient actual market presence to establish a *prima facie* case of nullification or impairment.

⁴⁰⁶ See Annex 1 to EC Answers to Questions from the Second meeting of the Panel.

⁴⁰⁷ Thus, vodka was approximately eight times the price of standard diluted soju and standard whisky was approximately nine times the price of standard diluted soju.

⁴⁰⁸ EC Second Submission to the Panel at Annex 7. Also, from the Dodwell study and other evidence it appears that the following are the relationships between the prices of the other products: Gin is approximately 3.25 times the price of premium diluted soju and 6.5 times the price of standard diluted. Tequila is approximately 5.5 times the price of premium diluted soju and 11 times the price of standard diluted. Liqueur is approximately 5 times the price of premium diluted and 10 times the price of standard diluted. Cognac is approximately 12 times the price of premium diluted soju and 24 times the price of standard diluted soju. We

which none of the parties argued rendered such subcategories of products not directly competitive or substitutable. Furthermore, we agree with the complainants that absolute price differences are less important than behavioural changes that occur due to relative price movements.⁴¹⁰ When examined as a whole, the price differences are not so large as to refute the other evidence of potential competitiveness and substitutability, and there was evidence that relative price movements are likely to result in changes in consumption patterns. Overall, we found that the data on prices and the potential for changes in consumer behavior based on relative price changes, to be supportive of a finding that the identified imported and domestic products are directly competitive or substitutable.

(v) *Conclusions with respect to "directly competitive or substitutable"*

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

10.96. The levels of overlapping end-uses are currently relatively low if end-uses are defined as narrowly as suggested by Korea. However, even within such overly-narrow end-use categories, the evidence must be viewed in light of the relatively recent introduction of the western-style beverages to the market. Furthermore, we do not agree with Korea's argument about the distinctness of current market differentiation. We think Korea has drawn too fine a distinction between products for purposes of Article III:2, second sentence. Again we recall the examples of substitutable products

note that Korea offered some lower price comparisons in its Interim Review comments to the effect that vodka was 5.7 times more expensive than diluted soju, while gin was 5 times more expensive and rum 6.2 times more expensive. Korea also stated that cognac/brandy was 19.2 times the price of diluted soju. Korea did not indicate if weighted averaging caused these differences from the figures above.

We note that in the decision in *Japan – Taxes on Alcoholic Beverages II*, adjustments were made for alcohol content. Panel Report in *Japan – Taxes on Alcoholic Beverages II*, *supra.*, Annex VI, Figure 10. When such adjustments are removed, it seems that the absolute price ratio differentials in the present case are more similar to those in Japan than otherwise appears.

⁴⁰⁹ See para.6.105; Dodwell Study.

⁴¹⁰ Indeed, we must reiterate that caution must be exercised in relying on absolute price ratio differences in making product distinctions in a market such as this. Prices can respond to extraneous factors such as exchange rates or can be affected through product mix or high overhead or distribution costs possibly caused in part by the government policies at issue.

offered by the drafters, which included apples and oranges. This also can be seen in the significantly overlapping channels of distribution both for off-premise sales and on-premise sales. In our view, the only meaningful distinction with respect to channels of distribution in this case is the distinction between on-premise and off-premise consumption and both imports and soju are distributed through both channels.

10.97. There is evidence both of some level of current actual competition and significant potential competition. However, complainants do not have to prove that there is a complete overlap in their analysis of substitutability. Moreover, we take guidance from the earlier panel findings that the current market conditions may be skewed by government tax and regulatory policies which tend to freeze consumer preferences in favour of the domestic products. The current price levels are probably the most telling evidence contrary to complainants assertions. In our view, the Dodwell study is a useful piece of evidence showing the potential competitive relationship between the domestic and imported products under various pricing scenarios. It is not perfect evidence, but we do not find the Korean critique conclusive in rebutting its basic premises. Indeed, we find confirmation of some of the basic points about potential competitiveness in both the Korean end-use survey conducted by the AC Nielsen study and the Trendscape survey. Furthermore, we do not accept that the price differences in the present case establish that the products in question are not even potential competitors. Prices are subject to change by extraneous factors such as exchange rates.

10.98. We are of the view that there is sufficient unrebutted evidence in this case to show present direct competition between the products. Furthermore, we are of the view that the complainants also have shown a strong potentially direct competitive relationship. Thus, on balance, we find that the evidence concerning physical characteristics, end-uses, channels of distribution and pricing, leads us to conclude that the imported and domestic products are directly competitive or substitutable.

5. Not similarly taxed

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

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

10.100. In the present case, the Liquor Taxes on diluted soju are 35 percent and 50 percent on distilled soju. The Education Tax is surtax of 10 percent levied on soju. With respect to imported alcoholic beverages, the Liquor Tax ranges from 50 percent for liqueurs to 100 percent for whisky and brandy. The Education Tax is 30 percent for all imported alcoholic beverages except liqueurs which have a 10 percent rate. Thus the total tax on diluted soju is 38.5 percent; on distilled soju and liqueurs it is 55 percent; on vodka, gin, rum, tequila and ad-mixtures it is 104 percent; on whisky, brandy and cognac it is 130 percent. Thus the tax rate on imported whisky, for example, is more than three times the *ad valorem* rate on diluted soju. These differentials are clearly in excess of *de minimis* levels.⁴¹²

⁴¹¹ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages*, *supra.*, at p. 27. It should be noted that in the case of Japan, the duties were specific and there was an ultimately unsuccessful argument by Japan that the tax/price ratios were not dissimilar. Because Korea's taxes are strictly *ad valorem*, the rates are more easily comparable and there is no such issue.

⁴¹² The fact that distilled soju and liqueurs are taxed at the same rate does not detract from this finding with respect to the other products and with respect to liqueurs compared to diluted soju.

6. So as to afford protection

10.101. The Appellate Body in the *Japan Alcoholic Beverages* case stated that the focus of this portion of the inquiry should be on the objective factors underlying the tax measure in question including its design, architecture and the revealing structure.⁴¹³ In that case, the Panel and the Appellate Body found that the very magnitude of the dissimilar taxation supported a finding that it was applied so as to afford protection. In the present case, the Korean tax law also has very large differences in levels of taxation, large enough, in our view, also to support such a finding.

10.102. In addition to the very large levels of tax differentials, we also note that the structures of the Liquor Tax Law and the Education Tax Law are consistent with this finding. The structure of the Liquor Tax Law itself is discriminatory. It is based on a very broad generic definition which is defined as soju and then there are specific exceptions corresponding very closely to one or more characteristics of imported beverages that are used to identify products which receive higher tax rates. There is virtually no imported soju so the beneficiaries of this structure are almost exclusively domestic producers.⁴¹⁴ Thus, in our view, the design, architecture and structure of the Korean alcoholic beverages tax laws (including the Education Tax as it is applied in a differential manner to imported and domestic products) afford protection to domestic production. We therefore conclude that there is nullification or impairment of the benefits accruing to the complainants under GATT 1994 within the meaning of Article 3.8 of the DSU.

7. Like Product

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

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

⁴¹³ Appellate Body Report, on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 29. See also *Canada - Certain Measures Concerning Periodicals*, *supra.*, at pp. 30-32.

⁴¹⁴ The only domestic product which falls into a higher category that corresponds to one type of imported beverage is distilled soju which represents less than one percent of Korean production.

⁴¹⁵ See para. 5.100et. seq.

⁴¹⁶ See para. 5.264et. seq. and para. 5.296 et. seq.

⁴¹⁷ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at p. 21.

⁴¹⁸ *Ibid.*

XI. CONCLUSIONS

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

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