

KOREA – TAXES ON ALCOHOLIC BEVERAGES

AB-1998-7

Report of the Appellate Body

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WORLD TRADE ORGANIZATION
APPELLATE BODY

Korea – Taxes on Alcoholic Beverages

AB-1998-7

Korea, *Appellant*
European Communities, *Appellee*
United States, *Appellee*

Present:

Matsushita, Presiding Member
Ehlermann, Member
Feliciano, Member

Mexico, *Third Participant*

I. Introduction

1. This is an appeal by Korea from certain issues of law and legal interpretation developed in the Panel Report, *Korea – Taxes on Alcoholic Beverages*.¹ That Panel was established² by the Dispute Settlement Body (the "DSB") to examine the consistency of two Korean tax laws: the Korean Liquor Tax Law of 1949 and the Korean Education Tax Law of 1982, both as amended (the "measures"), with Article III:2 of the GATT 1994. The Liquor Tax Law imposes an *ad valorem* tax on all distilled spirits. The rate of that tax depends on which of the eleven fiscal categories a particular alcoholic beverage falls within. The Education Tax Law imposes a surtax on the sale of most distilled spirits, the rate of the surtax being a percentage of the liquor tax rate applied to the spirit in question. A detailed description of the operation of these two taxes is to be found at paragraphs 2.1 to 2.23 of the Panel Report.

2. The Panel considered claims made by the European Communities and the United States that the contested measures are inconsistent with Article III:2 of the GATT 1994 because they accord preferential tax treatment to soju, a traditional Korean alcoholic beverage, as compared with certain imported "western-style" alcoholic beverages. The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 17 September 1998. The Panel "reached the conclusion

¹WT/DS75/R, WT/DS84/R, 17 September 1998.

²The Panel was established 16 October 1997 with standard terms of reference (see WT/DS75/7, WT/DS84/5, 10 December 1997) that were based on requests for the establishment of a panel made by the European Communities (WT/DS75/6, 15 September 1997) and the United States (WT/DS84/4, 15 September 1997).

that soju (diluted and distilled), whiskies, brandies, cognac, rum, gin, tequila, liqueurs and admixtures are directly competitive or substitutable products."³ The Panel also concluded that "Korea has taxed the imported products in a dissimilar manner and the tax differential is more than *de minimis*" and that "the dissimilar taxation is applied in a manner so as to afford protection to domestic production."⁴ The Panel made the following recommendation:

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 1994.⁵

3. On 20 October 1998, Korea notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal with the Appellate Body, pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures*"). On 30 October 1998, Korea filed its appellant's submission.⁶ On 16 November 1998, the European Communities and the United States filed their respective appellees' submissions⁷ and Mexico filed a third participant's submission.⁸ The oral hearing, provided for in Rule 27 of the *Working Procedures*, was held on 24 November 1998. At the oral hearing, the participants and the third participant presented their arguments and answered questions from the Division of the Appellate Body hearing the appeal.

³Panel Report, para. 11.1.

⁴*Ibid.*

⁵Panel Report, para. 11.2.

⁶Pursuant to Rule 21(1) of the *Working Procedures*.

⁷Pursuant to Rule 22 of the *Working Procedures*.

⁸Pursuant to Rule 24 of the *Working Procedures*.

II. Arguments of the Participants and the Third Participant

A. Korea – Appellant

1. "Directly Competitive or Substitutable Products"

4. Korea contends that the Panel misinterpreted and misapplied the term "directly competitive or substitutable product", especially the word "directly" which, in Korea's view, is at the heart of the term at issue. At some level all products are competitive, in that they compete for the consumer's limited budget, and it is therefore "directly" which gives meaning to the legal text and prevents Article III:2 from becoming an "unbridled instrument of tax harmonization and deregulation".

(a) Potential Competition

5. Korea claims that the alleged evidence of "potential" competition was essential to the Panel's finding of a directly competitive or substitutable relationship between the products at issue.⁹ However, Article III:2 does not speak of "potential" competition. Accordingly, it is at least ambiguous whether "potential" competition is embraced by the second sentence of Article III:2 of the GATT 1994. Given that ambiguity, Article 19.2 of the DSU and the principles of predictability and *in dubio mitius* should have been respected by the Panel.

6. In Korea's view, the term "directly competitive or substitutable" is not meant to exclude products that do not compete directly or are not substitutable because of the contested measure itself. The absence of a competitive relationship on the market concerned should be taken as a powerful counter-indication that the products involved are not "directly competitive or substitutable". The Panel, however, has read Article III:2 as covering both products that "are either directly competitive now or *can reasonably be expected to become* directly competitive in the *near future*."¹⁰ (emphasis added) In so doing, the Panel relieved the complainants of the need to prove that the lack of actual competition is caused by the contested measure, and opened the door to speculation about how the market could evolve in the future, irrespective of the measure in question. Korea warns against speculation about what consumers might (or might not) do, as opposed to looking at what they actually do. The Panel repeatedly excused the complainants' failure to produce evidence about actual competition by saying that preferences in the Korean market might have been *frozen* by government

⁹Panel Report, para. 10.97.

¹⁰Panel Report, para. 10.48. Korea also refers to paras. 10.40 and 10.73 of the Panel Report.

measures.¹¹ However, Korea points out that, at the time this case was argued, its market had been open for eight years.

7. Korea contends that the "potential" standard is impermissibly broad and speculative, and the wording and the purpose of Article III:2 do not permit this interpretation. There is nothing wrong with requiring complainants to wait until, if ever, their case becomes "ripe" and products actually compete directly. What if a Member has been forced to change its tax law because products might compete and then, in fact, they do not? Should that Member return to the panel to request permission to restore its tax system?

(b) Expectations, the "Trade Effects" Test and the "Nature" of Competition

8. Korea notes the considerable emphasis the Panel placed on "expectations" of an "equal competitive relationship" between imported and domestic products.¹² However, Korea argues that these "expectations" exist only for those products which are "like" or "directly competitive or substitutable". If products are not currently directly competitive or substitutable, there can be no relevant expectations with respect to them.

9. The Panel erroneously considered that to "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."¹³ This is a misunderstanding of the "trade effects" test. While past cases held that a lack of "trade effects" is not a defence to an Article III:2 violation, in those cases the products involved had *already been shown* to be "like" or "directly competitive or substitutable".

10. Korea observes that the Panel referred to the "nature" of competition many times in its findings, making statements such as: "the question is not of the degree of competitive overlap, but its nature."¹⁴ By examining the *nature* of competition, the Panel added a vague and subjective criterion which is not present in Article III:2, and dispensed with the complainants' obligation to show *direct* competitiveness or substitutability and also with the need to look at actual markets.

¹¹See, for example, Panel Report, para. 10.94.

¹²Panel Report, para. 10.48.

¹³Panel Report, para. 10.42.

¹⁴Panel Report, para. 10.44. Korea also refers to Panel Report, paras. 10.42, 10.44 and 10.66 in this respect.

(c) Evidence From Other Markets

11. The Panel stated that it could "look at other markets and make a judgement as to whether the same patterns could prevail in the case at hand."¹⁵ In Korea's view, this amounts to little more than guesswork and constitutes an impermissible broadening of the scope of Article III:2. The Panel also disregarded the fact that consumer responsiveness to different products "may vary from country to country".¹⁶ Moreover, there was no basis for the Panel to assume that the Korean and Japanese markets were, or were becoming, the same. Korea further contends that, even if evidence from other markets were relevant, the Panel should not have limited itself to looking at only one other country's market. To ensure a balanced view, evidence from more than one other market ought to have been reviewed.

12. Korea submits that all of the above misinterpretations of Article III:2 constitute a violation of provisions of the DSU and general principles of law, namely, the principle that neither panels nor the Appellate Body can add to or diminish the rights and obligations provided in the covered agreements (Article 19.2 of the DSU), the principle of predictability, and the principle of *in dubio mitius*.

(d) Grouping of the Products

13. Korea stresses the importance of the methodology used to compare domestic and imported products under Article III:2. It considers that the Panel committed a major legal error in wrongly defining the comparison it had to undertake. The Panel grouped together products that are not physically identical; are produced in different ways by different manufacturers using different raw materials; taste differently; are used differently; are marketed and sold differently at considerably different prices and are subject to different tax rates in Korea. The Panel also failed to carry out a separate analysis for diluted and distilled soju.¹⁷ Korea urges that the Panel erred in conducting its analysis on the basis of an agglomeration of the characteristics of two such different products. To extend conclusions that are primarily based on diluted soju to distilled soju is unacceptable logic. Further, by treating diluted soju and distilled soju together, the Panel overlooked the relevance of the considerable price differential between diluted soju and whisky.

¹⁵Panel Report, para. 10.46.

¹⁶Panel Report, *Japan – Taxes on Alcoholic Beverages* ("*Japan – Alcoholic Beverages*"), WT/DS8/R, WT/DS10/R, WT/DS11/R, adopted 1 November 1996, para. 6.28.

¹⁷Panel Report, para. 10.54.

14. Korea points out that the Panel decided to treat all the imported distilled spirits as one group.¹⁸ In Korea's view, the Panel's decision to group all these beverages together was, in effect, a decision (or at least a presumption) that they are directly competitive or substitutable everywhere, without considering whether that was true in the Korean market. By grouping all the imported beverages together, the Panel made it impossible to appreciate the differences between the imported products. The Panel could not, for example, conclude that in Korea diluted soju was directly competitive or substitutable for vodka, but not whisky.

15. Korea acknowledges that when the Panel considered the product characteristics, it examined the products in the group one by one. But the Panel dismissed as insignificant, differences between the products regarding such characteristics as colour, taste and price. In so doing, the Panel "trivialized" actual consumer perceptions which are at the heart of the "directly competitive or substitutable" standard. The erroneous approach adopted by the Panel makes it impossible to determine what the outcome of the case would have been if the Panel had not erred at the outset.

2. "So As to Afford Protection"

16. According to Korea, the Panel erred in finding that the Korean taxes had a protective effect mainly on the basis of an analysis of the structure of the law itself. The Panel ignored Korea's explanation for the structure of the law.¹⁹ The Panel also made too much of the fact that there is virtually no imported soju, overlooking the fact that there has simply been a lack of interest abroad in the manufacture of these typically Korean products. More importantly, the Panel did not follow the Appellate Body's ruling in *Japan – Alcoholic Beverages*, to the effect that, even though the tax differential may, in some cases, show that the tax is applied "so as to afford protection", "in other cases, there may be other factors that will be *just as relevant or more relevant* to demonstrating that the dissimilar taxation was applied 'so as to afford protection'."²⁰ (emphasis added)

17. Korea reiterates the argument it made before the Panel that, in view of the large, intrinsic pre-tax price-differences between diluted soju and the imported products at issue, the tax differential cannot be said to have the effect of "afford[ing] protection" to diluted soju. Where the price-difference between two products is so significant, the additional difference created by the variation in

¹⁸Panel Report, para. 10.60.

¹⁹Korea's explanation of the structure of its tax regime is set out at paras. 5.172 to 5.181 of the Panel Report. In its arguments before the Appellate Body, Korea placed particular emphasis on the arguments summarized at para. 5.176 of the Panel Report.

²⁰Adopted 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, p. 30.

tax can have no protective effect. Korea also maintains that demand for distilled soju is specific and static, and that it would not be affected a great deal by altering the price, especially not to the degree at issue in this case. Korea, therefore, claims that the tax differential does not "afford protection" to distilled soju, contrary to the conclusion reached by the Panel.

3. Application of Article III:2 of the GATT 1994

18. Korea submits that the Panel erred in several ways when assessing the evidence. While Korea recognizes that appellate review is limited to questions of law, it considers that, in reviewing a panel's interpretation and application of Article III:2, second sentence, the Appellate Body cannot avoid considering the factual underpinnings of the panel's assessment. In this case, the Panel drew conclusions which the evidence before it did not support. Errors of this type were decisive in the adjudication of the dispute in favour of the complainants, and thus constitute reversible legal errors.

19. The Panel also erred in applying different standards of proof to the evidence. The Panel was far more exacting when looking at evidence submitted by Korea than when considering evidence brought by the complainants. The Panel, in effect, applied a "double standard of proof".²¹ The Panel also misapplied the requirements on the burden of proof which follow from the Appellate Body Report in *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India* ("*United States – Shirts & Blouses*").²²

20. Despite evidence to the contrary provided by Korea, the Panel relied upon the notion that consumer preferences in the Korean market might have been frozen by the measures at issue. By so doing, the Panel unfairly put Korea in the position of having to prove a negative -- that the lack of competition was not due to the contested measures -- rather than requiring the complainants to prove positively that consumer preferences in Korea had been frozen.

²¹Korea's appellant's submission, para. 85.

²²Adopted 23 May 1997, WT/DS33/AB/R, WT/DS33/R, p. 14.

(a) Product Characteristics

21. Korea notes that the Panel found that "[a]ll the products ... have the essential feature of being distilled alcoholic beverages."²³ In essence, the Panel considered this sufficient to raise a presumption that all distilled alcoholic beverages are "directly competitive or substitutable". Korea disagrees that such a generic statement could give rise to a presumption of this type. The Panel erred in dismissing the importance of flavour in a case concerning beverages. The flavour of products is one of the consumer's primary considerations when choosing a beverage and distinctions between flavours are, therefore, not "minor"²⁴ from the consumer's perspective.

22. The Panel's focus on the fact that all the alcoholic beverages at issue are produced by distillation means that certain industrial products (e.g., paint thinner) or medicinal products (e.g., rubbing alcohol) would also be in a directly competitive or substitutable relationship with the beverages in question. Similarity in raw materials and the methods of production are, therefore, meaningless in defining a directly competitive or substitutable relationship between products.

23. That the Panel applied a "double standard of proof" is shown by its rejection, on the one hand, of Korea's example of bottled and tap water, which Korea believes demonstrated that close physical similarity is not always probative evidence of a directly competitive or substitutable relationship. On the other hand, the Panel relied on the United States' example of branded and generic aspirin to show that physical similarity was highly significant. Moreover, the Panel dismissed Korea's bottled and tap water example, in part, because it referred to "different products in different countries".²⁵ Yet, in another part of its Report, the Panel said that evidence from "other countries" was relevant.²⁶

(b) End-Uses

24. Before the Panel, Korea showed that, in Korea, the overwhelming end-use of diluted soju is consumption during meals whereas western-style drinks are hardly ever consumed with meals. The Panel, however, found that this distinction did not suffice to prevent the products from being considered as directly competitive or substitutable.²⁷ Korea believes the Panel erred, both as to the application of Article III:2 and as to requirements of the burden of proof, in accepting that all the beverages at issue were drunk for the same purposes, *inter alia*, socialization and relaxation. In

²³Panel Report, para. 10.67.

²⁴*Ibid.*

²⁵Panel Report, para. 9.23.

²⁶Panel Report, para. 10.45.

²⁷Panel Report, para. 10.76.

reaching this finding, the Panel drew upon three sources: (a) trends and anecdotal evidence; (b) marketing strategies; and, (c) the presence of admixtures.

25. The Panel placed emphasis on "trends and changes in consumption patterns"²⁸ which it said were demonstrated in the Nielsen Study and the Dodwell Study. However, neither of these studies nor the Trendscape Study contains evidence of trends. They show, instead, a "snapshot" of the market at a particular moment in time; they do not show changes over time. The Panel erred in considering that these studies contained evidence of trends, and the Panel's statements amount to mischaracterization of the evidence presented. Moreover, the Panel erred in speculating that those trends were "likely to continue",²⁹ without pointing to any supporting evidence.

26. Korea argues that the Nielsen Study was used "selectively" by the Panel. For example, even if it showed some overlap in beverages available in Japanese and western-style restaurants, it also showed that in the large majority of outlets there was no overlap. Thus, the overlap shown in the Nielsen Study is very limited and, in light of contrary evidence, cannot be considered as conclusive proof of the similarity of end-uses between the drinks at issue. In other words, the overall consumption pattern sufficiently rebuts any presumption of common end-uses raised by the minor overlap indicated by the Nielsen Study. The same is true of the figures given in the Nielsen Study for home-consumption of alcoholic beverages with meals. Even if 5.8 per cent of respondents stated that they drink whisky with their meals, that still leaves 94.2 per cent who do not. This evidence supports Korea's argument regarding the "meal" end-use of particular alcoholic beverages. Instead, it was turned around to become evidence of "overlap" in end-use. The speculation engaged in by the Panel was made worse by the Panel's consideration of trends on the Japanese market.

27. The Panel's treatment of Korean companies' marketing strategies discloses again a "double standard of proof". Where the Panel considered that marketing strategies supported a finding that the products were "like" or "directly competitive or substitutable", they became important evidence³⁰, whereas the Panel dismissed evidence from marketing strategies that it considered did not support such a finding.³¹

28. The Panel also erred when assessing the evidence submitted concerning admixtures. Korea argued that diluted soju and distilled soju are consumed "straight" in Korea (unlike some of the

²⁸Panel Report, para. 10.48.

²⁹Panel Report, para. 10.76.

³⁰Panel Report, para. 10.79.

³¹Panel Report, paras. 10.65 and 10.66.

imported beverages at issue in this case), a fact borne out in its market study.³² That soju cocktails are different from diluted soju and distilled soju is reflected in Korea's tax law. Korea maintains that the presence of diluted soju in admixtures cannot support a finding of similarity with other drinks which are drunk in a mixed form, just as the existence of Bailey's³³ is not proof that whisky is often drunk mixed. Like Bailey's and whisky, diluted soju, distilled soju and admixtures are different drinks and are treated as such under the Liquor Tax Law. The Panel wrongfully rejected Korea's point which rebutted the evidence on admixtures.

(c) Channels of Distribution

29. While recognizing that channels of distribution are revealing for a market structure, the Panel wrongly dismissed Korea's distinctions regarding on-premise consumption, and thereby erred in its assessment of the evidence.

30. The essence of Korea's argument was that most of the volume of diluted soju and of western-style drinks was sold and consumed in different types of outlets. This was borne out by the Nielsen Study which clearly shows that, except in the case of Japanese restaurants and café/western-style restaurants, there was no overlap for on-premise consumption. Before the Panel, the United States responded to this by noting that their embassy personnel knew of nine "traditional Korean-style restaurants" in Seoul serving both whisky and soju. Korea argues that the Panel should not have dismissed Korea's evidence about differences in places of consumption on the basis of evidence concerning nine restaurants, provided by the United States' embassy personnel.

31. The Panel also applied "double standards" to the evidence Korea and the complainants supplied on this issue. While Korea presented a market survey covering 320 restaurants that showed that there are different channels of distribution for the drinks in dispute, the Panel accepted the anecdotal evidence produced by the United States about only nine Korean restaurants.

³²See in particular Panel Report, paras. 5.268 and 5.273.

³³Panel Report, para. 7.11. Bailey's Irish Cream is an alcoholic beverage which is a mixture of whisky and cream.

(d) Prices

32. Korea considers that the large, undisputed price differences between diluted soju and the imported beverages are key elements of evidence, and that the larger the price difference between two products, the less influence a change in the price of one will have on the demand for the other. In the present case, there is no price overlap between diluted soju, including its premium version, and any of the western-style drinks.

33. Korea believes that the only evidence on consumer responsiveness to changes in prices which was submitted by the complainants was the Dodwell Study. But Korea raised "fundamental objections" about the Dodwell Study before the Panel, and the Study is so flawed that it should have been rejected. The Panel erred in failing to recognize the weaknesses in the Study. Korea notes that the Panel considered the Dodwell Study "helpful evidence"³⁴ sufficient to raise a presumption of a directly competitive or substitutable relationship, and rejected the "hard evidence" Korea had submitted in rebuttal. The Panel, therefore, wrongly allocated the burden of proof and also applied a "double standard" since it was lenient with the complainants' evidence, but strict with Korea's rebuttal evidence.

34. Korea contends that the evidence of the large price differences between diluted soju and most of the imported beverages is sufficient to rebut the complainants' claims about the existence of a directly competitive or substitutable relationship between the imported and domestic beverages. However, the Panel essentially disregarded the evidence and did not address Korea's argument that the absolute price differences were so great that behavioural changes were unlikely.

35. When stating that premium diluted soju was a "fast growing category"³⁵, the Panel neglected Korea's evidence. Korea had emphasized during the second meeting with the Panel that premium soju production was declining, apparently as a result of Korean consumers' unwillingness to pay more for an up-market version of diluted soju.

36. According to the Panel, cognac is a directly competitive or substitutable product for standard diluted soju even though, before any tax is applied, the products differ in price by a factor of 20.³⁶ Admittedly, for some of the western-style beverages, the price differential from soju is smaller, and even negative (e.g. distilled soju as compared to standard whisky). However, the Panel did not

³⁴Panel Report, para. 10.92.

³⁵Panel Report, para. 10.94.

³⁶This factor is based on the prices of the Dodwell Study. However, the Panel mentions an even higher price difference: a factor of 24 (Panel Report, footnote 408).

distinguish between types of product and concluded broadly that "the price differences [were] not so large as to refute the other evidence".³⁷ Korea believes that in the case of consumer products, to say that an actual price difference of a factor of 10 or 20 is insufficient to refute hypothetical evidence on competition, such as the Dodwell Study, flies in the face of common sense and shows that the Panel wrongly applied Article III:2.

(e) Treatment of Tequila

37. Korea observes that, although virtually no evidence on tequila was submitted by either the complainants or the third party, the Panel found that Korea had violated Article III:2 with respect to this beverage. The United States identified tequila as one of the products covered by the measures at issue, and tequila was included in the Dodwell Study presented by the European Communities. Mexico also made certain descriptive comments concerning the physical characteristics, tariff classification and patterns of consumption of tequila and mescal. The Panel included tequila in its examination because evidence was presented with respect to it³⁸, although it excluded mescal which "was mentioned without positive evidence" being provided.³⁹ The only additional elements concerning tequila were statements made by the complainants that tequila is drunk with spicy food in Mexico, that tequila is becoming popular in Japan⁴⁰ and that tequila was included in the Dodwell Study. Korea considers the evidence on tequila to be insufficient to give rise to a presumption of a directly competitive or substitutable relationship with soju.

38. The Panel made no attempt to analyze what the Dodwell Study actually said. The Dodwell Study shows that consumers responded inconsistently to a possible price change for tequila. In fact, it even appears from the Dodwell Study that demand for tequila may not change if its price were lowered. The Panel, nonetheless, concluded that there was evidence that consumers were sensitive to relative price changes of soju and tequila.

³⁷Panel Report, para. 10.94.

³⁸Panel Report, para. 10.58.

³⁹*Ibid.*

⁴⁰Panel Report, paras. 5.72 and 6.182.

4. Article 11 of the DSU

39. Korea submits that, contrary to Article 11 of the DSU, the Panel failed to apply the standard of review appropriate to an Article III:2 dispute. Korea maintains that, in this case, the Panel simply did not have sufficient evidence to enable it to conduct an "objective assessment" and, instead, relied on speculation. The Panel also failed to accord due deference to Korea's description of its own market. Korea believes that, when faced with conflicting descriptions of a foreign market, a panel should be very careful in making assertions about what this market is like and should certainly not engage in speculation about its possible future development. Where there was disagreement between the parties about the Korean market, the Panel should have accepted Korea's description, unless the complainants brought compelling evidence to the contrary.

40. Despite its "strong misgivings" about the Panel Report, Korea states that it does not assert that the Panel acted in bad faith. However, Korea believes that the matters it has raised under Article 11 of the DSU are, nonetheless, serious enough to merit reversal of the Panel's conclusions.

5. Article 12.7 of the DSU

41. Finally, Korea claims that the Panel failed to fulfil its obligation under Article 12.7 of the DSU. Korea considers much of the Panel's reasoning to be obscure, making it very difficult to determine the evidence the Panel relied upon in reaching its conclusions and the weight it gave to different evidence and arguments. In addition, the Panel Report is also "unacceptably vague". The Panel relies upon open-ended concepts, such as "potential" competition in the "near term", "potential" end-uses and the "nature" of competition, to support its conclusions which can be stretched to cover any outcome. Furthermore, certain evidence, such as the Sofres Study, was simply ignored without the Panel giving reasons therefor. The inadequate reasoning, in Korea's view, also prevented the Panel from making an objective assessment under Article 11 of the DSU.

B. *European Communities - Appellee*

1. "Directly Competitive or Substitutable Products"

42. The European Communities submits that Korea's appeal is grounded on the erroneous premise that the term "directly competitive or substitutable" must be interpreted "strictly". That proposition finds no support in the GATT, in its drafting history or in previous panel reports. As noted by the Panel, the drafting history of Article III:2 suggests that the drafters had in mind a rather broad notion of "directly competitive or substitutable" products, that could include apples and oranges.⁴¹ Furthermore, the Korean argument that Article III:2, second sentence, must be interpreted "strictly" is equally applicable to virtually any GATT provision.

(a) Potential Competition

43. The European Communities believes that the Panel's finding that there is "present direct competition" between the imported beverages and soju⁴² would be sufficient to conclude that those products are "directly competitive or substitutable". The additional finding of "a strong potentially direct competitive relationship" provides further support for that conclusion but is not indispensable.

44. In any event, the Panel's analysis of the evidence of "potential" competition is consistent with the wording of Article III:2, its object and purpose, as well as previous Appellate Body and panel reports. Korea relies on the fact that neither Article III:2 nor the *Ad Article* mention "potential" competition. But nor do they mention "actual" competition. In the European Communities' view, potential competition *is* "competition", both in the ordinary economic sense and within the meaning of the *Ad Article*. The use in the *Ad Article* of the words "competitive" (rather than "competing") and "substitutable" (instead of "substitute") is a further indication that the drafters envisaged the application of Article III:2 in the case of both "actual" and "potential" competition. The French and Spanish texts also support this view.

45. To the European Communities, the relevance of potential competition flows directly from the fact that Article III does not protect export volumes but expectations of an equal competitive relationship. The prohibition against protective taxation applies even if there are *no* imports of "directly competitive and substitutable" products. Korea's insistence on the existence of actual competition is, therefore, inconsistent with the proper interpretation of Article III:2. Korea's "but for"

⁴¹See Panel Report, para. 10.38.

⁴²Panel Report, para. 10.98.

test is an admission that potential competition is relevant in some circumstances, but that test is too restrictive and finds no support in Article III:2, second sentence.

(b) Evidence From Other Markets

46. A determination of whether two products are "directly competitive or substitutable" must be made on a case-by-case basis and in respect of the market of the Member applying the contested tax measures. Nevertheless, other markets may provide a strong indication of the nature of the competitive relationship between the products in the market at issue. This may be particularly true in cases where there is either very little or no actual competition on the market at issue. In the present case, the Panel made very limited use of evidence drawn from third country markets. The Panel looked at evidence from the Japanese market to corroborate findings made concerning the Korean market. Although the Panel could have looked at other markets in addition to the Japanese market, that was not necessary.

47. The European Communities contends that Korea's interpretation of Article III:2 diminishes the rights of Members. Furthermore, the principle *in dubio mitius* is a supplementary method of interpretation that applies only where there is a genuine ambiguity. That is not the case here. Finally, the Panel's interpretation promotes "predictability".

(c) Grouping of the Products

48. The European Communities views the Panel's decision on how to group the products as a methodological one made for analytical purposes only. It does not involve any interpretation of Article III:2 and does not, therefore, raise any "question of law" which could form the subject of an appeal, unless the Panel failed to make an "objective assessment" of the facts.

49. Contrary to Korea's assertions, the Panel did not find that distilled soju and diluted soju were directly substitutable and competitive products. The Panel held that if diluted soju were found to be directly competitive or substitutable with imported spirits, it would follow necessarily that distilled soju, which is more similar to imported spirits, would also be directly competitive or substitutable with those spirits.⁴³ Korea has not challenged the premise underlying the Panel's reasoning.

⁴³Panel Report, para. 10.54.

50. The European Communities contends that, in deciding to consider together all imported beverages, the Panel did not anticipate the outcome of the case nor did it find that the imported products were directly competitive or substitutable *inter se*. Korea has not shown that applying a different analytical approach would have led to a different result. There is no significant difference between Korea's strict product-by-product approach and the Panel's method. In practice, the Panel switched to a product-by-product approach whenever there were differences between the imported spirits in respect of a particular criterion.

2. "So As To Afford Protection"

51. According to the European Communities, the Panel's finding that Korea's measures are applied "so as to afford protection to domestic production", is based on three factors: the sheer magnitude of the tax differential, the lack of rationality of the product categorization, and the fact that there were virtually no imports.⁴⁴ There is no indication in the Panel Report that the Panel considered the second of these three factors to be particularly important.

52. Korea has not explained why it was necessary to add a series of exceptions to the definition of soju which resulted in the most important categories of imported spirits being placed in a much higher tax bracket than soju. The reasons why there are no imports of soju are irrelevant. What matters is that, in practice, imports of soju are and always have been negligible.

53. The European Communities considers the Korean argument that the measures do not appreciably change the competitive opportunities of the imported products to be factually wrong. In any event, comparing pre-tax price-differences is not sufficient to take account of all possible price distortions caused by the measures.⁴⁵ Furthermore, prices may be affected by extraneous factors, such as fluctuations in exchange rates.⁴⁶

54. The European Communities argues that the "so as to afford protection" requirement is concerned exclusively with *whether* the contested measures protect domestic production and not with *how much* protection is afforded. If two products are directly competitive or substitutable, then any tax differential which is more than *de minimis* may affect the competitive relationship between the

⁴⁴Panel Report, paras. 10.101 and 10.102.

⁴⁵See Panel Report, para. 10.94 and footnote 410.

⁴⁶*Ibid.*

products and, as a result, "protect" the less taxed product. The only remaining issue is whether protecting the less taxed product favours "domestic production".

3. Application of Article III:2 of the GATT 1994

55. The European Communities asserts that Korea's claims under this heading do not raise any "question of law", but only factual issues which, in principle, are not subject to appellate review. These claims can only be considered by the Appellate Body under Article 11 of the DSU. However, an appellant invoking this ground of appeal must show that the Panel abused its discretion in a manner which attains a "certain level of gravity".⁴⁷ The European Communities contends that the Panel did not make the errors Korea alleges. However, even if Korea could demonstrate that the Panel committed those errors, they would not come close to constituting "egregious errors that call into question the good faith of the Panel".⁴⁸

(a) Product Characteristics

56. According to the European Communities, Korea's argument that flavour is one of the consumer's primary considerations when choosing a beverage is flawed. If two products are nearly identical, the consumer's choice between them will necessarily turn on very minor differences. For instance, the only reason for choosing a green necktie instead of a red necktie is the colour. Yet, colour remains a relatively minor feature of neckties and differences in colour do not prevent neckties from being "directly competitive and substitutable".

57. Korea also considers that the Panel erred in relying on the "commonality of raw materials" and the similarity of manufacturing processes as a decisive criterion. In the European Communities' view, Korea improperly characterizes the Panel's reasoning. The Panel stated in unequivocal terms that "commonality of raw materials" is a relevant factor, but not a dispositive one. Nor did the Panel consider that the similarity of manufacturing processes is, in and of itself, decisive.

58. The European Communities does not accept that Korea's tap and bottled water example is comparable with that of generic and branded aspirin. Generic aspirin and branded aspirin are

⁴⁷European Communities' appellee's submission, para. 68, citing Appellate Body Reports in *European Communities – Measures Affecting the Importation of Certain Poultry Products* ("European Communities – Poultry"), WT/DS69/AB/R, adopted 23 July 1998 and *EC Measures Concerning Meat and Meat Products (Hormones)* ("European Communities – Hormones"), WT/DS26/AB/R, WT/DS48/AB/R, adopted 13 February 1998.

⁴⁸*European Communities – Hormones, supra*, footnote 47.

identical or nearly identical products, even if they are marketed differently. Tap water and bottled water have the same appearance, but it may be highly questionable whether they have close physical characteristics.

(b) End-Uses

59. The European Communities argues that the Nielsen Study refutes Korea's assertions on consumption patterns of soju and western-style spirits. It showed that some consumers drank whisky with their meals and that soju is not always drunk with meals. The Trendscape survey confirmed that western-style spirits are sometimes consumed with meals. The Panel did not base its conclusion that soju and western-style spirits have similar end-uses on the Nielsen Study's finding that 6 per cent of consumers drank whisky with their meals. Rather, the Panel rejected the relevance of the narrow distinction between consumption with meals and without meals, and also between consumption with "snacks" or with "meals".⁴⁹

60. The European Communities disagrees with Korea that there is a contradiction in the Panel's treatment of marketing strategies. Although the Panel stated that marketing strategies can be used to create primarily perceptual distinctions between products, it also stated that marketing strategies can be useful tools for analysis if they highlight fundamental product distinctions or similarities.⁵⁰ The Panel thereafter relied on marketing strategies that highlight underlying product similarities.⁵¹

61. The European Communities recalls that the complainants adduced evidence before the Panel that certain pre-mixed drinks contained soju, thereby refuting Korea's claim that soju is always drunk straight. Whether pre-mixes are considered as soju or as liqueurs for tax purposes is altogether irrelevant. Pre-mixed "gin and tonic", "whisky and cola" or "piña colada" would not be classified as whisky, gin or rum. Yet, their very existence constitutes irrefutable evidence that some consumers like to drink those spirits mixed with non-alcoholic beverages.

⁴⁹Panel Report, para. 10.76.

⁵⁰Panel Report, para. 10.65.

⁵¹Panel Report, para. 10.79.

(c) Channels of Distribution

62. The Panel relied on the "anecdotal" evidence provided by the United States embassy staff to show that Korea was drawing distinctions which were too fine. The Panel's reasoning, in the European Communities' view, was that the only relevant distinction was between off-premise consumption (i.e. consumption at home or at friends' places) and on-premise consumption (i.e. consumption at public places such as restaurants and bars).⁵² Korea does not challenge the Panel's finding that both soju and western-style spirits are currently sold in a similar manner for off-premise consumption. Nor has Korea disputed that off-premise consumption represents a substantial share of total consumption. Further, if western-style spirits were taxed similarly to soju, more people would drink them in inexpensive public places than at present.

(d) Prices

63. The European Communities notes that Korea does not challenge the Panel's view that consumer responsiveness to changes in relative prices is, in principle, more relevant than a comparison of absolute prices when assessing whether products are directly competitive or substitutable. Korea argues that premium soju "only represents 5 per cent of the market". To put things in perspective, the European Communities recalls that the total sales volume of premium diluted soju exceeds the combined sales volume of all imported spirits.

64. Korea also claims that the Panel "wilfully neglected"⁵³ Korea's evidence when it observed that premium diluted soju was a "fast growing category"⁵⁴ of product. The Panel, however, responded to Korea's arguments during the interim review, stating that, although sales had slowed, that was true for all higher priced products and was a consequence of the financial crisis. In any event, Korea did not submit evidence to show that sales of premium diluted soju had decreased.

65. Korea's arguments concerning the Dodwell Study seek, purely and simply, a *de novo* examination by the Appellate Body of facts already determined by the Panel. Korea's critique of the Dodwell Study's methodology was refuted point-by-point by the European Communities in its submissions to the Panel, and the European Communities does not consider it necessary to repeat those arguments on appeal.

⁵²Panel Report, para. 10.86.

⁵³Korea's appellant's submission, para. 155.

⁵⁴Panel Report, para. 10.94.

66. The European Communities underlines that the authors of the Sofres Report, who also prepared the Dodwell Study, assumed that all spirits were part of the same market. Although overlooked by Korea, this Report also states that imported beverages are increasingly preferred by Koreans. The passages Korea relies on have been quoted out of context.

(e) Treatment of Tequila

67. The Panel's finding that tequila and soju are "directly competitive or substitutable" products was based on the similarity of their physical characteristics and end-uses.⁵⁵ In addition, the Panel relied upon the Dodwell study.

4. Article 11 of the DSU

68. In respect of Korea's assertion that the Panel failed to accord due deference to Korea's description of the Korean market, the European Communities states that the "deferential" standard of review advocated by Korea finds no support in either the DSU or the GATT 1994. As stated by the Appellate Body⁵⁶, the appropriate standard of review for the application of the GATT 1994 and of all other covered agreements (with the sole exception of the *Agreement on the Implementation of Article VI of GATT 1994*) is contained in Article 11 of the DSU. A different standard of review would alter a "finely drawn balance".⁵⁷

5. Article 12.7 of the DSU

69. This ground of appeal does not raise any issue that has not been addressed already.

⁵⁵Panel Report, para. 10.58.

⁵⁶*European Communities – Hormones*, *supra*, footnote 47, para. 114.

⁵⁷*European Communities – Hormones*, *supra*, footnote 47, para. 115.

C. *United States - Appellee*

1. "Directly Competitive or Substitutable Products"

70. The United States observes that many of Korea's complaints in this case relate to questions of fact. Each allegation must be examined to determine whether it concerns a legal question that may be the subject of appellate review.

(a) Potential Competition

71. According to the United States, the Panel followed the Appellate Body's guidance in *Japan - Alcoholic Beverages* that the breadth of the category of "directly competitive or substitutable" products "is a matter for the panel to determine based on all the relevant facts", and that product comparisons "involve an unavoidable element of individual, discretionary judgment."⁵⁸

72. The United States considers that the concepts of "potential" and "actual" competition are redundancies. Competition may be shown by many means, including through a demonstration that current substitution is occurring or through the inherent degree of substitutability evidenced by the products' similar physical characteristics and basic end-uses.

73. Contrary to Korea's claims, the United States observes that the Panel did not rely exclusively, or even mostly, on evidence of potential competition. The Panel's reference to "significant potential competition"⁵⁹ does not detract from the fact that it concluded that there was evidence of "present direct competition".⁶⁰

74. In any event, the Panel was correct to consider evidence of potential competition in concluding that the imported products and the domestic products were "directly competitive or substitutable". Korea's argument to the contrary finds no support in the ordinary meaning of the relevant GATT 1994 provisions, taken in their context and read in light of their object and purpose, nor is it consistent with past panel and Appellate Body reports.

⁵⁸Appellate Body Report, *Japan – Alcoholic Beverages*, *supra*, footnote 20, pp. 25 and 21.

⁵⁹Panel Report, para. 10.97.

⁶⁰Panel Report, para 10.98. The United States also refers to Panel Report, paras. 10.71 – 10.73, 10.79, 10.82, 10.83, 10.86 and 10.95, all of which refer to aspects of current competition between the products.

75. According to the United States, the purpose of the provisions at issue is to prohibit protective taxation. The word "substitutable" clearly shows that Article III:2, second sentence, applies in the case of "potential substitution" (i.e. where products are *able* to be substituted). The French and Spanish texts of the provision support this reading. Likewise, the ordinary economic sense of the word "competition" is not limited to actual instances of observed substitution. The phrase "competition was involved"⁶¹ must be read as referring to situations where competition -- both current and potential -- is present.

76. Article III:2 protects "expectations" and Members' "potentialities" as exporters. The Panel was, therefore, correct to reject Korea's argument for a quantification of current substitution. A complete absence of imports is not a defence in the case of a violation of Article III and a particular degree of current market penetration of imports should not, therefore, be required.

77. The Panel was also correct, the United States believes, to consider that evidence from other markets could be "relevant, albeit of less relative evidentiary weight" than evidence from the market actually at issue.⁶² Indeed, evidence from another market may be highly probative, whereas evidence from the market at issue may be unreliable because of protection. Although the Panel could have considered more than one other market, it may have felt it most relevant and useful to consider the Japanese market, given its history of restrictions and the structure of its tax laws which appear similar to those of the Korean market. The United States also notes that the Panel's decision to consider other markets is consistent with broader GATT practice.⁶³

78. The United States views Korea's arguments concerning Article 19.2 of the DSU, the principle of *in dubio mitius* and the so-called principle of "predictability" as aids to the interpretation of Article III rather than as independent claims. In any event, the United States argues that it is Korea's interpretation which would violate Article 19.2 of the DSU and the principle of predictability. Furthermore, the principle *in dubio mitius* only applies in case of ambiguity, and there is none here.

(b) Grouping of the Products

79. The United States contends that the Panel properly examined extensive evidence concerning the categorization of products, including physical characteristics, end-uses, channels of distribution

⁶¹Ad Article III:2, second sentence.

⁶²Panel Report, para. 10.78.

⁶³The United States refers, in particular, to *Panel on Poultry*, GATT Doc. L/2088, unadopted report issued 21 November 1963, para. 10, and *Japan - Restrictions on Imports of Certain Agricultural Products*, BISD 35S/163, adopted 22 March 1988, para. 5.1.3.7.

and points of sale, and prices. The Panel's determinations with regard to the "grouping" of products was an analytical methodology that was not used to "prejudge the substantive discussion". Moreover, the Panel also analyzed the competitive relationship between individual categories of imported and domestic products. Thus, the use of the "analytical tool" had no practical repercussions on the outcome of the case.

80. Korea's objections to the Panel's decision to "combine" diluted and distilled soju for the purposes of the comparison with imported spirits amount to a disagreement with the Panel's finding that the two types of soju are similar. Pursuant to Article 17.6 of the DSU, such issues cannot, however, form the subject of an appeal.

2. "So As To Afford Protection"

81. The Panel analyzed the protectionist character of the measures in a manner consistent with the guidance given by the Appellate Body in *Japan – Alcoholic Beverages*. The three factors relied upon by the Panel were: the size of the tax differentials, the structure of the Liquor Tax Law and its application. The United States observes that Korea's explanation of the structure of the tax provides no objective reason to tax the domestic and imported products at issue so differently, given the very minor physical differences between them. The fact that detailed product definitions, corresponding to the western beverages, were introduced over time shows a specific intent to apply different fiscal treatment to soju and imports as the imports entered the Korean market. The fact that there was no imported soju shows only that the design of the law can be safely equated with protection of domestic production.

82. To the United States, Korea's argument that the large price differences between diluted soju and the imported products prevented the tax measures from affording protection is specious. First, the magnitude of the tax differentials itself can be sufficient to conclude that there is a protective effect. Second, the Panel had already made a factual finding that, despite the large price differentials, the products were directly competitive or substitutable. Third, since the tax differentials exceeded *de minimis* levels, there is no factual or legal basis to argue that the measures are *incapable* of affording protection.

3. Application of Article III:2 of the GATT 1994

83. According to the United States, Korea's request to have the Appellate Body review the "misapplication of the facts" and Korea's arguments under various articles of the DSU and

international law principles amount, in essence, to an attempt to relitigate the facts. To the extent that Korea has raised any legal claims, for instance, specific violations of Article 11 and 12.7 of the DSU, these are without basis and would, if accepted, undermine Article 17.6 of the DSU.

84. Korea alleges that the Panel refused to recognize that the complainants did not satisfy the burden of proof requirements. According to the United States, these arguments amount to an objection to the Panel's weighing of the evidence.

4. Article 11 of the DSU

85. In short, to establish that the Panel has failed to discharge its duties under Article 11 of the DSU, Korea must show that the Panel committed an error so egregious that it calls into question the "good faith" of the Panel. This is a high standard and appropriately so. As Korea concedes, its allegations concerning the facts do not call into question the Panel's good faith. Therefore, none of Korea's allegations meet the requisite standard for a violation of Article 11 of the DSU.

86. Nevertheless, Korea asks the Appellate Body to look beyond instances of bad faith. In particular, Korea asks the Appellate Body to lower the present standard by introducing new criteria for the term "objective assessment". The Appellate Body should reject these proposals as they would require it to undertake a *de novo* factual review, thereby contradicting Article 17.6 of the DSU.

87. Korea's criticisms of the Dodwell Study and the Sofres Report basically find fault with the credibility and weight given to a piece of evidence, which the Appellate Body has confirmed is "part and parcel of the fact finding process".⁶⁴ Although the Panel does not explicitly mention the Sofres Report in its findings, the Panel is clearly aware of that Report. It is mentioned in the Panel Report and is quoted extensively in Korea's oral arguments.⁶⁵

88. Korea's allegations concerning the application of a "double standard" of proof relate largely to the Panel's appreciation of the evidence before it. Korea's argument that the Panel did not have enough evidence to enable it to conduct an objective assessment is, essentially, an objection to the sufficiency of the evidence before the Panel. This is, again, a criticism of the weight and credibility of the facts.

⁶⁴*European Communities – Hormones*, *supra*, footnote 47, para. 132.

⁶⁵See, for example, Panel Report, paras. 6.121 and 6.125.

89. While the United States agrees that a country's description of its own market and culture should be respected, there is no basis in the DSU for Korea's claim that, in the event of a disagreement about the Korean market, the Panel should accept Korea's descriptions unless the complainants submit compelling evidence to the contrary. Moreover, this is a standard never before contemplated in any panel or Appellate Body report.

5. Article 12.7 of the DSU

90. The term "basic rationale" is not defined in the DSU. Under Article 31(1) of the *Vienna Convention on the Law of Treaties*⁶⁶, the text of a provision is to be given its "ordinary meaning". Dictionary definitions emphasize the minimal nature of the explanation required by Article 12.7 of the DSU.⁶⁷

91. Given the ordinary meaning of these terms, the United States sees no basis for Korea's allegation that the Panel failed to provide a sufficient explanation of its findings. A panel need not give a detailed and exhaustive statement of its reasons for every factual determination it makes. It need only provide the fundamental reasoning behind each factual and legal finding or recommendation, thereby making it possible for the Appellate Body to exercise its review and ensuring that Members understand the manner in which the panel applied the provision in question. The Panel has more than satisfied this threshold, examining each legal element in great detail and listing the factual elements it considered important.

⁶⁶Done at Vienna, 23 May 1969, 1155 U.N.T.S. 331; (1969), 8 International Legal Materials, 679.

⁶⁷Webster's Dictionary defines the word "basic" as "of, relating to, or forming the base or essence; fundamental; constituting or serving as the basis or starting-point", and "rationale" as "an explanation of controlling principles of opinion, belief, practice, or phenomena; an underlying reason; basis". The Concise Oxford Dictionary defines "basic" as "forming or serving as a base; fundamental; simplest or lowest in level," and "rationale" as "the fundamental reason or logical basis of anything; a reasoned exposition; a statement of reason".

D. *Arguments of the Third Participant – Mexico*

1. "Directly Competitive or Substitutable Products"

(a) Potential Competition

92. Mexico contends that Korea overlooks that the Panel made an express ruling concerning "direct competition"⁶⁸ and applied all of the criteria established by the panel, and endorsed by the Appellate Body, in *Japan – Alcoholic Beverages*. These criteria are: physical characteristics, common end-uses, tariff classifications and the market-place.

93. Mexico also considers that Korea's assertions regarding the "potential competition" criterion are contradictory. Korea sometimes accepts, through the "but for" test, that potential competition may be a necessary element in analysis under Article III:2, while at other times it objects to that criterion.

94. In Mexico's view, Korea places considerable emphasis on the irrelevancy and danger of speculating on the possible future evolution of a market. It is difficult to believe that Korea really thinks that the complainants and the third party in this dispute have any interest in such speculation or that they would invest considerable resources merely to obtain a hypothetical, advisory opinion. Mexico seeks only to be able to export tequila to Korea without having to face a discriminatory tax regime.

(b) Evidence From Other Markets

95. According to Mexico, the Panel analyzed evidence from the Japanese market because the Korean market "still has substantial tax differentials"⁶⁹, and, in those circumstances, the Japanese market was relevant. The Panel did not evade its obligation to examine the Korean market since that market was also analyzed.

⁶⁸Panel Report, paras 10.95, 10.97 and 10.98.

⁶⁹Panel Report, para. 10.45.

(c) Grouping of the Products

96. Mexico is of the view that Korea has misunderstood the Panel's intention in proceeding primarily with an examination of the relationship between diluted soju and the imported beverages. The Panel simply based its examination on diluted soju and, when it detected a relevant difference between the two types of soju, highlighted that difference.

97. The Panel did not improperly group the imported beverages nor did it ignore differences between them. The Panel based its comparison on the characteristics common to all of them and, in any event, also noted relevant distinctions between the beverages where appropriate.

2. "So As to Afford Protection"

98. Mexico contends that Korea's arguments under this heading are wrong because the Panel mentioned not only the difference in tax burden between the domestic beverages and the imported beverages, but also noted that the structure of the Liquor Tax Law itself was discriminatory.

3. Application of Article III:2 of the GATT 1994

99. Mexico considers that, since this is a dispute concerning alleged failure to comply with obligations in the GATT 1994, Korea's measures are presumed to nullify or impair benefits accruing under that Agreement and, consequently, under Article 3.8 of the DSU, the burden of refuting the allegations is incumbent upon Korea and not on the appellees or the third party. Contrary to Korea's assertions, the complaining parties and Mexico submitted several pieces of evidence, including: evidence on the physical similarities of the spirits; evidence on the tariff classification of tequila and soju; and evidence from the market-place, in the form of the Dodwell Study, which also covered the relationship between tequila and soju.

100. Mexico agrees with the Panel's rejection of Korea's arguments that the appropriate end-use to be considered in this case was consumption of the beverages with or without meals. As regards admixtures, Mexico considers that the existence of soju cocktails is evidence that soju is not only drunk straight, but is also drunk mixed.

101. Korea argues that it has greater authority than the Panel to analyze its own market. In Mexico's view, this claim is not only difficult to defend, but is also contradictory. If the Koreans have

a special authority not possessed by others, why did Korea entrust analysis of the Korean market to non-Korean companies, such as A.C. Nielsen?

III. Issues Raised In This Appeal

102. This appeal raises the following issues:

- (a) whether the Panel erred in its interpretation and application of the term "directly competitive or substitutable product" which appears in the *Ad Article to Article III:2*, second sentence, of the GATT 1994;
- (b) whether the Panel erred in its interpretation and application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, by specific reference to the "principles set forth in paragraph 1" of Article III of the GATT 1994;
- (c) whether the Panel erred in its application of the rules on the allocation of the burden of proof;
- (d) whether the Panel failed to make an objective assessment of the matter as required by Article 11 of the DSU; and
- (e) whether the Panel failed to set out the basic rationale behind its findings and recommendations as required by Article 12.7 of the DSU.

IV. Interpretation and Application of Article III:2, second sentence, of the GATT 1994

103. The first issue that we have to address is whether the Panel erred in interpreting Article III:2, second sentence, of the GATT 1994.

104. Article III:2 provides:

The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.⁷⁰

105. The meaning of the second sentence of Article III:2 is clarified by paragraph 2 of *Ad Article III*, which reads:

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

106. Article III:1 provides:

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

107. In our Report in *Japan - Alcoholic Beverages*, we stated that three separate issues must be addressed when assessing the consistency of an internal tax measure with Article III:2, second sentence, of the GATT 1994. These three issues are whether:

⁷⁰The provisions of Article III:2, second sentence, of the GATT 1994 include paragraph 2 of *Ad Article III* and, by specific incorporation, the term "so as to afford protection" which appears in paragraph 1 of Article III.

- (1) the imported products and the domestic products *are "directly competitive or substitutable products" which are in competition with each other;*
- (2) the directly competitive or substitutable imported and domestic products *are "not similarly taxed";* and
- (3) the dissimilar taxation of the directly competitive or substitutable imported and domestic products *is "applied ... so as to afford protection to domestic production".*⁷¹

A. *"Directly Competitive or Substitutable Products"*

108. The Panel concluded its examination of the first issue arising under Article III:2, second sentence, as follows:

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.⁷²

109. According to the Panel, the "key question" with respect to the first issue arising under Article III:2, second sentence, "is whether the products are **directly** competitive or substitutable."⁷³ (emphasis in the original) The Panel stated that "an assessment of whether there is a direct competitive relationship between two products or groups of products requires evidence that consumers consider or could consider the two products or groups of products as alternative ways of satisfying a particular need or taste."⁷⁴ The determination of whether domestic and imported products are directly competitive or substitutable "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."⁷⁵ The Panel reasoned, furthermore, that the "focus should not be exclusively on the quantitative extent of the competitive overlap, but on the methodological basis on

⁷¹Appellate Body Report, *Japan – Alcoholic Beverages*, *supra*, footnote 20, p. 24.

⁷²The "products" referred to by the Panel are diluted soju, distilled soju, whiskies, brandies, cognac, rum, gin, vodka, tequila, liqueurs and admixtures. Panel Report, para. 10.98.

⁷³Panel Report, para. 10.39.

⁷⁴Panel Report, para. 10.40.

⁷⁵Panel Report, para. 10.43.

which a panel should assess the competitive relationship."⁷⁶ "[Q]uantitative analyses, while helpful, should not be considered necessary."⁷⁷ Similarly, "quantitative studies of cross-price elasticity are relevant, but not exclusive or even decisive in nature."⁷⁸ A determination of the precise extent of the competitive overlap can be complicated by the fact that protectionist government policies can distort the competitive relationship between products, causing the quantitative extent of the competitive relationship to be understated.⁷⁹ The Panel cautioned 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."⁸⁰

110. The Panel noted that assessment of competition has a temporal dimension.⁸¹ It considered that panels should look at "evidence of trends and changes in consumption patterns and make an assessment as to whether such trends and patterns lead to the conclusion that the products in question are either directly competitive now or can reasonably be expected to become directly competitive in the near future."⁸² The Panel stated:

... 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. ... 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.⁸³

⁷⁶Panel Report, para. 10.39.

⁷⁷Panel Report, para. 10.42.

⁷⁸Panel Report, para. 10.44.

⁷⁹Panel Report, para. 10.42.

⁸⁰*Ibid.*

⁸¹Panel Report, para. 10.47.

⁸²Panel Report, para. 10.48.

⁸³Panel Report, para. 10.50.

111. According to Korea, the Panel misinterpreted the term "directly competitive or substitutable product" by, *inter alia*, "relying on 'potential' competition, comparing the Korean market to the Japanese market and undertaking the wrong product comparisons."⁸⁴

1. Potential Competition

112. Korea argues that the Panel took an unacceptably broad and speculative approach to the role of potential competition, which is not permitted by the wording, context and object and purpose of Article III:2, second sentence.⁸⁵ Korea agrees that this provision is not intended to exclude products that are not directly competitive or substitutable because of the contested measure itself. However, the Panel's overly broad approach has opened the door to speculation about how the market could evolve in the future, irrespective of the tax measure in question.⁸⁶

113. Contrary to Korea's assertions, the Panel has not relied on potential competition in order to overcome the absence today of a "directly competitive or substitutable" relationship between the domestic and imported products on the basis that such a relationship might develop in the future. The Panel concluded that "there is sufficient unrebutted evidence in this case to show *present* direct competition between the products".⁸⁷ (emphasis added) This legal finding is not a speculative one concerning the future, but is based firmly in the present. The reference to "a strong potentially direct competitive relationship" does no more than buttress the Panel's finding of "present direct competition".⁸⁸

114. The term "directly competitive or substitutable" describes a particular type of relationship between two products, one imported and the other domestic. It is evident from the wording of the term that the essence of that relationship is that the products are in competition. This much is clear both from the word "competitive" which means "characterized by competition"⁸⁹, and from the word "substitutable" which means "able to be substituted".⁹⁰ The context of the competitive relationship is

⁸⁴Korea's appellant's submission, para. 22.

⁸⁵Korea's appellant's submission, paras. 26 and 31.

⁸⁶Korea's appellant's submission, para. 28.

⁸⁷Panel Report, para. 10.98. Likewise, the Panel also stated that "the evidence overall supports a finding that the imported and domestic products at issue *are* directly competitive or substitutable" (para. 10.95). (emphasis added)

⁸⁸Panel Report, para. 10.98.

⁸⁹Lesley Brown (ed.), *The New Shorter Oxford English Dictionary*, Vol. I, p. 459 (Clarendon Press, 1993).

⁹⁰Lesley Brown (ed.), *op. cit.*, Vol. II, p. 3125.

necessarily the marketplace since this is the forum where consumers choose between different products. Competition in the market place is a dynamic, evolving process. Accordingly, the wording of the term "directly competitive or substitutable" implies that the competitive relationship between products is *not* to be analyzed *exclusively* by reference to *current* consumer preferences. In our view, the word "substitutable" indicates that the requisite relationship *may* exist between products that are not, at a given moment, considered by consumers to be substitutes but which are, nonetheless, *capable* of being substituted for one another.

115. Thus, according to the ordinary meaning of the term, products are competitive or substitutable when they are interchangeable⁹¹ or if they offer, as the Panel noted, "alternative ways of satisfying a particular need or taste".⁹² Particularly in a market where there are regulatory barriers to trade or to competition, there may well be latent demand.

116. The words "competitive or substitutable" are qualified in the *Ad Article* by the term "directly". In the context of Article III:2, second sentence, the word "directly" suggests a degree of proximity in the competitive relationship between the domestic and the imported products. The word "directly" does not, however, prevent a panel from considering both latent and extant demand.

117. Our reading of the ordinary meaning of the term "directly competitive or substitutable" is supported by its context as well as its object and purpose. As part of the context, we note that the *Ad Article* provides that the second sentence of Article III:2 is applicable "only in cases where competition *was* involved". (emphasis added) According to Korea, the use of the past indicative "was" prevents a panel taking account of "potential" competition. However, in our view, the use of the word "was" does not have any necessary significance in defining the temporal scope of the analysis to be carried out. The *Ad Article* describes the circumstances in which a hypothetical tax "*would* be considered to be inconsistent with the provisions of the second sentence". (emphasis added) The first part of the clause is cast in the conditional mood ("would") and the use of the past indicative simply follows from the use of the word "would". It does not place any limitations on the temporal dimension of the word "competition".

118. The first sentence of Article III:2 also forms part of the context of the term. "Like" products are a subset of directly competitive or substitutable products: all like products are, by definition, directly competitive or substitutable products, whereas not all "directly competitive or substitutable"

⁹¹Appellate Body Report, *Canada – Certain Measures Concerning Periodicals* ("Canada – Periodicals"), WT/DS31/AB/R, adopted 30 July 1997.

⁹²Panel Report, para. 10.40.

products are "like".⁹³ The notion of like products must be construed narrowly⁹⁴ but the category of directly competitive or substitutable products is broader.⁹⁵ While perfectly substitutable products fall within Article III:2, first sentence, imperfectly substitutable products can be assessed under Article III:2, second sentence.⁹⁶

119. The context of Article III:2, second sentence, also includes Article III:1 of the GATT 1994. As we stated in our Report in *Japan - Alcoholic Beverages*, Article III:1 informs Article III:2 through specific reference.⁹⁷ Article III:1 sets forth the principle "that internal taxes ... should not be applied to imported or domestic products so as to afford protection to domestic production." It is in the light of this principle, which embodies the object and purpose of the whole of Article III, that the term "directly competitive and substitutable" must be read. As we said in *Japan - Alcoholic Beverages*:

The broad and fundamental purpose of Article III is to *avoid protectionism* in the application of internal tax and regulatory measures. ... Toward this end, Article III obliges Members of the WTO to *provide equality of competitive conditions* for imported products in relation to domestic products. ... 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.⁹⁸ (emphasis added).

120. In view of the objectives of avoiding protectionism, requiring equality of competitive conditions and protecting expectations of equal competitive relationships, we decline to take a static view of the term "directly competitive or substitutable." The object and purpose of Article III

⁹³Panel Report, *Japan - Alcoholic Beverages*, *supra*, footnote 16, para. 6.22, approved by the Appellate Body at p. 23 of its Report.

⁹⁴Appellate Body Report, *Japan - Alcoholic Beverages*, *supra*, footnote 20, p. 20, and *Canada - Periodicals*, *supra*, footnote 91, p. 21.

⁹⁵Appellate Body Report, *Japan - Alcoholic Beverages*, *supra*, footnote 20, p. 25.

⁹⁶*Canada - Periodicals*, *supra*, footnote 91, p. 28.

⁹⁷Appellate Body Report, *Japan - Alcoholic Beverages*, *supra*, footnote 20, p. 23.

⁹⁸*Ibid*, p. 16, with references to earlier Panel Reports.

confirms that the scope of the term "directly competitive or substitutable" cannot be limited to situations where consumers *already* regard products as alternatives. If reliance could be placed only on current instances of substitution, the object and purpose of Article III:2 could be defeated by the protective taxation that the provision aims to prohibit. Past panels have, in fact, acknowledged that consumer behaviour might be influenced, in particular, by protectionist internal taxation. Citing the panel in *Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages* ("1987 Japan – Alcohol")⁹⁹, the panel in *Japan – Alcoholic Beverages* observed that "a tax system that discriminates against imports has the consequence of creating and even freezing preferences for domestic goods."¹⁰⁰ The panel in *Japan – Alcoholic Beverages* also stated that "consumer surveys in a country with ... a [protective] tax system would likely understate the degree of *potential* competitiveness between substitutable products".¹⁰¹ (emphasis added) Accordingly, in some cases, it may be highly relevant to examine latent demand.

121. We observe that studies of cross-price elasticity, which in our Report in *Japan – Alcoholic Beverages* were regarded as one means of examining a market¹⁰², involve an assessment of latent demand. Such studies attempt to predict the change in demand that would result from a change in the price of a product following, *inter alia*, from a change in the relative tax burdens on domestic and imported products.

122. Korea itself recognizes that potential demand may be taken into account in determining whether products are "directly competitive or substitutable". Before the Panel, Korea acknowledged that this term is not intended to exclude products that are not directly competitive or substitutable because of ("but for") the contested measure itself. At the oral hearing before us, Korea accepted that this "but for" test would permit account to be taken "not only [of] the direct price increasing effect of a tax differential but also [of] other elements that could show an impairment of competitive opportunities because of the tax differential, that distribution costs had been higher, etc."¹⁰³

123. We note, however, that actual consumer demand may be influenced by measures other than internal taxation. Thus, demand may be influenced by, *inter alia*, earlier protectionist taxation,

⁹⁹*Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, adopted 10 November 1987, BISD 34S/83. The panel in *Japan – Alcoholic Beverages*, *supra*, footnote 16, cited para. 5.9 of this panel report.

¹⁰⁰Panel Report, *Japan – Alcoholic Beverages*, *supra*, footnote 16, para. 6.28. This passage was expressly approved by the Appellate Body in its Report in this case (p. 25).

¹⁰¹*Ibid.*

¹⁰²Appellate Body Report, *Japan – Alcoholic Beverages*, *supra*, footnote 20, p. 25.

¹⁰³Response by Korea to questions at the oral hearing.

previous import prohibitions or quantitative restrictions. Latent demand can be a particular problem in the case of "experience goods", such as food and beverages, which consumers tend to purchase because they are familiar with them and with which consumers experiment only reluctantly.¹⁰⁴

124. We, therefore, conclude that the term "directly competitive or substitutable" does not prevent a panel from taking account of evidence of latent consumer demand as one of a range of factors to be considered when assessing the competitive relationship between imported and domestic products under Article III:2, second sentence, of the GATT 1994. In this case, the Panel committed no error of law in buttressing its finding of "present direct competition" by referring to a "strong potentially direct competitive relationship".¹⁰⁵

2. Expectations

125. In the course of its reasoning on potential competition, the Panel referred to the "settled law that competitive expectations and opportunities are protected"¹⁰⁶ and noted our statement in *Japan - Alcoholic Beverages* that "Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products".¹⁰⁷

126. Korea takes the view that "expectations" exist only for products which are already "like" or "directly competitive or substitutable" and that it was improper for the Panel to consider that there could be expectations regarding products that are not currently "directly competitive or substitutable", but which might become so in the near future.¹⁰⁸

127. As we have said, the object and purpose of Article III is the maintenance of equality of competitive conditions for imported and domestic products.¹⁰⁹ It is, therefore, not only legitimate, but even necessary, to take account of this purpose in interpreting the term "directly competitive or substitutable product".¹¹⁰

¹⁰⁴Panel Report, paras. 10.44, 10.50 and 10.73.

¹⁰⁵Panel Report, para. 10.98.

¹⁰⁶Panel Report, para. 10.48.

¹⁰⁷*Supra*, footnote 20, p. 16, with references to earlier panel reports.

¹⁰⁸Korea's appellant's submission, para. 33, citing, in part, the Panel Report, para. 10.48.

¹⁰⁹*Supra*, para. 119.

¹¹⁰Moreover, as we noted earlier, the Panel concluded that there was evidence of "present direct competition" between the imported and domestic products. (Panel Report, para. 10.98, emphasis added)

3. "Trade Effects" Test

128. The Panel expressed 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."¹¹¹

129. Korea complains that this is a misunderstanding of the "trade effects" test.¹¹² In our view, when the Panel referred to a "type of trade effects test", it was simply expressing its scepticism about the consequences of placing undue emphasis on quantitative analyses of the competitive relationship between products. This is clear from the sentence immediately following the sentence containing the reference to a "type of trade effects test":

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.¹¹³ (emphasis in the original)

130. Thus, the Panel stated that if a particular degree of competition had to be shown in quantitative terms, that would be similar to requiring proof that a tax measure has a particular impact on trade. It considered such an approach akin to a "type of trade effects test".

131. We do not consider the Panel's reasoning on this point to be flawed.¹¹⁴

¹¹¹Panel Report, para. 10.42.

¹¹²*Supra*, para. 9.

¹¹³Panel Report, para. 10.42.

¹¹⁴We note, moreover, that the Panel cites correctly the "trade effects" test in para. 10.42 of the Report, the very paragraph in which it refers to a "type of trade effects test".

4. Nature of Competition

132. The Panel makes numerous references to the "nature of competition".¹¹⁵ Korea considers that, through the use of the term "nature of competition", the Panel has inserted a "vague and subjective element" which is not found in Article III:2, second sentence.¹¹⁶ Korea argues that this reference to the "nature of competition", therefore, amounts to another failure properly to interpret the term "directly competitive or substitutable".

133. We believe that the Panel uses the term "*nature* of competition" as a synonym for *quality* of competition, as opposed to *quantity* of competition. The Panel considered that in analyzing whether products are "directly competitive or substitutable", the focus should be on the *nature* of competition and not on its *quantity*:

... the question is not of the degree of competitive overlap, but its *nature*. *Is there a competitive relationship and is it direct?* ...¹¹⁷
(emphasis added)

134. In taking issue with the use of the term "nature of competition", Korea, in effect, objects to the Panel's sceptical attitude to quantification of the competitive relationship between imported and domestic products. For the reasons set above, we share the Panel's reluctance to rely unduly on quantitative analyses of the competitive relationship.¹¹⁸ In our view, an approach that focused solely on the quantitative overlap of competition would, in essence, make cross-price elasticity *the* decisive criterion in determining whether products are "directly competitive or substitutable". We do not, therefore, consider that the Panel's use of the term "nature of competition" is questionable.

5. Evidence from the Japanese Market

135. The Panel considered that, in assessing whether products are directly competitive or substitutable, it was appropriate to look at "the nature of competition in other countries".¹¹⁹ It stated:

¹¹⁵See Panel Report, paras. 10.42, 10.45, 10.66, 10.76, 10.78 and 10.92.

¹¹⁶Korea's appellant's submission, paras. 37 and 38.

¹¹⁷Panel Report, para. 10.44.

¹¹⁸*Supra*, para. 120.

¹¹⁹Panel Report, para. 10.45.

[A]s 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. ... We do not need, in this case, to give substantial weight to conditions in markets outside Korea, but such factors are relevant... . 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.¹²⁰

136. According to Korea, the Panel's approach constitutes an impermissible broadening of the scope of Article III:2, second sentence. Moreover, Korea believes that if evidence from other markets were to be admitted, more than one other market ought to be reviewed. In this case, as there was "considerable evidence available as to what is taking place within the Korean market"¹²¹, Korea considers that there was no reason to rely on evidence drawn from another market when making conclusions about the Korean market.

137. It is, of course, true that the "directly competitive or substitutable" relationship must be present in the market at issue¹²², in this case, the Korean market. It is also true that consumer responsiveness to products may vary from country to country.¹²³ This does not, however, preclude consideration of consumer behaviour in a country other than the one at issue. It seems to us that evidence from other markets may be pertinent to the examination of the market at issue, particularly when demand on that market has been influenced by regulatory barriers to trade or to competition. Clearly, not every other market will be relevant to the market at issue. But if another market displays characteristics similar to the market at issue, then evidence of consumer demand in that other market may have some relevance to the market at issue. This, however, can only be determined on a case-by-case basis, taking account of all relevant facts.

138. In the present case, the Panel did not err in referring to the Japanese market in its reasoning.

¹²⁰Panel Report, paras. 10.45 and 10.46.

¹²¹Panel Report, para. 10.46.

¹²²Appellate Body Report, *Japan – Alcoholic Beverages*, *supra*, footnote 20, p. 25, and *Canada - Periodicals*, *supra*, footnote 91, p. 25.

¹²³Panel Report, *Japan – Alcoholic Beverages*, *supra*, footnote 16, para. 6.28, with reference to Working Party Report on "Border Tax Adjustments", L/3464, adopted 2 December 1970, BISD 18S/97, p. 102, para. 18, approved by the Appellate Body Report, *Japan – Alcoholic Beverages*, *supra*, footnote 20, p. 25.

6. Grouping of the Products

139. Before embarking on its assessment of whether the imported and domestic products at issue are directly competitive or substitutable, the Panel considered how it would carry out that assessment.

It stated:

... With respect to the domestic product, soju, there are two primary categories identified. There is distilled soju and 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.¹²⁴

With respect to the imported products, the Panel said:

... We ... 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. ... The question becomes where to draw the boundaries between categories, rather than whether it is appropriate to utilize categories for *analytical* purposes. ... [W]e 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.* (emphasis added)¹²⁵

* 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. ... (emphasis added)

140. Korea argues that the Panel erred in failing to examine distilled soju and diluted soju separately and also in examining all of the imported products together. Korea's argument is based, in large part, on allegedly significant differences between the products that the Panel grouped together. Korea is concerned that by considering the products together, the Panel overlooked important

¹²⁴Panel Report, paras. 10.51 and 10.54.

¹²⁵Panel Report, paras 10.59 and 10.60.

differences between them. Korea believes that, in so doing, the Panel was able to conclude that all the products at issue were directly competitive or substitutable, whereas had the imported products been examined individually, this result would not have been possible.

141. We consider that Korea's argument raises two distinct questions. The first question is whether the Panel erred in its "analytical approach". The second is whether, on the facts of this case, the Panel was entitled to group the products in the manner that it did. Since the second question involves a review of the way in which the Panel assessed the evidence, we address it in our analysis of procedural issues.

142. The Panel describes "grouping" as an "analytical tool". It appears to us, however, that whatever else the Panel may have seen in this "analytical tool", it used this "tool" as a practical device to minimize repetition when examining the competitive relationship between a large number of differing products. Some grouping is almost always necessary in cases arising under Article III:2, second sentence, since generic categories commonly include products with *some* variation in composition, quality, function and price, and thus commonly give rise to sub-categories.¹²⁶ From a slightly different perspective, we note that "grouping" of products involves at least a preliminary characterization by the treaty interpreter that certain products are sufficiently similar as to, for instance, composition, quality, function and price, to warrant treating them as a group for convenience in analysis. But, the use of such "analytical tools" does not relieve a panel of its duty to make an objective assessment of whether the components of a group of imported products are directly competitive or substitutable with the domestic products. We share Korea's concern that, in certain circumstances, such "grouping" of products *might* result in individual product characteristics being ignored, and that, in turn, *might* affect the outcome of a case. However, as we will see below, the Panel avoided that pitfall in this case.

143. Whether, and to what extent, products can be grouped is a matter to be decided on a case-by-case basis. In this case, the Panel decided to group the imported products at issue on the basis 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...¹²⁷

¹²⁶The Panel mentions the product category of "whiskies" which include several subcategories of types of whisky such as Scotch (premium and standard), Irish, Bourbon, Rye, Canadian, etc., all of which differ. Panel Report, para. 10.59.

¹²⁷Panel Report, para. 10.60.

144. As the Panel explained in the footnote attached to this passage¹²⁸, the Panel's subsequent analysis of the physical characteristics, end-uses, channels of distribution and prices of the imported products confirmed the correctness of its decision to group the products for analytical purposes. Furthermore, where appropriate, the Panel did take account of individual product characteristics.¹²⁹ It, therefore, seems to us that the Panel's grouping of imported products, complemented where appropriate by individual product examination, produced the same outcome that individual examination of each imported product would have produced.¹³⁰ We, therefore, conclude that the Panel did not err in considering the imported beverages together.

145. With respect to diluted soju and distilled soju, the Panel did not "group" these products as such. Rather, it concentrated on diluted soju in assessing the competitive relationship between the domestic and imported beverages. The Panel considered that distilled soju was an "intermediary" product, with respect to physical characteristics, end-uses and prices, between diluted soju and the imported products. On that assumption, it reasoned, *a fortiori*, taking the view that if diluted soju was shown to be competitive with the imported products, the intermediate product, distilled soju, would also necessarily be "directly competitive or substitutable" with them.¹³¹ We do not consider the Panel's reasoning on this point to be objectionable.

B. *"So As To Afford Protection"*

146. We now address whether the Panel erred in its application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, by specific reference to paragraph 1 of Article III.

147. With regard to this third element of Article III:2, second sentence, the Panel stated:

¹²⁸Panel Report, footnote 375. See also Panel Report, footnotes 382 and 399.

¹²⁹See Panel Report, paras. 10.67, 10.71, 10.72, 10.85 and 10.94 and footnotes 385, 386, 387 and 408.

¹³⁰We note that the panels in *1987 Japan – Alcohol* and in *Japan – Alcoholic Beverage*, followed the same approach. This approach was implicitly approved in our Report on *Japan – Alcoholic Beverages*.

¹³¹Panel Report, 10.54.

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. 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.

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.* 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. ...¹³²

*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.

148. According to Korea, the Panel committed several errors in applying the third element of Article III:2, second sentence. It ignored Korea's explanations for the structure of the tax. It made "much" of the virtual absence of imported soju. It did not observe the Appellate Body's guidance in *Japan – Alcoholic Beverages*, that, even though the tax differential may prove that a tax is applied "so as to afford protection", "in other cases, there may be other factors that will be just as relevant or more relevant to demonstrating that the dissimilar taxation at issue was applied 'so as to afford protection'." ¹³³

149. In our Report in *Japan – Alcoholic Beverages*, we said that examination of whether a tax regime affords protection to domestic production "is an issue of how the measure in question is *applied*", and that such an examination "requires a comprehensive and objective analysis" ¹³⁴:

¹³²Panel Report, paras. 10.101 and 10.102.

¹³³*Supra*, footnote 20, p. 30.

¹³⁴*Supra*, footnote 20, p. 28.

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

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such protective application Most often, there will be other factors to be considered as well.¹³⁵

150. The Panel followed this approach. In finding that the Korean measures afford protection to domestic production, the Panel relied, first, on the fact that "the Korean tax law ... has very large differences in levels of taxation."¹³⁶ Although it considered that the magnitude of the tax differences was sufficiently large to support a finding that the contested measures afforded protection to domestic production, the Panel also considered the structure and design of the measures.¹³⁷ In addition, the Panel found that, in practice, "[t]here is virtually no imported soju so the beneficiaries of this structure are almost exclusively domestic producers".¹³⁸ In other words, the tax operates in such a way that the lower tax brackets cover almost exclusively domestic production, whereas the higher tax brackets embrace almost exclusively imported products. In such circumstances, the reasons given by Korea as to *why* the tax is structured in a particular way do not call into question the conclusion that the measures are applied "so as to afford protection to domestic production". Likewise, the reason why there is very little imported soju in Korea does not change the pattern of application of the contested measures.

151. Korea claims that the Panel erred in failing to find that the "intrinsic" pre-tax price difference between diluted soju and the imported alcoholic beverages was so large that "the additional difference created by the variation in tax can have no [protective] effect".¹³⁹ According to Korea, the Panel "should have inquired whether the tax is capable of affecting reasonable expectations about the

¹³⁵*Supra*, footnote 20, p. 29.

¹³⁶Panel Report, para. 10.101. In para. 10.100, the Panel set out the tax differentials: "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 admixtures it is 104 percent; on whisky, brandy and cognac it is 130 percent".

¹³⁷Panel Report, para. 10.101.

¹³⁸Panel Report, para. 10.102. We note that we considered a similar finding by the panel in *Japan – Alcoholic Beverages*, *supra*, footnote 16, p. 31, to be relevant for the establishment of the third element of Article III:2, second sentence.

¹³⁹Korea's appellant's submission, para. 75.

competitive relationship between the products."¹⁴⁰ Korea also argued that "the demand for a product like distilled soju is specific and static and that it would be difficult to affect it a great deal in either direction by altering the price."¹⁴¹

152. In making these arguments, Korea seems to be revisiting the question whether the products can be treated as directly competitive or substitutable. As regards diluted soju, Korea seems to be saying, in effect, that the large pre-tax price difference is such that consumers do not treat the products as substitutable, and that consumers' decisions whether to buy the imported products will not, therefore, be affected by the higher tax burden imposed on these imports. Similarly, as regards distilled soju, Korea is arguing that there is no cross-elasticity of demand between distilled soju and the imported beverages. However, Korea overlooks the fact that the two products have already been found to be directly competitive or substitutable.¹⁴² Its arguments are, therefore, misplaced at this stage of the analysis and do not cast doubt on the Panel's finding that the contested measures afford protection to domestic production.

153. Korea also seems to be insisting that a finding that a measure affords protection must be supported by proof that the tax difference has some identifiable trade effect. But, as we have said above, Article III is not concerned with trade volumes.¹⁴³ It is, therefore, not incumbent on a complaining party to prove that tax measures are capable of producing any particular trade effect.

154. We believe, and so hold, that the Panel did not err in its application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, by specific reference to paragraph 1 of Article III.

¹⁴⁰Korea's appellant's submission, para. 76.

¹⁴¹Korea's appellant's submission, para. 79.

¹⁴²The significant price differential between the products was taken into account in determining whether the products are, in fact, directly competitive or substitutable (Panel Report, para. 10.94).

¹⁴³*Supra*, para. 119.

C. *Allocation of the Burden of Proof*

155. Korea argues that the Panel misapplied the burden of proof and that it applied a "double standard" when assessing the evidence. We note that although the Panel did not actually articulate the rules on allocation of the burden of proof, it made specific reference to passages of our Report in *United States – Shirts and Blouses* where we enunciated these rules.¹⁴⁴

156. It is clear from paragraphs 10.57, 10.58 and 10.82 of the Panel Report that the Panel properly understood and applied the rules on allocation of the burden of proof.¹⁴⁵ First, the Panel insisted that it could make findings under Article III:2, second sentence, only with respect to products for which a *prima facie* case had been made out on the basis of evidence presented.¹⁴⁶ Second, it declined to establish a presumption concerning all alcoholic beverages within HS 2208.¹⁴⁷ Such a presumption would be inconsistent with the rules on the burden of proof because it would prematurely shift the burden of proof to the defending party. The Panel, therefore, did not consider alleged violations of Article III:2, second sentence, concerning products for which evidence was not presented.¹⁴⁸ Thus, the Panel examined tequila because evidence was presented for it, but did not examine mescal and certain other alcoholic beverages included in HS 2208 for which no evidence was presented. Third, contrary to Korea's assertions, the Panel did consider the evidence presented by Korea in rebuttal¹⁴⁹, but concluded that there was "sufficient *unrebutted* evidence" for it to make findings of inconsistency.¹⁵⁰ (emphasis added)

157. It is, therefore, clear that the Panel did not err in its application of the rules on allocation of the burden of proof.

¹⁴⁴Panel Report, footnote 374.

¹⁴⁵In paragraphs 10.57 and 10.58 of its Report, the Panel considered whether it was entitled to make findings with respect to products, including tequila, mescal and certain other alcoholic beverages, for which "virtually no evidence" had been provided. In para. 10.82, the Panel assessed whether the complainants had satisfied the burden of proof with respect to end-uses.

¹⁴⁶Panel Report, para. 10.57. See also Panel Report, para. 10.82, where the Panel considered that, with respect to end-uses, "the complainants submitted adequate evidence ... to establish this portion of their case".

¹⁴⁷Panel Report, para. 10.57. HS 2208 is the category in Section IV, Chapter 22 of the Harmonised System of Customs Classification that applies to "Undenatured ethyl alcohol of an alcoholic strength by volume of less than 80% vol; spirits, liqueurs and other spirituous beverages".

¹⁴⁸Panel Report, paras. 10.57 and 10.58.

¹⁴⁹See, for example, Panel Report, paras. 10.71, 10.82 and 10.85.

¹⁵⁰Panel Report, para. 10.98.

158. We note, finally, that many of Korea's arguments concerning the burden of proof are, in reality, arguments about whether the Panel made an objective assessment of the matter before it. This is considered in the next section.

D. *Article 11 of the DSU*

159. Korea claims that the Panel failed to make an objective assessment of the matter before it and failed to apply the appropriate standard of review under Article 11 of the DSU. Korea contends that the Panel did not have sufficient evidence before it to enable it to conduct an objective assessment of the matter, and that, as regards the evidence that was, in fact, before it, the Panel made a series of "manifest and/or egregious errors of assessment".¹⁵¹

160. In *European Communities - Hormones*, we stated:

Under Article 17.6 of the DSU, appellate review is limited to appeals on questions of law covered in a panel report and legal interpretations developed by the panel. ... Determination of the credibility and weight properly to be ascribed to (that is, the appreciation of) a given piece of evidence is part and parcel of the fact finding process and is, in principle, left to the discretion of a panel as the trier of facts. The consistency or inconsistency of a given fact or set of facts with the requirements of a given treaty provision is, however, a legal characterization issue. It is a legal question. Whether or not a panel has made an objective assessment of the facts before it, as required by Article 11 of the DSU, is also a legal question which, if properly raised on appeal, would fall within the scope of appellate review.¹⁵²

161. The Panel's examination and weighing of the evidence submitted fall, in principle, within the scope of the Panel's discretion as the trier of facts and, accordingly, outside the scope of appellate review. This is true, for instance, with respect to the Panel's treatment of the Dodwell Study, the Sofres Report and the Nielsen Study. We cannot second-guess the Panel in appreciating either the evidentiary value of such studies or the consequences, if any, of alleged defects in those studies. Similarly, it is not for us to review the relative weight ascribed to evidence on such matters as marketing studies, methods of production, taste, colour, places of consumption, consumption with "meals" or with "snacks", and prices.

¹⁵¹Korea's appellant's submission, para. 84.

¹⁵²*Supra*, footnote 47, para. 132.

162. A panel's discretion as trier of facts is not, of course, unlimited. That discretion is always subject to, and is circumscribed by, among other things, the panel's duty to render an objective assessment of the matter before it. In *European Communities - Hormones*, we dealt with allegations that the panel had "disregarded", "distorted" and "misrepresented" the evidence before it. We held that these allegations amounted to charges that the panel had violated its duty under Article 11 of the DSU, allegations which, at the end of the day, we found to be unsubstantiated:

... Clearly, not every error in the appreciation of the evidence (although it may give rise to a question of law) may be characterized as a failure to make an objective assessment of the facts. ... The duty to make an objective assessment of the facts is, among other things, an obligation to consider the evidence presented to a panel and to make factual findings on the basis of that evidence. The deliberate disregard of, or refusal to consider, the evidence submitted to a panel is incompatible with a panel's duty to make an objective assessment of the facts. The wilful distortion or misrepresentation of the evidence put before a panel is similarly inconsistent with an objective assessment of the facts. "Disregard" and "distortion" and "misrepresentation" of the evidence, in their ordinary signification in judicial and quasi-judicial processes, imply not simply an error of judgment in the appreciation of evidence but rather an egregious error that calls into question the good faith of a panel. A claim that a panel disregarded or distorted the evidence submitted to it is, in effect, a claim that the panel, to a greater or lesser degree, denied the party submitting the evidence fundamental fairness, or what in many jurisdictions is known as due process of law or natural justice.¹⁵³

163. We have scrutinized with great care Korea's allegations that the Panel acted in breach of its duty under Article 11 of the DSU, especially Korea's contentions that the Panel applied a "double standard" in assessing the evidence before it: one standard, relaxed and permissive, for the complainants, and another, very strict and demanding, for the defending party, Korea. In our view, notwithstanding Korea's express disclaimer that it is not challenging the good faith of the Panel, an allegation of a "double standard" of proof in relation to the facts is equivalent to an allegation of failure to render an "objective assessment of the matter" under Article 11 of the DSU. In *European Communities – Poultry*, we observed:

¹⁵³*Supra*, footnote 47, para. 133.

An allegation that a panel has failed to conduct the "objective assessment of the matter before it" required by Article 11 of the DSU is a *very serious allegation*. *Such an allegation goes to the very core of the integrity of the WTO dispute settlement process itself.* ...¹⁵⁴
(emphasis added)

164. We are bound to conclude that Korea has not succeeded in showing that the Panel has committed any egregious errors that can be characterized as a failure to make an objective assessment of the matter before it. Korea's arguments, when read together with the Panel Report and the record of the Panel proceedings, do not disclose that the Panel has distorted, misrepresented or disregarded evidence, or has applied a "double standard" of proof in this case. It is not an error, let alone an egregious error, for the Panel to fail to accord the weight to the evidence that one of the parties believes should be accorded to it.

165. In light of the above, we do not believe that the Panel has failed to make an objective assessment of the matter before it within the meaning of Article 11 of the DSU.

E. *Article 12.7 of the DSU*

166. Korea claims that the Panel has failed to fulfil its obligation under Article 12.7 of the DSU to set out the basic rationale behind its findings and recommendations. Korea maintains that "much" of the Panel Report contains contradictions and that it is vague.¹⁵⁵

167. Article 12.7 of the DSU reads, in relevant part:

Where the parties to the dispute have failed to develop a mutually satisfactory solution, the panel shall submit its findings in the form of a written report to the DSB. *In such cases, the report of a panel shall set out the findings of fact, the applicability of relevant provisions and the basic rationale behind any findings and recommendations that it makes.* ... (emphasis added)

168. In this case, we do not consider it either necessary, or desirable, to attempt to define the scope of the obligation provided for in Article 12.7 of the DSU. It suffices to state that the Panel has set out a detailed and thorough rationale for its findings and recommendations in this case. The Panel went to some length to take account of competing considerations and to explain why, nonetheless, it made

¹⁵⁴*Supra*, footnote 47, para. 133. This passage was cited in our Report in *Australia – Measures Affecting Importation of Salmon*, adopted 6 November 1998, WT/DS18/AB/R, para. 265.

¹⁵⁵Korea's appellant's submission, para. 172.

the findings and recommendations it did. The rationale set out by the Panel may not be one that Korea agrees with, but it is certainly more than adequate, on any view, to satisfy the requirements of Article 12.7 of the DSU. We, therefore, conclude that the Panel did not fail to set out the basic rationale for its findings and recommendations as required by Article 12.7 of the DSU.

V. Findings and Conclusions

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

- (a) upholds the Panel's interpretation and application of the term "directly competitive or substitutable product" which appears in the *Ad Article to Article III:2*, second sentence, of the GATT 1994;
- (b) upholds the Panel's interpretation and application of the term "so as to afford protection", which is incorporated into Article III:2, second sentence, by specific reference to the "principles set forth in paragraph 1" of Article III of the GATT 1994;
- (c) upholds the Panel's application of the rules on the allocation of the burden of proof;
- (d) concludes that the Panel did not fail to make an objective assessment of the matter as required by Article 11 of the DSU; and
- (e) concludes that the Panel did not fail to set out the basic rationale behind its findings and recommendations as required by Article 12.7 of the DSU.

170. The Appellate Body *recommends* 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.

Signed in the original at Geneva this 16th day of December 1998 by:

Mitsuo Matsushita
Presiding Member

Claus-Dieter Ehlermann
Member

Florentino Feliciano
Member