

## VII. ANSWERS TO QUESTIONS

### A. EUROPEAN COMMUNITIES

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

- (a) As noted by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, how much broader the category of "directly competitive or substitutable products" may be in a given case is a matter for the panel to determine based on all the relevant factors in that case.<sup>285</sup> Accordingly, it would be inappropriate to try and define a standard of general application, and in particular a quantitative one.
- (b) There is no support for Korea's contention that the notion of "directly competitive or substitutable products" must be interpreted "strictly". On the contrary, as demonstrated by the complainants, an examination of the drafting history of GATT and of previous Panel and Appellate Body reports (including the two cases on *Japan - Taxes on Alcoholic Beverages II*) shows that in practice the "directly" has been given a rather broad interpretation.
- (c) In *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body made it clear that cross-price elasticity is not "the decisive criterion"<sup>286</sup> for establishing whether two products are directly competitive or substitutable. According to the Appellate Body, cross-price elasticity is but one of the means of examining a relevant market. In turn looking at competition in the relevant markets is just "one among a number of means"<sup>287</sup> of identifying the products that are directly competitive or substitutable in a particular case. The other means mentioned by the Appellate Body are the physical characteristics, the end uses and the customs classification of the products.
- (d) Furthermore, the relevance of a particular level of cross-price elasticity may vary according to the circumstances of each case. For instance, if two products have been sold for a long time and under similar conditions on the same geographical market, a "very low rate of cross-price elasticity" could be an indication that they 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

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<sup>285</sup> Appellate Body Report, *supra.*, p. 25.

<sup>286</sup> Ibid.

<sup>287</sup> 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,<sup>288</sup> the Appellate Body also noted the fact that Japanese shochu was "isolated" from imports of shochu<sup>289</sup>. 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.<sup>290</sup>
- (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.<sup>291</sup>

- (c) Thus, the third element of Article III:2, second sentence, is concerned only and exclusively with the question whether, by taxing one product less than another

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<sup>288</sup> Ibid., p. 29.

<sup>289</sup> Ibid., p. 31.

<sup>290</sup> See also the Appellate Body Report on *Canada - Certain Measures Concerning Periodicals*, *supra.*, pp. 31-32.

<sup>291</sup> 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 taxed<sup>292</sup> product. In other words, the third element of Article III:2, second sentence, is not about how much protection is afforded, but rather about who is protected.

- (d) The view that in order to establish a violation of Article III:2 it is necessary for the complainants to show that the measures actually afford a certain "degree" of protection by effectively reducing sales of imports above a *de minimis* level would be in contradiction with the well established principle that GATT Article III is concerned with the protection of competitive opportunities and not of actual trade flows. More specifically, according to the Appellate Body:

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

- (e) In sum, the European Communities is of the view that the third element of Article III:2, second sentence, does not introduce another *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.

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<sup>292</sup> 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 taxed equally.

<sup>293</sup> 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".<sup>294</sup>
- (b) There is, nevertheless, an essential difference. When applying GATT Article III:2, first sentence, Panels must take into account the "potential" competition which would materialise between the products concerned in the absence of the tax differential in dispute and not the "actual" competition existing under current taxation conditions. In contrast, competition authorities tend to consider tax differentials as a permanent barrier to competition and disregard any additional competition which may arise from removing that barrier.<sup>295</sup> As a result, the scope of the "relevant product" markets defined for competition purposes will generally be narrower than the scope of "directly competitive products" defined for the purposes of Article III:2, second sentence.
- (c) It must also be borne in mind that the notions of "competition" and of "substitutability" are relative ones. From an economic perspective, two products are not either "competitive" or "non competitive". Rather, products are "more or less" competitive. For that reason, as important as the criteria for defining a relevant market or for defining the notion of "directly competitive or substitutable products" is the degree of competition which is deemed relevant in each case. That degree will determine the standard by which the criteria are to be interpreted. That standard may vary depending on the purpose of the legal provision to be applied. It may vary also from one jurisdiction to another.
- (d) This link is expressly recognised in an EC Commission Notice on the definition of relevant markets for Competition law purposes, which states that "the concept of relevant market is closely related to the objectives pursued under Community competition policy".<sup>296</sup> Further, that Notice acknowledges that the definition of the relevant market may vary depending "on the nature of the competition issue being examined."<sup>297</sup>

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

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

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

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

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

<sup>296</sup> Notice, para 10.

<sup>297</sup> 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.<sup>298</sup> In Article III:2, first sentence, it must be construed narrowly. In other GATT provisions, it may be construed more broadly. *A fortiori*, the notion of "directly competitive or substitutable" may also have a different scope in Article III:2 of GATT and in the competition laws of Members, which pursue an altogether different objective.
- (i) More relevant for the interpretation of GATT Article III:2 is the case law of the European Court of Justice (ECJ) regarding the application of Article 95 of the EC Treaty,<sup>299</sup> whose wording is almost identical to that of GATT Article III:2 and therefore, unlike EC Competition Law, shares a similar purpose. In a long line of cases, the ECJ has concluded that all distilled spirits are either "similar" (the equivalent concept of "like") or "directly competitive or substitutable".<sup>300</sup>

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

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

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

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

<sup>300</sup> 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*.<sup>301</sup> Although that Panel report is concerned with GATT Article III:4, the European Communities is of the view that the same principle applies also with respect to Article III:2.
- (b) In the present case, it is relevant that all distilled spirits are obtained by the same manufacturing process (distillation) because it has the consequence that all of them share the same basic physical characteristics. On the other hand, differences regarding the method of distillation (continuous or pot-still), the method of filtration (through white birch or other methods) or the production volume (artisanal v. industrial) are irrelevant because they have either no impact at all or only a minor impact on the physical characteristics and end uses of the products.

#### B. UNITED STATES

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

- (a) The standard that should be used to establish that two products are "directly competitive or substitutable" within the meaning of Article III:2 is a case-by-case examination that may consider a number of factors. There is no one standard that can operate across all cases. Cross-price elasticity is but one factor that may be helpful in conducting an analysis of whether products are directly competitive or 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,<sup>302</sup>

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varieties of spirits remains doubtful or contested" (Judgement of the ECJ of 27 February 1980, *Commission of the European Communities v Kingdom of Denmark*, Case 171/78, ECR 1980, 447, at par. 12)

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

<sup>302</sup> 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".<sup>303</sup>

- (b) In concluding that the panel had not erred in determining that the tax was protective solely on the basis of the large differentials between tax rates applied to shochu and Western spirits, the Appellate Body appears to have reasoned that the large differences between such physically similar products could not be otherwise explained. The United States considers that the magnitude of the differences in tax rates between such similar products in this case compel the same inference. On the 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

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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.

<sup>303</sup> 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.”<sup>304</sup> 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.<sup>305</sup> Pre-mixes have 10 per cent to 15 per cent alcoholic content.
- (b) Standard soju has 25 per cent alcoholic content. The salient features which distinguish premixes from standard soju are that the former contains scent, coloration and more than 2 per cent extract. To be precise, pre-mixes do not contain standard soju. The mixture is a combination of various ingredients and joojung (ethyl Alcohol) which is the raw material from which standard soju is produced.
- (c) To make the pre-mixes appeal to women, the producers first eliminated the pungent odour and taste of joojung by adding fruit scents (such as lemon and cherry). Thus, the producers add lemon/cherry juice concentrate, acerola juice concentrate, and lemon/cherry spices which cannot be added to standard soju pursuant to the law. Sweeteners such as stevioside, sugar and fructose are added in higher dosage than standard soju to give the pre-mixes a sweeter taste.

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<sup>304</sup> Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 16.

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

| <u>Pre-mixes</u><br>(Lemon/cherry remixes) | <u>Standard soju</u><br>(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 soju<sup>306</sup>. But for soju and scotch to be complements, they must be drunk in a tight combination with one another. What then counts is the price of the combination. But with the price of scotch so many multiples of the price of soju, a 10 per cent change in the price of soju will have only a very small effect on the price of a soju-whisky *combination*. For a 100-won rise in the price of soju to cause the number selecting premium whisky to fall from 41 to 36, and the number selecting standard scotch to fall from 56 to 49 requires a sensitivity to price that is neither plausible nor suggested by anything else in the Dodwell findings.

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<sup>306</sup> 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".<sup>307</sup> Korea sees no reason to change that assessment.
- (g) Korea also continues to believe that the attention of respondents might have wandered during their progress though the 16 sets of hypothetical prices offered them by Dodwell interviews (to say nothing of that of the interviewers themselves). That hypothesis is the one that seems to best fit the facts.

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

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

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<sup>307</sup> 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.<sup>308</sup>

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

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

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<sup>308</sup> 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.<sup>309</sup>
- (b) There are no other differences (such as physical characteristics or end use) to suggest that imported and domestic whisky are positioned differently on the Korean market. Next to the small difference in price, this is relevant as well. As Korea has emphasized before, the decision of whether products are "like" or directly competitive or substitutable products is a matter of an overall appreciation of their relationship, weighing all the relevant factors. Of course, no distinction is made in Korea's liquor and education tax rates between imported and domestic whisky.

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

- (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.<sup>310</sup> Such determinations, also in respect of the other products cited, cannot be made in the abstract.
- (c) These examples then are relevant to the present case, in that they illustrate that products with different physical characteristics may be directly competitive or substitutable products. This was also shown in the *Japan - Taxes on Alcoholic Beverages II*, where whisky and certain other spirits were found to be in a directly competitive or substitutable product-relationship with Japanese shochu. That case also shows, however, that such findings depend on a factual analysis of individual markets.

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

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

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.<sup>311</sup> In fact, in Canada's view, given the magnitude of the tax differentials in the dispute at hand, it is unnecessary to examine any other factors.<sup>312</sup>

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

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<sup>311</sup> Appellate Body Report, *supra*, p. 29.

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

B. MEXICO

1. Background

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

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

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

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

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

2. Legal Aspects

(a) General

8.12. Mexico claims that:

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

(b) 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

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<sup>313</sup> 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".<sup>314</sup>

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

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

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

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

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

<sup>317</sup> 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".<sup>318</sup>

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

|                         | Distilled <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.

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

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

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

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

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

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

8.20. Mexico also notes that in *Japan - Taxes on Alcoholic Beverages II*, which presented 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'".<sup>320</sup>

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.<sup>321</sup> The Panel in that case accepted the evidence submitted by Japan<sup>322</sup> 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.

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<sup>319</sup> Appellate Body Report, *Canada - Certain Measures Concerning Periodicals*, *supra*.

<sup>320</sup> Appellate Body Report, *supra*, Section I, p.32.

<sup>321</sup> 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.

<sup>322</sup> 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,<sup>323</sup> obliging Korea to impose on its soju imports tariffs 50 to 100 per cent higher than those applied to other spirits. As a result, on the one hand soju imports are practically non-existent, while on the other hand, soju accounts for almost the entire Korean production of spirits.

8.23. The Government of Mexico requests that the Panel:

- (a) find that Korea has contravened its obligations under the first sentence of Article III.2 of the GATT 1994 in that its internal taxes levied on various spirits of HS 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.

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<sup>323</sup> 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.<sup>324</sup> 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

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<sup>324</sup> See Article 10.4 DSU.

close that they can be considered 'like'.<sup>325</sup> 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'.<sup>326</sup> 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

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<sup>325</sup> 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.

<sup>326</sup> 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.<sup>327</sup>

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.<sup>328</sup>

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<sup>327</sup> 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.

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

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.<sup>329</sup> This also is how Korea referred to these establishments during the Second Meeting of the Panel. These establishments were not offered as a representative sample and we did not view them that way. Rather, we reviewed all of the arguments of all of the parties and took account of and balanced all of the evidence presented. Arguments here and elsewhere that the Panel "relied" upon any particular piece of evidence or assessment must be evaluated in that light. Korea examines in too isolated a manner the various other factors assessed by us in reaching our conclusions. Ultimately, we relied upon all of the evidence presented, not any single element. In our view, the arguments at that time and in the Korean comments on the Interim Report were not persuasive, in light of all the evidence, in rebutting the case established by the complainants.

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

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

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

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

<sup>331</sup> See EC Answer to Questions, Question 1 from the Panel at 1-2, and accompanying chart.

<sup>332</sup> 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".<sup>333</sup> 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

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<sup>333</sup> 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".<sup>334</sup> 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.<sup>335</sup> 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.

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<sup>334</sup> Emphasis added.

<sup>335</sup> *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.<sup>336</sup>

#### **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.

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<sup>336</sup> 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.<sup>337</sup> The United States argues that Korea's request that the Panel limit the proceeding to five specific products (whisky, brandy, vodka, rum, and gin) is equally without basis in Article 6.2. According to the United States, the panel request, which defines the terms of reference of the panel, refers to taxation of "other distilled spirits" -- i.e., distilled spirits other than soju. By using the term "such as," the United States 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.<sup>338</sup>

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

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

10.15. Korea argues that each imported product must be specifically identified in order to be within the scope of the panel proceeding. The complainants argue that the appropriate imported product is all distilled beverages. They claim, in fact, that for purposes of Article III, there is only one category

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

<sup>338</sup>*Ibid.*, at para. 142.

<sup>339</sup>*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*,<sup>340</sup> that all imported distilled alcoholic beverages were discriminated against. That element of the decision is not controlling on the ultimate resolution of other cases involving other facts; however, it cannot be considered inappropriate for complainants to follow it in framing their request for a panel in a dispute involving distilled alcoholic beverages. While it is possible that in some cases, the complaint could be considered so vague and broad that a respondent would not have adequate notice of the actual nature of the alleged discrimination, it is difficult to argue that such notice was not provided here in light of the identified tariff heading and the Appellate Body decision in the *Japan - Taxes on Alcoholic Beverages II*. Furthermore, we note that the Appellate Body recently found that a panel request based on a broader grouping of products was sufficiently specific for purposes of Article 6.2.<sup>341</sup> We find therefore, that the complainants' requests for a panel satisfied the requirements of Article 6.2 of the DSU.

## 2. 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,<sup>342</sup> 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.

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

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

<sup>342</sup> 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. ...<sup>343</sup>

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

### 3. Confidentiality

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

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

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

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

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<sup>343</sup>Ibid., 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.<sup>344</sup> Korea adds that the Appellate Body also noted that representation by counsel of a government's own choice in proceedings before it (the Appellate Body) might well be a matter of particular significance to enable WTO Members to participate fully in WTO dispute settlement proceedings. According to Korea, the same holds true with respect to delegations presenting a case before a Panel. Korea further submits that under customary international law, it has the sovereign right to determine the composition of its delegation to panel hearings.<sup>345</sup> Korea also believes its right to counsel of its choice is consistent with what it considers to be basic due process principles implicit in the DSU. Korea indicated that it appreciated that the Panel might have concerns about the confidentiality of the proceedings. Korea assured the Panel that it would ensure that any member of its delegation, including private counsel, will fully respect the confidentiality of the proceedings in accordance with applicable rules.

10.28. The European Communities indicates that it has no objection, in principle, to the presence of private counsel as part of Korea's delegation during substantive meetings of the Panel. The European Communities states, however, that they attach great importance to the preservation of confidentiality of panel proceedings. The EC acceptance was, therefore, made conditional upon Korea assuming full responsibility for any breach of confidentiality which may result from the presence at the Panel

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<sup>344</sup> Appellate Body Report, *supra.*, p. 8.

<sup>345</sup> 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.<sup>346</sup>

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

10.36. The general approach in past Article III:2 cases has been to examine first whether any of the products at issue are "like." However, previous cases have found that the category of like products is

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<sup>346</sup> *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.

<sup>347</sup> 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.<sup>348</sup> It therefore seems more logical to us to approach the issue by examining the broader category first.

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

10.38. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* stated that "like product" should be narrowly construed for purposes of Article III:2. It then noted that directly competitive or substitutable is a broader category, saying: "How much broader that category of 'directly competitive or substitutable products' may be in a given case is a matter for the panel to determine based on all the relevant facts in that case."<sup>349</sup> Article 32 of the Vienna Convention provides that it is appropriate to refer to the negotiating history of a treaty provision in order to confirm the meaning of the terms as interpreted pursuant to the application of Article 31. A review of the negotiating history of Article III:2, second sentence and the *Ad Article III* language confirms that the product categories should not be so narrowly construed as to defeat the purpose of the anti-discrimination language informing the interpretation of Article III. The Geneva session of the Preparatory Committee provided an explanation of the language of the second sentence by noting that apples and oranges could be directly competitive or substitutable.<sup>350</sup> Other examples provided were domestic linseed oil and imported tung oil<sup>351</sup> and domestic synthetic rubber and imported natural rubber.<sup>352</sup> There was discussion of whether such products as tramways and busses or coal and fuel oil could be considered as categories of directly competitive or substitutable products. There was some disagreement with respect to these products.<sup>353</sup>

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

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

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<sup>348</sup> 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.

<sup>349</sup> Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

<sup>350</sup> EPCT/A/PV/9, at p. 7.

<sup>351</sup> E/Conf.2/C.3/SR.11,p.1 and Corr. 2.

<sup>352</sup> *Ibid.* at p. 3.

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

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

between two products or groups of products requires evidence that consumers consider or could consider the two products or groups of products as alternative ways of satisfying a particular need or taste.

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

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

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

10.42. In our view, it is also the case that quantitative analyses, while helpful, should not be considered necessary. In examining the Korean market, a determination of the precise extent of the competitive overlap is complicated by the fact that, as the 1987 and 1996 panels noted in the *Japan – Taxes on Alcoholic Beverages I and II*, the intervention of government policies can cause distortions, including understatement, of the quantitative extent of the competitive relationship. Indeed, there must be some concern that a focus on the quantitative extent of competition instead of the nature of it, could result in a type of trade effects test being written into Article III cases. 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.<sup>356</sup>

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.<sup>357</sup>

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

<sup>356</sup> 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.

<sup>357</sup> 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.<sup>358</sup> 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.<sup>359</sup>

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.

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<sup>358</sup> Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

<sup>359</sup> 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.<sup>360</sup> 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.<sup>361</sup> As noted above, the Appellate Body in *Japan -- Taxes on Alcoholic Beverages II* stated:

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

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

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<sup>360</sup> See, Appellate Body Report on *European Communities – Customs Classification of Certain Computer Equipment*, *supra.*, at para. 93.

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

<sup>362</sup> 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.<sup>363</sup>

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

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

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

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

The same dictionary defines "expectation" as follows:

*expectation* 1. The action of waiting for someone or something. . . .4. A thing expected or looked forward to.<sup>366</sup>

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

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

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

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

<sup>366</sup>*Ibid.* Vol. 1 at p. 885 (emphasis in original).

solution extracted by a method of single-step distillation.<sup>367</sup> 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.<sup>368</sup> 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.<sup>369</sup> 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".<sup>370</sup>

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

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

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

We are not convinced that this difference is significant. Moreover, in our view, to the extent there are differences between the two types of soju, distilled soju is more similar to the imported products than diluted soju. Distilled soju is higher priced than diluted soju; distilled soju (40-45 percent) has a higher alcohol content than diluted soju (20-25 percent); distilled soju often is used as gifts, an end-

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<sup>367</sup> 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.

<sup>368</sup> 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.

<sup>369</sup> 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.

<sup>370</sup> Korea First Submission, Attachment 1, *supra.*, at 3.

<sup>371</sup> *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.<sup>372</sup> 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, prejudice 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

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<sup>372</sup> 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.<sup>373</sup> The complainants have not carried their burden of establishing a *prima facie* case with respect to the remainder of the products under HS 2208.<sup>374</sup>

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

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

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

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<sup>373</sup>These 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   |

<sup>374</sup>See 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.<sup>375</sup>

#### 4. Product comparisons

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

##### (i) *Physical characteristics*

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

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

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

10.64. We do not agree with Korea's narrow interpretation. The Panel is examining the nature of the competitive relationship and determining whether there is an actual or potential relationship sufficiently direct to come within the strictures of Article III:2, second sentence. The physical characteristics themselves must be reviewed for if two products are physically identical or nearly so, then it obviously means that there is a greater potential for a direct competitive relationship. The United States argued that there can be two products of identical physical properties such as name

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<sup>375</sup> 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.

<sup>376</sup> 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.<sup>377</sup> Marketing strategies that highlight fundamental product distinctions or, alternatively, underlying similarities may be useful tools for analysis. However, marketing strategies sometimes aim to create distinctions that are primarily perceptual between products with very similar physical characteristics. The existence of such perceptions based on 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.<sup>378</sup> 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.<sup>379</sup> All are bottled and labelled in a similar manner.<sup>380</sup> 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

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<sup>377</sup> Report of the Panel on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.28.

<sup>378</sup> Appellate Body Report on *Canada -- Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, at p. 28.

<sup>379</sup> 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.

<sup>380</sup> 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.<sup>381</sup> While there are some differences in the physical characteristics of the products, weighing the evidence presented, we find that there are fundamental physical similarities between the imported and domestic products that would support a finding that the imported and domestic products in question are directly competitive or substitutable.<sup>382</sup>

(ii) *End-uses*

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

1. 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.<sup>383</sup>

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-

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<sup>381</sup> See para. 5.55 and para. 7.18.

<sup>382</sup> 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.

<sup>383</sup> 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.<sup>384</sup> 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

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<sup>384</sup> 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.<sup>385</sup> Furthermore, we do not agree with the whole concept of basing a distinction on preferences for traditional drinks with traditional meals.<sup>386</sup> 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

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<sup>385</sup> 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.

<sup>386</sup> 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.<sup>387</sup>

10.78. End-uses constitute one factor which is particularly relevant to the issue of *potential* competition or substitutability. If there are common end-uses, then two products may very well be 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 markets<sup>388</sup> 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.<sup>389</sup> 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.<sup>390</sup> Evidence was also produced from various sources including Korean Air's in-flight magazine showing very similar advertising strategies for distilled soju and western-style beverages.<sup>391</sup>

10.80. Korea argued that advertisements in Korean Air's in-flight magazine should not be considered as aimed at the broad domestic market. Similarly, according to Korea, information from the website of the largest Korean soju producer, Jinro, in English or other advertisements in Japanese would be aimed at the export market not at the Korean domestic market, which is the only relevant one here. We take note of Korea's criticisms of these materials. However, we continue to disagree that the *only*

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<sup>387</sup> 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.

<sup>388</sup> Appellate Body report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

<sup>389</sup> See US Exhibits E and F and EC First Submission, Annex 12. See also the Sofres Report, *supra.*, at pp. 23-24.

<sup>390</sup> US Exhibit Q.

<sup>391</sup> US Exhibit D.



relevant market for collecting data is the Korean domestic market.<sup>392</sup> Rather the Korean market is the one that is the subject of our decision. In assessing the 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").<sup>393</sup> On the other hand, in examining a merger under the European Merger Regulation,<sup>394</sup> the Commission of the European Communities found that whisky constituted a separate market.<sup>395</sup> Similarly, in an Article 95 case, bananas were considered in competition with other fruits.<sup>396</sup> However, under EC competition law, bananas constituted a distinct product market.<sup>397</sup> 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

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<sup>392</sup> 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.

<sup>393</sup> 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.

<sup>394</sup> Council Regulation No. 4064/89 of 21 December 1989 on the control of concentrations between undertakings.

<sup>395</sup> Case No. IV/M 938 – *Guinness/Grand Metropolitan*.

<sup>396</sup> *Commission v. Italy*, Case 184/85, 1987 ECR 2013.

<sup>397</sup> *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.<sup>398</sup>

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.<sup>399</sup>

(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.<sup>400</sup> 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

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<sup>398</sup> 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.

<sup>399</sup> 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.

<sup>400</sup> 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.<sup>401</sup> In response to these arguments, the United States sent its embassy personnel in Seoul in search of large, traditional Korean-style restaurants to test the hypothesis. They claim to have found nine such establishments in the vicinity of the US Embassy that sold both whisky and soju. This prompted a discussion among the parties as to whether the identified restaurants would be typical or more expensive than normal. The resolution of the question of whether these restaurants were representative or were too expensive to qualify as "traditional Korean-style" is less important than the nature of the discussion itself. We do not think that a product distinction in a dispute under Article III:2, second sentence, can turn on such a thin and changeable distinction as Korea has attempted to make based on whether a restaurant is "high-class" or "expensive" or not. The only meaningful distinction in channels of distribution and points of sale that came to light in this case was the distinction between on-premise and off-premise distribution, but that distinction does not appear to distinguish between the imported and domestic products at issue. We find that, overall, there is considerable evidence of overlap in channels of distribution and points of sale of these products and such evidence is supportive of a finding that the identified imported and domestic products are directly competitive or substitutable.

(iv) *Prices*

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

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

13.8% for imports at current levels to 23.8% when soju was again increased 20% in price and imports were at their lowest survey levels.<sup>402</sup>

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

10.90. The complainants repeated that the Dodwell study had much more modest purposes than calculating cross-price elasticities for alcoholic beverages in the Korean market. Complainants noted that the Korean market had only been even partially deregulated for a few years and cited the findings of both panels examining Japanese alcoholic beverage taxes to the effect that government regulations and taxes often can freeze consumer preferences. In light of this, according to complainants, it stands to reason that the Dodwell study must be based on a selection of persons who have tried western-style beverages in order that they might have a frame of reference. Because of the recent arrival of western-style beverages in the market, they had to be asked a series of hypothetical questions rather than asking merely for factual information about current behaviour. Also, given the nature of alcoholic beverage purchases as on-going decisions on relatively low cost consumables, it was correct to ask whether the respondents to the survey would be willing to 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*.<sup>403</sup>

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

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<sup>402</sup>First Submission of the United States at paras. 78-85.

<sup>403</sup>See Report of the Panel on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.32.

<sup>404</sup>EC 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.<sup>405</sup> 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.<sup>406</sup>

10.94. In examining the evidence before us, we found that, while there currently are significant price differences between the imported and domestic products, overall the differences were not decisive. Korea presented prices as weighted averages which obscured the higher prices for premium diluted soju, which was the small but fast growing category created specifically by Korean manufacturers to be most competitive with imports. The price of premium diluted soju appears to be approximately two times the price of standard diluted soju, while vodka was four times the price and standard whisky four and a half times the price of premium diluted soju.<sup>407</sup> Distilled soju was twice the price of standard whisky.<sup>408</sup> There are greater price differences within some categories, e.g., whisky,<sup>409</sup>

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<sup>405</sup> 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.

<sup>406</sup> See Annex 1 to EC Answers to Questions from the Second meeting of the Panel.

<sup>407</sup> 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.

<sup>408</sup> 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.<sup>410</sup> 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

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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.

<sup>409</sup> See para.6.105; Dodwell Study.

<sup>410</sup> 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 un rebutted 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.<sup>411</sup>

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.<sup>412</sup>

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<sup>411</sup> 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.

<sup>412</sup> 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.<sup>413</sup> 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.<sup>414</sup> 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.<sup>415</sup> Korea disagreed.<sup>416</sup> We note that there are many similarities between vodka and soju and that these are sufficient to establish that the products are directly competitive or substitutable. However, as the Appellate Body found in *Japan – Taxes on Alcoholic Beverages II*, the concept of "likeness" in Article III:2, first sentence, is to be narrowly construed.<sup>417</sup> The question is whether the products are sufficiently close in nature that they fit within this narrow category.

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

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<sup>413</sup> 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.

<sup>414</sup> 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.

<sup>415</sup> See para. 5.100et. seq.

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

<sup>417</sup> Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at p. 21.

<sup>418</sup> *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.

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